INDEPENDENT INTERNATIONAL EXPERTS COMMISSION

A REFORM PROGRAM
FOR A NEW PRESIDENT OF UKRAINE

PROPOSALS FOR UKRAINE: 2010 – TIME FOR REFORMS

Co-Chairmen: Anders Åslund and Oleksandr Paskhaver

Kyiv – 2010

INDEPENDENT INTERNATIONAL EXPERTS COMMISSION

PROPOSALS FOR UKRAINE: 2010 – TIME FOR REFORMS

Kyiv – 2010

Table of Contents

Members of the Independent International Expert Commission

Anders Åslund, co-chairman
Torbjörn Becker
C. Fred Bergsten
Ihor Burakovsky
Oleksandr Chalyi
Edward Chow
Marek Dabrowski
Mikhail Dmitriev
Sergei Guriev
Ihor Koliushko
Ella Libanova
Vira Nanivska
Irina Paliashvili
Oleksandr Paskhaver, co-chairman
Volodymyr Saprykin
Olga Shumylo, co-ordinator
Marcin Swiecicki
Oleksandr Todiychuk
Aleh Tsyvinski
Lidia Verkhovodova
Johannes de Beaufort Wijnholds
Charles Wyplosz
Valentin Zelenyuk

Reform Priorities for Ukraine in 2010

By International Commission of Independent Experts

This is an action program for the first year of a new presidency. After the presidential elections, Ukraine will have a unique opportunity to implement reforms that will lay foundation for sustainable economic growth. The new presidential mandate, the shock of a recent severe economic crisis, and popular dissatisfaction with the status-quo create ideal conditions for successful reforms. Our three main conclusions are: Ukraine needs (1) new organizational capacity for reforms, and (2) prioritization of reforms, and (3) utilization of international organizations as lighthouses to guide its reforms.

Our Commission's first conclusion is that Ukraine needs to establish new capacity to carry out reforms that is independent of the agencies to be reformed. We recommend creation of a Reform Commission at the Cabinet of Ministers, headed by a Deputy Prime Minister with overarching authority. The Reform Commission should have its own budget and a single goal: to design and implement reforms. Together with the European Integration Secretariat, it should lead Ukraine's reforms from the Cabinet of Ministers.

Our second conclusion is that Ukraine needs to formulate clear priorities for reforms. Such priorities (listed below) have to be are either qualitatively or quantitatively measurable. First things need to be done first. Measurability is key for accountability. Ukraine must: (a) improve the effectiveness of the state, (b) achieve financial stability, (c) allow private enterprise freedom on the market, and (d) make social policy more effective. Our selection is based on experts' views of priorities that are also politically feasible within one year.

Our third conclusion is that it is necessary for Ukraine to use its international leverage or external guidance to break through the domestic logjam on reforms. The Commission has identified three anchors that can guide Ukraine to realize its commitment to its reforms: The IMF, the European Union and the World Bank.

Ukraine's ten top priorities for 2010 are:

1. Carry out gas reform!
2. Make the National Bank of Ukraine independent!
3. Move toward inflation targeting!
4. Cut public expenditures!
5. Undertake comprehensive deregulation of enterprise!
6. Conclude a European Association Agreement!
7. Get privatization going again!
8. Legalize private sales of agricultural land!
9. Adopt a Law on Public Information!
10. Complete the modern commercial legislation!

The International Commission of Independent Experts was established in September 2009 to draft an action program for Ukraine after the presidential elections. The initiators were Anders Åslund and Oleksandr Paskhaver, who have been its co-chairmen. The committee is comprised of prominent international and Ukrainian academics, policymakers, and lawyers. The work of the Commission has been financed by the Swedish and Netherlands Ministries for Foreign Affairs, with additional support from the United Nations Development Program. The International Centre for Policy Studies has functioned as its secretariat.

Introduction

Ukraine has gone through a rollercoaster in the last decade. Eight years of an average economic growth of 7.5 percent from 2000 until 2007 has been followed by severe economic crisis, with gross domestic product (GDP) anticipated to slump by 14 percent in 2009. Ukraine's presidential elections offer a great opportunity to launch a major revitalization of the country.

Ukraine is not performing up to its potential. In 2009, the International Monetary Fund (IMF) assessed that its GDP per capita will be as little as $2,540 in current US dollars, placing it 110th in the world. The situation looks only marginally better when GDP is expressed in purchasing power parities, which reflects the actual living standard: $6,460 per capita, at 99th place in the world. In purchasing power parities, Ukraine's GDP amounted to 22 percent of the European Union (EU) level and 40 percent of the Russian level in 2009.

Qualitative international comparisons present an even more worrisome picture. At the request of the Foundation of Effective Governance, the World Economic Forum carried out an overview in 2009. Overall, it ranks Ukraine 72nd among 131 countries. On its twelve measures, Ukraine is lagging behind most in three specific areas: institutions, macroeconomic stability, and goods market efficiency. Ukraine is doing comparatively well with regard to primary education, higher education, labor market efficiency, and innovation. The picture that emerges is one of a country with impressive human capital, but this human capital does not produce as much as it could because the state does not deliver macroeconomic stability while hampering the functioning of the goods market, not allowing private enterprise to operate sufficiently freely.

A more specialized qualitative international comparison, the World Bank Doing Business index, investigates the business environment on ten measures. Overall, it shockingly ranks Ukraine 142nd out of 183 countries. Particularly arduous are obtaining construction permits and tax payments, where Ukraine ranks 181. The country does very poorly also on starting and closing a business, registration of property, and trading across borders. Also the Doing Business index indicates that Ukraine's strengths are education and relatively free labor markets, as well as banking and, amazingly, the enforcement of contracts. Similarly, Transparency International ranks Ukraine 146th out of 180 countries on its 2009 corruption perception index.

The position of Ukraine on these indexes has been similar for several years, while some other countries have made great strides recently, showing that big and fast qualitative changes are possible. The only big change in Ukraine has been the collapse of macroeconomic stability in 2008. The steadily rising inflation peaked out, while the current account deficit became excessive, rendering a large depreciation of the currency necessary. In the last five years, the only major reform Ukraine has undertaken is adopting legislation for its accession to the World Trade Organization in May 2008.

During the last half-decade, a large number of domestic and international studies have been undertaken on Ukraine's conundrum and proposals for change. The current authors were responsible for the Blue Ribbon Report *Proposals for the New President* in January 2005 sponsored by the United Nations Development Program (UNDP). The UNDP has followed up with three successive reports, the latest of which contains very detailed proposals for legislative change. The Organization for Economic Cooperation and Development (OECD) has carried out a few studies on how to improve the business environment and legal system. The World Bank has conducted numerous large sector studies and issued many country memoranda. The Doing Business index offers very specific observations on the problems, rendering it useful also as a checklist for what to do. The International Monetary Fund's letters of intent with the Ukrainian government outline the macroeconomic cure. The European Business Association has offered detailed and concrete proposals for the elimination of barriers to business, while the American Chamber of Commerce has provided similar advice particularly on how to improve tax administration. The Foundation of Effective Governance has sponsored two McKinsey studies on what reforms to undertake, one of which is broad and general and the other narrow and specific. Other think tanks have also undertaken useful studies, notably the Institute for Economic Research and Policy Consulting, the International Center for Policy Studies, and the Center for Economic Development. As a matter of style, this report does not include detailed references, but we gratefully acknowledge all these useful studies and list them in an appendix.

All these prior reports with reform proposals have contributed to the formation of a broad Ukrainian and international consensus about what needs to be done in Ukraine. The question is less what to do but rather how to get it done. Hopefully, the presidential elections, regardless of the outcome, will break the political stalemate that is preventing reform in Ukraine. Broad Ukrainian policy consensus can then deliver effective policy changes, and it is important to have a feasible action program at hand.

This report aims to offer an operative action program for the first 300 days of a new administration. Our Commission has three goals. First, we want to provide a useful narrative for why reforms are necessary and how to undertake them. Our aim is to reflect the broad consensus that exists in Ukrainian society. Second, we endeavor to offer a clear list of policy priorities. Therefore, the Commission is not covering all topics but only a limited number of key themes. Within these areas we have jointly chosen a dozen top priorities to be undertaken or at least initiated within the first year after the presidential elections, with the understanding that both policy capacity and time are limited. Third, we have compiled a separate appendix with a list of detailed actions, which draws on the work of the Blue Ribbon Analytical and Advisory Centre.

The Commission has adopted this report with consensus, and our intention is to compose a report that reflects a broad consensus on what Ukraine needs to do, thus avoiding the most controversial and divisive issues. We have talked and listened to both the government and the opposition to present a balanced analysis, but we are reserving our right as independent experts to point out what is truly necessary.

This Independent International Expert Commission is building on the lessons derived from the Blue Ribbon Commission in the fall of 2004. The co-chairmen came up with the proposal and received the endorsement from Ukraine's prime minister at a roundtable in Kyiv on September 28, 2009, which was attended by representatives of think tanks and international organizations as well as several members of government. The prime minister promised necessary government assistance with information. The co-chairmen invited the commissioners, half of whom are Ukrainians and the other half foreigners. The commissioners are prominent experts on different aspects of reform and policy and are all independent of government, political parties, and business. The International Center for Policy Studies (ICPS), a Kyiv think tank, has functioned as the secretariat of the Commission.

The Commission report is based on contributions from Ukrainian commissioners. The drafts were discussed intensely in six working group meetings in Kyiv on December 8-10, 2009. Each working group had about a dozen participants, representing a broad spectrum of interested think tanks and associations. After the discussion, the chapters were revised and the whole report edited for substance by the co-chairmen. The draft report was circulated to the whole Commission, and their comments were incorporated by the co-chairmen. Madona Devasahayam has language edited the English version and Oleksandr Shevtsov the Ukrainian version. The Commission adopted the final report at a whole-day plenary meeting on February 2, 2010, in Kyiv.

The Commission's work has been financed by generous matching grants from the Swedish and Netherlands Ministries for Foreign Affairs. In addition, we have greatly benefited from a variety of services offered by the UNDP in Kyiv.

Kyiv, February 2, 2010

Anders Åslund — *Oleksandr Paskhaver*
Co-Chairman — *Co-Chairman*

Chapter 1
A New Wave Of Reforms Is Critically Needed

In February 2010, Ukraine faces an extraordinary window of opportunity. The country has a unique political possibility and great economic need to launch a new wave of reform. The new Ukrainian authorities need to act fast and forcefully to shore up the state.

A presidential election offers a great opportunity for a new start. The new president enjoys a political mandate, and if the parliament gives a honeymoon of legislative support, a new administration is ready to govern. But the period of "extraordinary politics," when the parliament and public allow the president to act fast and radically, will probably be brief.

At this time, Ukraine badly needs to launch a new wave of substantial and comprehensive reforms, which are widely perceived as necessary. The economic crisis has shown the weakness of the old Ukrainian state and economy, and at present the state has no room for increased public expenditures. According to the European Bank for Reconstruction and Development, Ukraine is a relative laggard among the post-Soviet countries in terms of economic and institutional reforms. A comparative World Bank study in 2005 assessed that Ukraine was one of the post-Soviet countries with the least amount of novel market economic legislation. Since then Ukraine has adopted minimum new legislation, while another laggard, Georgia, has forged ahead.

The Ukrainian people have learned their bitter lesson and are ready for change: Their state is only partially reformed, and the many distortions both in legislation and execution of power breed dysfunction and corruption, which they have to pay for. The public feel that "we cannot go on like this any longer." One of Ukraine's greatest assets is freedom of media, expression, and association, which has flourished after the Orange Revolution in late 2004. This freedom has facilitated a broad public debate that has brought about great public understanding about the problems and a broad consensus about what reforms Ukraine requires. This report attempts to specify this consensus and suggests operative solutions.

Because of the many years of neglecting reform, tasks have in many ways become more difficult in Ukraine. First, legislation is substandard. The common statement that Ukraine has good laws but they have not been implemented is not true. On the contrary, the country has few modern laws, and the quality of new legislation is generally considered unsatisfactory. Too much Soviet legislation has persisted for too long, and it permeates many new laws. During the many years of distorted markets, multiple vested interests have twisted many laws to their advantage. Endemic corruption has bred legislation that offers corrupt officials the opportunity to reap more corrupt revenue. The competence to draft laws has also been insufficient.

Second, not only the legislation but also the legislative process is tilted to the advantage of vested interests. This process is inordinately complex and non-transparent in Ukraine. It should be opened up, abridged, and made more cohesive. It must be made easier for the ruling political forces to have legislation adopted in line with their design.

Third, the government's capacity to formulate and carry out reforms is limited. The great bureaucratization and centralization mean that central authorities are overwhelmed by decision making on all kinds of current matters, leaving them little time for reforms. Therefore, the Ministry of Finance or the Ministry of Economy can hardly lead reforms as has been the case in other countries. We see a need for a Reform Commission to be established within the Cabinet of Ministers to be headed by a Deputy Prime Minister.

One aim of this report is to suggest ways to overcome these obstacles. Ukraine does have resources. It possesses substantial and well-educated human capital, which is greatly underutilized. Ukraine's accession to the World Trade Organization in 2008 has secured considerable market access. Reforms in other post-Soviet countries, early on in Estonia and most recently in Georgia, show that sudden changes are possible and may greatly improve people's welfare. Ukraine can adopt many of these countries' successful cures. Ukraine is part of the western community. The current negotiation of a European Association Agreement with the European Union offers many possibilities. One is deep free trade; another is European engagement in Ukraine's institutional reform; and a third is the adoption of European legislation.

Ukraine's Reform Experience

So far, Ukraine has experienced two waves of substantial reform. The first reform wave started in the last quarter of 1994, after Leonid Kuchma was elected president. The second wave arose in the first quarter of 2000, when Kuchma was reelected and Victor Yushchenko became prime minister. In these two cases, reforms occurred immediately after a presidential election and in the midst of financial and economic crisis, underlining that Ukraine currently has a great chance to reform.

However, after two presidential elections, Ukraine did not opt for economic reforms. By the first presidential elections in 1991, the economic crisis was complete, but the country was focused only on state-building. After the Orange Revolution, there was no economic crisis and euphoria prevailed. Not surprisingly, no reform followed.

During its first ten years of independence (1991-2000), Ukraine created the institutions necessary for the functioning of the new state and national economy. New or radically changed administrative and judicial systems were created. Mass privatization helped to form a novel market economy. Monetary, fiscal, and tax systems were established, as well as systems for the regulation of private enterprise and competition. The corresponding body of laws was adopted. However, this grand process of creating new state institutions took place in quite unfavorable circumstances.

First, when attaining independence Ukraine entered a deep financial and systemic crisis that affected all aspects of life. It was connected with the collapse of the Soviet Union and its system of state planning. Excessive money supply and fiscal expenditures prompted devastating shortages, high inflation, and Soviet state default. The military-industrial complex that had constituted most of the industry instantly lost its market. The traditional ties of the other sectors of the economy were broken off as well.

Second, the experience of living and surviving under foreign rule for centuries had nurtured a profound mistrust among Ukrainian citizens against state institutions and state power. An elite with the tradition of serving the state, continuity of power, and experience of the strategic vision and governance was absent.

Third, seventy years of Soviet rule had weakened the skills and thinking necessary for a democratic society and a market economy. During these years all forms of civil society had been destroyed. In the course of three generations the traditions of self-organization and solidarity had been eradicated. In the 1930s, the social strata—that is, the Ukrainian bourgeoisie and democratic intelligentsia and the wealthy peasantry—needed for building the state and a market economy was annihilated.

Any new state that accumulates the experience of statehood needs decades to improve its construction. For Ukraine such a strategic effort was all the more necessary, as the building of the new state took place in parallel with the formation of an open market economy. It led to an abrupt change of the social structure of society. A positive development was the emergence of millions of entrepreneurs, who were self-contained and financially independent of the state. They entered into complicated and contradictory relations with the state, among themselves, and their employees. These developments posed new demands on the state to provide high quality regulation and to persistently adjust the regulatory system.

In the extreme systemic crisis and without experience of statehood, the formation of institutions and laws was schematic rather than well-designed. Pervasive informal management naturally introduced corruption into all spheres of state activity, which in turn distorted the construction of the state apparatus and the legislative system.

Yet, because of heated political conflicts, institutional reforms stopped half-way until 2000. The Orange Revolution of 2004 was a sharp reaction of the new social strata against the stagnation of institutional reforms. But during the five years that have passed since that revolution, the process of institutional reforms has not been launched.

The poor institutional base of state machinery makes it difficult for the state to respond quickly and accurately. The global financial and economic crisis tested the maturity and quality of Ukraine's state institutions. On the one hand, at the end of 2008 and during 2009, the government successfully averted the most catastrophic possibilities. On the other hand, the crisis also revealed that the under-reformed state apparatus had only limited capacity to handle such challenges.

The beginning of post-crisis recovery growth in the fourth quarter of 2009 underlined another problem: The post-Soviet Ukrainian economy adjusted to the open market economy at a low-tech level. It is an economy of low productivity, with little diversification, high energy consumption, and dependent on external energy monopolies. Post-crisis, the economy is being restored back to the same. So far, the crisis has not facilitated the necessary structural developments of the Ukrainian economy.

To overcome these dangerous trends Ukraine needs to build an economic system that is capable of delivering fast economic growth. The state budget is overloaded with paternalist functions of the unreformed Soviet state, most of all social expenditures but also direct support of the traditional industrial and agrarian sectors (coal mining, metallurgy, and agriculture) and natural monopolies in exchange for prices administratively set below the market level.

The new wave of institutional reforms should remove these lingering contradictions. Strategic reforms are needed to fundamentally improve the quality of the state and economy. We must obliterate the image of Ukraine as the country of incomplete reforms and unrealized potential.

The development of society, as well as the current economic and political dynamics, appears to have created favorable preconditions for a new wave of institutional reforms. It should also help improving the business climate and attract more domestic and foreign investment.

First, 19 years of independence have not only made the social structure more complex but also formed a pluralist view of the future. In parallel to this natural diversity, a nationwide consensus has been formed about the foundations of society. It may be defined as the European Choice: democracy and market economy, inalienable human rights and political freedoms, the rule of law, and a strong socially oriented state. This consensus is the pledge of positive embrace of a new wave of institutional reforms aimed at removing the most painful impediments to Ukraine's development.

Second, the crisis itself has shown the need for reform. The forthcoming phase of post-crisis economic growth will alleviate the contradictions of the reform process, especially at its initial stage.

Third, the presidential elections are likely to renew political power and give the new leader a clear mandate for a brief period to take decisive reform action.

Fourth, the awareness of the costs of not undertaking reforms is growing. The overextended budget cannot fulfill its obligations in education, health care, justice and infrastructure. The young are loosing faith in their future because of the endemic corruption and many choose emigration. Domestic and foreign businessmen are deterred to invest because of the unfavorable business climate.

Goals and Priorities of Reforms

The main goal of the new wave of institutional reforms is to improve the quality of life of Ukraine's citizens in line with the European Choice and lay the foundation for fast economic growth both in the medium and long term. This report is devoted to the most painful problems of the state that hinder the realization of this goal and therefore require urgent reform.

Critically weak links in state capacity need to be strengthened: improvement of the legislative, executive, and judicial branches of government, not least to improve the institutional ability to combat pervasive corruption. To accomplish this, the country requires reform of the gas sector; a sensible exchange rate policy; reform of budget and tax policies; comprehensive market deregulation; administrative and judicial reform; reinforcement of market competition and a fundamental improvement of governance; completion of privatization; improved efficiency in the social sector; and further integration with the European Union. Taken together the reforms aim to improve the standard of living of Ukrainians and utilize their human capital, thus unleashing the country's potential of self-development.

The logic of reforms and the limited resources at hand require that the political leaders choose clear priorities. Ukraine's key problem is that the state malfunctions so much that it is unable to carry out its duties toward its citizens, while hindering the citizens from solving their problems on their own. Therefore, the top priority is to enhance the ability of the state to respond adequately to external and internal challenges. Without reforming the state, all other reforms will end up as a waste of resources. The legislative, executive, and judicial branches of the state themselves need to greatly improve.

After the state, three broad priorities are apparent. First, macroeconomic stability must be restored and be given a permanent base. *Second, the functioning of Ukraine's markets for goods and property* requires radical improvement. The Soviet management system in the natural monopolies, including cross-pricing and preferential tariffs as tools of social paternalism and corruption, needs to be ended. This is particularly true of the energy sector. *Third, the efficiency and efficacy of social policy* must improve to the benefit of the population.

Defense of Reforms: Establish a Reform Commission

Reforms must not only be started but also completed. Political, organizational, and legal protection may be as important as the design of reform, because reforms must be made irreversible.

Therefore, *a special agency of reform is needed*. It should not be connected with any agency to be reformed, because all agencies tend to be conservative and resist their own reform. This is also to avoid conflicts of interest. The agency of reform should have its own budget and a single goal: to design and implement the reform. To avoid the bureaucratization of such an agency, it should be headed by a prominent politician who assumes the responsibility before society for implementing the reforms. He or she should have sufficient powers, responsibility, and accountability to a higher state authority. The natural solution would be to form a reform commission at the Cabinet of Ministers headed by a Deputy Prime Minister entitled to give orders to other ministers, as many other post-communist countries have done during the intensive phase of their reforms. One of the most successful examples is Poland. Ukraine would do so later than others because so many reforms remain to be undertaken. At the same time, the government needs to imbed a sufficient number of enlightened, modern thinking and reform-committed bureaucrats into other key government bodies, notably the Ministry of Finance and the Ministry of Economy.

The most important impediment for politicians to carry out long-term reforms is the view that reforms harm the political career of the politician who initiates and carries them out. It is considered an axiom that such reforms are painful for the population and that future profits for the people have no value compared with current costs. Such fears are justified. Apart from real shortcomings and discomfort for the population, major social transformations are psychologically challenging and therefore breed distrust of power. Even the most successful reforms with an evidently positive balance appear at best the least evil. But in the post-communist period, almost every incumbent government has lost the next democratic election, and the few that have won are actually a couple of radical reform governments: the Czech government in the early 1990s and the Slovak government in 2004.

Major reforms or modernizations are naturally controversial because they undermine the position of some old elites while elevating new elites. Therefore, such metamorphoses tend to take place after a major crisis, when the elite is weakened and the public has realized that monumental change is necessary. Usually, such reforms take place just after an election that has given a mandate of legitimacy to a government. In recent history, most such reforms have indeed taken place under democracy. This was true of both Eastern Europe and Latin America in the 1980s and 1990s. The stronger the national cohesion and the popular consensus, the easier it is to carry out structural reforms that lead to fast economic growth. In countries with liberal and democratic traditions, where the power is more sensitive to public opinion, implementation of reform is less painful and results more predictable. Late comers enjoy the advantage that they can learn from the successes and failures of preceding reforms in other countries.

The actual results of major reforms are always different from expectations because of their very complexity and unpredictable popular responses. Therefore, political leaders have to act innovatively with a mixture of stubbornness and flexibility. To make sound judgments, they require sophisticated analysis of the effects and options to constantly adjust plans.

To break popular resistance to reforms, it is also vital that the political leaders clearly explain the goals and logic of reforms. The success of reform often lies with public education. People must understand why reforms are being undertaken as well as their potential advantages and drawbacks. The government needs to constantly analyze the development of reforms and their effects on the citizens. An outstanding historical example is Franklin D. Roosevelt's "fireside chats" by radio with the American people during the New Deal in the 1930s. With the new means of communications, the government can do so much more to sell its program. When necessary, it should be able to quickly adjust the reforms. The government must also keep the population updated about the evolution and results of the reforms. Popular resistance to reforms can be mitigated with social compensation designed to shield the population from the most evident negative effects of reforms, such as price increases because of liberalization. In short, reforms are unlikely to be successful if the population is not being persuaded that the reforms are in their interests.

Fierce and inventive resistance to reforms is inevitable, but reforms can be carried out by a government that possesses the persuasion and energy and ability to listen and adjust its actions. Stubbornness is also necessary. The government must show a will to stick to its principles and complete the reforms once started. Otherwise it will lose credibility, and its opponents will be encouraged to rally against the government. One way of resolving this problem is to give the Reform Commission clear quantitative goals, such as improving Ukraine's ranking on the World Bank Doing Business index. Another possibility would be to give the Reform Commission extraordinary powers for a limited period, for example, one year.

Recommendation

A Reform Commission should be formed at the Cabinet of Ministers headed by a Deputy Prime Minister entitled to give order to other ministers. The Commission should be provided with adequate financial and human resources, including high quality experts. The Reform Commission would work in parallel to the European Integration secretariat.

The Anti-Crisis Policy: The IMF External Anchor for Fiscal and Exchange Rate Reforms

The global financial crisis has hit Ukraine hard. In late September 2008, global liquidity froze, and Ukraine was completely excluded from global finance. Several industries—construction, metallurgy, mining, and machine-building—saw their output falling momentarily by about half. Only agriculture escaped the crisis. Ukraine has been one of the countries in the world most severely hit by the crisis. The impact of the crisis and the anti-crisis policy will constrain the country's economic policy for the next few years.

Ukraine suffered so badly for several reasons. The fundamental problem was Ukraine's exchange rate policy. The country had maintained a fixed exchange rate to the US dollar for years. Therefore, currency inflows increased the money supply excessively, resulting in inflation. Ukraine had experienced double-digit inflation from 2004, and in May 2008 inflation peaked at 31 percent year over year. As a consequence, Ukraine priced itself out of the market. Imports rose more than exports, and the current account deficit expanded to 7 percent of GDP in 2008.

The crisis was aggravated by structural disproportions. Steel accounted for no less than 42 percent of Ukraine's exports in the first half of 2008, but from July 2008 steel prices and exports plummeted. The outside world was unimpressed with the Ukrainian political stage, which appeared to be in gridlock, and the poor business climate. Without membership of the European Union or other international community, Ukraine had the option to turn to the International Monetary Fund (IMF) and other international financial institutions—the World Bank, European Bank for Reconstruction and Development (EBRD), and the European Investment Bank (EIB).

Ukraine speedily concluded its stabilization program with the IMF in October 2008, and rightly so, because the crisis was dire. Initially, the IMF posed its standard demand of a balanced state budget, but over time it has relaxed this demand and accepted a consolidated state budget deficit of as much as 6 percent of GDP in 2009. The second IMF demand was a realistic exchange rate, which meant that the exchange rate would float and the hryvnia thus be depreciated. In effect, the National Bank of Ukraine (NBU) did so in November. The third key condition was bank restructuring and bank recapitalization. In return, the IMF committed a very large amount of $16.4 billion in financing over two years, and this financing was heavily front-loaded and made available at very low interest rate. By extending large loans and pressing for fiscal reforms IMF became the external anchor for the stabilization of the Ukrainian economy.

Ukraine has been able to draw three tranches of a total of nearly $11 billion by the end of 2009. Contrary to standard IMF procedures, it could use much of this financing for its budget expenditures and not only for its international currency reserves. In addition, in September 2009, the IMF issued new special drawing rights, which means that the IMF printed money and distributed it to the member countries in relation to their quotas with the IMF. Ukraine received $2.1 billion, which was used for additional budget financing. Thus, Ukraine has managed to keep afloat in 2009 in spite of the crisis swelling needs for public expenditures and reducing state revenues. Because of a public debt of only 12 percent of GDP in 2007, Ukraine's public debt remains relatively low. By the end of 2008, Ukraine had accumulated a foreign debt of around $103 billion or about 57 percent of GDP, which implied some vulnerability, but about 80 percent of the debt service falling due has been refinanced. By the end of 2009, Ukraine's international reserves remained at the level of $27 billion or one-quarter of GDP. The big concern, however, is that GDP in 2009 is likely to have fallen by no less than 14 percent.

The anti-crisis policy has put Ukraine on a specific track. It has severely limited its options for the next few years. Ukraine has simply fewer possible choices than it had before the crisis. In order to thrive, its political leaders must consider these restrictions.

Exchange rate policy. Ukraine must not peg its exchange rate again. The only sensible exchange rate regime for Ukraine appears to be inflation targeting, that is, the exchange rate will float and monetary policy will aim at keeping inflation low and stable. The NBU can undertake limited currency interventions to smoothen fluctuations, but it must not target one specific exchange rate any longer. A precondition for inflation targeting is that the NBU be truly independent from daily political vagaries.

Public expenditures. Ukraine's public finances will be under tremendous pressure for the next few years, and public expenditures will be severely restricted. Major public expansion will not be possible for years to come. On the contrary, this is the time to rationalize public expenditures, while ad hoc cuts should be avoided after the acute crisis has passed. The government needs to set agreed targets for overall public expenditures as a share of GDP, and the proportions of the main components of public expenditures as a share of GDP should also be set for the medium term. In order to offer the citizens as much as possible from the available public funds, public expenditure as such and its main components need to go through fundamental reforms.

State revenues. Just as public expenditures are constrained and rationalized, tax revenues need to be buffeted and rationalized. Major loopholes in the tax system need to be closed, while taxation needs to become more purposeful. Taxation and especially tax administration should be simplified and equalized. While the main structure of the tax system makes sense, the tax administration is excessively burdensome and inefficient, harming both the state and the taxpayers.

International finance. For the next couple of years, Ukraine will have limited access to international financial markets. The most significant forms of international financing will be governmental financing (international financial institutions and foreign governments) and foreign direct investment. This is a propitious time to improve the business environment to stimulate both domestic enterprise and foreign direct investment. International financial institutions provide an important external anchor for Ukraine's economic reforms.

Bank restructuring and nationalization. The financial crisis has forced Ukraine to carry out substantial bank restructuring. Rather than stopping halfway, the authorities should take the opportunity to clean out bad banking practices and substandard banks. The government has been forced to nationalize seven banks. While this was necessary for financial stability as well as the banks' state recapitalization, the government should plan their privatization as soon as it makes commercial sense.

Regulation and state aid. Crisis requires ad hoc measures. Certain industries have received discretionary state support, for example, lower gas prices for fertilizer plants or direct subsidies. Currency regulation has been aggravated. These temporary emergency measures should be eliminated as soon as feasible.

The Ukrainian nation has incurred tremendous costs due to the global financial crisis. It is important to ensure that these costs are not sheer waste but an investment in a better society and economy.

Chapter 2
How to Reform the State

Bad governance can jeopardize the greatest opportunities of any country. The quality of governance depends, on the one hand, on a government's institutional organization and, on the other hand, on the abilities of politicians, civil servants, and judges. To quickly replace all untalented and corrupt officials with fair and skilled professionals is impossible. But a rational organization of government creates conditions for a gradual improvement of the political, managerial, and judicial elite, thus facilitating a better state policy and management, as well as limiting corruption. No success can be expected in any sector without institutional reforms.

Ukraine's fundamental problem has been the dysfunction of its state. Ukraine's whole history as an independent state has been colored by intense disputes over the Constitution. These problems are manifold. The adoption of the Constitution of Ukraine in 1996 brought about some clarity, but the constitutional amendments of December 2004 aggravated the situation by precluding a sensible division of powers. Severe problems persist in all branches of power, which are all characterized by gridlock as well as intrusive petty tutelage.

The functions of the state need to be clarified, simplified, and improved. The parliament's legislative process should be streamlined to improve the quality of legislation. The executive needs to be streamlined and decentralized through an administrative reform to allow for more effective and accurate application of law. The administration needs to be endowed with a new sense of public service. Judicial reform is necessary not least for effective judicial control of the functioning of the state. Because of the malfunctioning of the state, many problems have been solved by corruption, which has become endemic. All the reforms of the state should serve to contain corruption, but it also needs to be attacked head on with a realistic anti-corruption program.

The strengthening of the effectiveness of the state depends on the resolution of five groups of interrelated issues: improvement of the parliamentary and legislative system, administrative reform, judicial reform, anti-corruption action, and constitutional reform.

Improvement of Parliamentarism and Legislative System

The main problem with the work of Ukraine's parliament is that the parliament, on the one hand, finds it very difficult to enact laws. On the other hand, when laws are actually promulgated the process is swift and haphazard. The outcome is that laws needed for reform are not adopted and that the enacted laws are often of poor quality as vested interests can manipulate the legislative process through deft actions.

The Ukrainian electoral system has gradually moved from the majority election of candidates in one-man constituencies to fully proportional elections with a threshold, currently of 3 percent, for representation. The trend has been toward increasing party discipline and fewer political parties represented in parliament. Four concerns stand out about the Ukrainian parliament, namely, personal choice of candidates, campaign financing, legislative efficacy, and the accountability of parliamentarians.

Open lists. At present, the leadership of each party decides the order of candidates on a party's electoral list. A broad Ukrainian consensus advocates that a personal choice be added to the party choice through "open lists," that is, proportional voting should be complemented with preferences for specific candidates: A voter would vote both for a party and one of many candidates presented by that party. In one electoral district, a party receives a certain number of seats, which would be distributed within the party on the basis of the individual vote tolls. Such electoral systems function successfully in

Germany, Finland and Poland. This would enhance democratic competition and make it more difficult to buy a seat in parliament.

Campaign financing is a problem in most democracies, but Ukrainian election campaigns are among the most expensive in the world. The legal limits for party financing are implausibly low and not taken seriously. It would be desirable to limit the funding of parties with private contributions. A more feasible approach would be to insist on transparency of party financing. If the efficacy and transparency of the parliament improve, campaign financing is likely to decline to a more normal level. Then, it might be possible to introduce state financing of parties, but today it is not.

Decision through simple majority. It has become exceedingly difficult to reach decisions in parliament because of the requirement that a majority of all deputies (226 out of 450) approve of any decision. In order to ensure effective parliamentary lawmaking, proper quality and stability of laws, the Constitution should stipulate that most of the matters be decided by a simple majority of votes of the parliamentarians present, as is the practice in most parliaments, abandoning the current demand for an absolute majority of all deputies for all decisions. Only the most important decisions, such as a vote of no confidence in the government, should require an absolute or qualified majority of all the parliamentarians.

Simplify and standardize the legislative process. When a law is actually adopted, however, the process is often haphazard and surprising. The legislative process needs to be standardized and simplified, which is largely a matter of internal parliamentary organization. Bills should be prepared in advance and posted a certain time before they are presented for parliamentary debate or votes, and the rules should really be imposed. They should also be subject to mandatory government assessment. It is necessary to stop the abuse of the abbreviated discussion of bills and to introduce specific mechanisms of involving the public and all stakeholders in their preparation and consideration.

Improve existing legislation. Much of the current legislation is of insufficient quality and major elements are often missing, relegated to subordinate regulatory acts. The European integration involves the adoption of a large number of legal acts, but the European body of laws, the *acquis communautaire*, does not include major laws and legal codes, which remain national legislation. When time arises, Ukraine should undertake a thorough review of already existing legislation whose quality needs to improve. One convenient way of doing so is to import good laws from post-Soviet countries with modern legislation of high quality, such as Estonia.

The lack of accountability of the parliamentarians is a concern. The easiest way to introduce some accountability is to limit their parliamentary immunity.

Recommendations

1. *Open party lists* with not only party choice but also personal choice in parliamentary elections should be introduced through amendment of the election law.
2. *Transparency of party financing* should be improved by demanding that all political contributions be made public.
3. *Ordinary parliamentary decisions should require only a simple majority of those present.* The legislative process must be simplified and tightened. It contains too many steps, and the changes that can be undertaken in any step are too great. These rules should be set through the adoption of a Law on the *Verkhovna Rada* Regulations.

Administrative Reform

Ukraine's malfunctioning executive is perhaps of greatest concern. Without systemic reform of the executive branch, local self-governments, as well as public and municipal services, the country cannot prosper. The organization of the state needs to be improved through a clear distribution of tasks and authority and decentralization.

Reform should be based on the Public Administration Reform Concept, which exists in draft. It builds on three documents approved by the presidents of Ukraine: the Administrative Reform Concept, the Concept of Development of Public Service Legislation, and the Concept of Improvement of the State Regulation of Natural Monopolies.

Reform of executive power should *make the Cabinet of Ministers the center of political leadership and policymaking*, while delegating administrative powers to executive authorities at lower levels as far as feasible. The ministers should concentrate on policymaking rather than administration. The work of the government needs to become more formal and guided by strategic thinking rather than by haphazard "instructions" from various top officials. Concepts, bills, and acts of the Cabinet of Ministers should be drafted by the ministries and initiated by ministers in line with strategic political decisions.

Strengthen the government's control over budget legislation. The annual state budget is a central government program. It should be given special treatment in the legislative process. The parliament should be given less leeway than it is today in budget matters. Some countries allow their parliaments only to adopt or refute the budget, while others permit merely limited and balanced changes to make it easier for the government to pursue a consistent budget strategy. Another common rule is that the parliament should not be allowed to incur new expenditures without corresponding financing, which facilitates the tightening of budgetary expenditures.

Reinforce the ministries' focus on policymaking. The ministries are the central executive authorities. They need to combine two qualities: provide political leadership, while maintaining high professional standards. In order to do so, the government needs to draw a clear line between political and administrative posts in the ministries. Deputy ministries should be considered political appointees and their number be reduced significantly. In each ministry, a top civil servant, a state secretary, should be responsible for managing the ministry's apparatus, serving as its institutional memory. State secretaries of the ministries should be appointed by the Cabinet of Ministers on merit in a competitive manner, according to the procedure stipulated by the civil service legislation.

Ministries should be relieved of most of their current administration functions, which should be delegated to autonomous government services, agencies, and inspectorates. Ministries are not supposed to manage enterprises. The Cabinet of Ministers should appoint the heads of all government bodies after nomination by the responsible minister. Although a minister is politically responsible for the activities of subordinate government bodies, they should perform their work independently, based on relevant legislation, without petty tutelage from the ministry. All state agencies should be subject to regular audits by the Auditing Chamber.

Regulating agencies of natural monopolies need independence and integrity. The regulating agencies of natural monopolies form a special category. They should be guaranteed independence and protected from political and commercial interference. Reform of the regulators should attempt to balance the interests of consumers, monopolies, and the state, securing the autonomy of the regulators from all three. Work of regulators should be based on collegiality principles. Consumers should be guaranteed access to services of sufficient quality at prices based on economic reason (cost recovery rates). As long as state-owned monopolistic companies persist, they should enjoy a reasonable margin of profit so that they can maintain necessary services and investments in infrastructure. The state should be interested in guaranteeing supply, national efficiency, and social sustenance. State companies should be separated from regulatory agencies and ministries and be subject to the same regulatory rules as private companies.

Currently, independent regulators supervise only energy and communications, but their regulation should be extended to transportation and utilities, which at present are unregulated. The governance of independent regulators should be improved through fixed appointment terms of their management and through enhanced transparency to ensure that they are truly independent from all stakeholders.

Improve the civil service. The civil service needs to be reformed to create a professional, politically neutral, and responsible corps of civil servants accepted through competitive exams and promoted on merit.

A reform of the government is essential, but the transition is always difficult because everybody in the state administration has to be involved. The experience from especially Russia shows that such a reform can cost almost one year when the whole state administration is only preoccupied with itself. Therefore, this organizational reform should be carried out but only after other reforms that are immediately needed have been carried out, that is, not in the first year of reform, whereas the government should immediately undertake measures to improve the quality of the state service and hire skilful professionals for essential parts of the state administration.

Recommendation

> *Ukraine should adopt a Law on Ministries and Other Central Executive Agencies and a new version of the Law on State Service to pursue a civil service reform*. This law should separate political and civil service functions. To ensure professionalism of public service, all civil servants should be recruited through competitive entrance exams based on merit, and their advancement should also be determined on merit. Their salaries should be market-related and competitive to minimize the temptation of corruption. Political neutrality of public service should be ensured by banning civil servants from engaging in political activities up to a ban on membership in political parties for top civil servants. Legislation should be adopted to establish professional ethics for civil servants and to monitor their property, incomes, and expenditures to combat corruption.

Reform of Local Self-Governments and the Administrative-Territorial System

Ukraine has both regional and local executive organs as well as local self-government, but neither has been given a suitable framework for its functioning. The Concept of Local Self-Government Reform, approved by the Cabinet of Ministers of Ukraine in 2009, can serve as a basis for such a reform.The establishment of an effective system of local government requires joint reform of local self-government and the state administrative-territorial system. The goal should be to create a clear three-tier system of territorial units, which could serve as a territorial base for local and regional self-governance: communities, districts (*raiony*), and regions (*oblasti*). When determining the powers of each level of authority, the subsidiarity principle should be the guide: All administrative tasks should be carried out at as low a level as is practical.

The community should be the basic unit of the administrative-territorial structure. Their current number is far too large and they need to be merged (around economically successful locations) to be able to function. The community's head and council should be elected by direct vote. To fulfill their mandates, local self-governments should possess sufficient property and financial resources. Local tasks should include police, fire-fighting, and provision of most of administrative services.

Also, districts (*raiony*), the second level of self-governance, require major consolidation. They should be responsible only for those public tasks that cannot be successfully performed at the community level. District councils could be formed through indirect elections among community councils. They should have their own executive committees, which requires an amendment of the Constitution. Provision of in-patient medical care is a natural task for district-level self-governance.

24 oblasts and the Autonomous Republic of Crimea should be the territorial basis for regional self-governance. Once the local self-government reform is completed, the Concept of Regional Self-Government should be developed and approved. The main tasks of regional self-governments should be to ensure the region's social and economic development, investment promotion, development of regional transportation infrastructure, culture, sports, tourism, environment protection, preservation of a region's ethnic and cultural specifics, and operation of specialized health care and educational institu-

tions. Regional councils should be directly elected by the region's residents, and their executive bodies should work as regional self-governments.

Financing of regional and local authorities needs to be profoundly decentralized. In the current system almost all tax revenues are supposed to go up to the central state treasury and then some go back down to localities. These large vertical transfers of funds are inefficient and distort incentives. Regional and local authorities would be much more interested in the development of their territories if they were dependent on local tax revenues. Incentives to introduce small nuisance taxes and focus on penalties and fees that they control themselves would disappear. Preferably, each level of government should be allowed to live on taxes appropriate for their level and care for a certain sphere of expenditures. For example, communities collect taxes from personal income, land and property, and small enterprises so that they care about local development. Regions could receive a certain share of corporate income taxes.

The executive branch at the local level needs to become more effective in its relations with both the Cabinet of Ministers and local self-government. In order to ensure political neutrality and professionalism, the heads of local public administration should be civil service career officials. Tasks should be clearly divided between the local public administration and the local self-government.

Ideally, public services should be decentralized to the lowest feasible level, and each level of government should receive its revenues from taxes that it controls and collects itself. Then authorities will stop harassing local businessmen and nuisance taxes will fade away, as such practices hinder local development and thus the tax base and tax revenues. Meanwhile, local and regional elections of both councils and executives will lead to transparency and democratic control with checks and balances.

A territorial-administrative reform takes a long time to carry out and requires thorough preparation. Therefore it should be well-prepared in 2010 and carried out in 2011.

Recommendation

A reform of regional and local self-government needs to be initiated. It should contain four major elements. First, the units at the two lowest levels of the administrative hierarchy (communities and districts) need to be merged and the number sharply reduced to become viable; the number of oblasts seems fine. Second, a large number of functions should be decentralized. Third, oblasts, districts, and communities should all receive larger direct tax revenues so that they do not have to depend almost completely on the central state treasury and are not tempted to expand their revenues in harmful ways by extracting penalties through damaging inspections. Fourth, the reform should follow the principles of the European Charter of Local Self-Government that Ukraine has ratified.

A New Sense of Public Service

One of the greatest needs is to efficiently and justly regulate the relations between public administration and individuals. Citizens should be endowed with greater power in relation to state and municipal authorities, which should be contained and disciplined. State and self-governance bodies should be encouraged to adopt a new attitude of public service toward the citizens. Three documents that outline such reforms are the government-approved Concept of Development of a System of Administrative Service and the presidential Concepts of Combating Corruption on the Way to Integrity and of Reform of Criminal Justice in Ukraine.

Contacts between government and individual should be minimized, and administrative procedures should be simple and rational. To minimize the contact between individuals and enterprises with the state, the number of administrative procedures must be sharply reduced and concentrated. As far as possible, public services should require only one stop at government offices, providing an individual or enterprise with the opportunity to complete all formalities at one time in one spot. Any additional procedures should be carried out by that public office. All government agencies should be obliged to accept and consider the documents submitted through municipal one-stop shops of administrative services. To make the administrative simplification effective, all legal requirements need to be specified in law.

Adopt a Law on Public Information. The most important weapon against corruption is transparency. Ukraine's free media are excellent at exposing corruption, but the state should make it easier for them to obtain information. The Scandinavian countries, which have the least corruption in the world, have for a long time had far-reaching laws that render all state information available to the citizenry, with three exceptions: national security issues, strictly private matters such as medial records, and commercial matters. Ukraine should adopt such a Law on Public Information, which should guarantee that all state information be available to the public, except the three areas just mentioned. It should declare that a broad range of public information should be freely available on the internet. Much public information is already available on the internet in Ukraine, notably laws, but budgets at all administrative levels and all court decisions should also be publicized on the web. Major politicians already have to declare their spouses' and their wealth and incomes, but the range of officials who have to make such declarations should be widened, and it is all too evident that many politicians understate their wealth and incomes. Control over the veracity of this information should be strengthened. In particular, the funding of political parties and candidates for elections should be transparent and subject to public control.

Promote e-government. One of the best ways of making contacts between individuals and the government efficient, standardized, fast, simple, cheap, and transparent is e-government. Electronic document management should be utilized as far as possible at all public administration levels. To a maximum, individuals should be offered the option of addressing government agencies through information and communication technologies, and the government should provide maximum information content and interaction through public websites. Estonia has been the pioneer in e-government, and Ukraine can draw on its success.

Rights of individuals. All individuals should be given plenty of opportunities to complain about and rectify government interference. The state must guarantee each individual the right to impartial and fair decisions on his or her issue within reasonable time. Particularly important are procedural guarantees of the protection of the rights of individuals. Administrative procedural legislation should strictly control any interference by any public body on its own initiative into the rights and lawful interests of individuals. Simple and cheap administrative out-of-court appeals should be developed for the protection of individuals' rights in relation to public administration.

Reinforce auditing of state institutions. Instead of the state controlling the citizens, the citizens need to control the state and its many arms. A standard method of doing so is through a powerful independent Auditing Chamber, whose head is appointed by the parliament. Ukraine has such an institution and order, but its Auditing Chamber could be reinforced with greater authority and resources to enable it to audit all kinds of state institutions to audit the utilization of state funds.

The relationship between state officials and individuals must change fundamentally. The government should serve the citizens rather than commanding them or even behaving as their owner as was the case under Soviet rule. To ensure that state officials behave legally and respectfully toward the citizens, the officials must bear legal responsibility for their acts.

Recommendations

1. *Ukraine should adopt an Administrative-Procedural Code* guaranteeing the rights of the individual in relation to the state administration.

2. *A Law on Public Information should be adopted.* All state information should be available to the public, as far as possible free of charge through the internet, apart from three kinds of information: national security issues, strictly private matters such as medial records, and commercial matters.

3. Ukraine has started developing *e-government*, but much more must be accomplished. Most government formalities should be possible to carry out on the internet, from enterprise registration to tax administration. The aim should be to standardize and minimize the contacts between the state and entrepreneurs and to make the remaining contacts as impersonal as possible to minimize corruption. Estonia appears the most successful example of e-government.
4. *The powers and resources of the Auditing Chamber should be reinforced*.
5. *Effective disciplinary and criminal responsibility of public officials for non-compliance with the law should be introduced*.

Judicial Reform

Judging from Ukrainian public opinion, the judicial system is the weakest link in the Ukrainian state. The court system is perceived as one of the most pervasively corrupt parts of the government, subject to commercial and political influences, and incompetent. Therefore, judicial reform is vital, but it is a long-term, complex undertaking. All elements of the judicial system need to be improved. The judicial division of labor and hierarchy must be clarified. Training and selection of judges need to be improved, made more transparent, and meritocratic. Courts and judges require sufficient financing. Since the court system is considered profoundly corrupt, an independent, central, and powerful auditing authority is needed for court judgments.

Judicial reform has been undertaken in bits and pieces for many years and a strategy has been elaborated. Three concepts approved by the president in 2006-2008 form the basis of further reform: the Concept for the Improvement of the Judiciary to Ensure Fair Trial in Ukraine in Line with European Standards, Concept of Building a System of Free Legal Aid in Ukraine, and Concept of Reforming the Criminal Justice of Ukraine.

Clarify division of competence and jurisdiction. According to the Law on the Judiciary, justice in Ukraine is administered by general and specialized (at present: commercial and administrative) courts. In addition, military courts are functioning within the system of general courts. Because of unclear division of competence among these different types of courts, it is often unclear to which court a case belongs. For example, civil cases are being allocated to civil and economic courts depending on the status of the parties. The unclear division of competence between specialized courts results in frequent conflicts of competence between commercial or administrative courts, which at present are resolved by superior specialized courts. There are also often conflicts as to the rules for the allocation of cases to one kind of court. They need to be clarified by a law to limit competition over jurisdiction.

To *improve the professionalism of judges*, their selection should be transparent and centralized based on competition and competence. Candidates for judges should receive better training at the Academy of Judges, as well as regular further training. Judges should be appointed by judiciary collectives and not by political bodies. In the long term, the Supreme Council of Justice—an independent body consisting of the best experts—should appoint judges for long fixed mandates or even unlimited periods, but first the procedure of forming the Supreme Council of Justice needs to be reformed so that it becomes a truly professional and impartial body.

Reinforce judges' integrity. A judge should be truly independent from political or commercial interference into the execution of justice. Heads of courts should be deprived of the powers they use to influence other judges. An automatic distribution of cases among judges should be introduced in all types of courts to render the allocation impartial. Such a system already has been introduced in administrative courts. Both courts and judges must receive sufficient public financing from the central state to ensure the proper functioning of courts (a sufficient number of judges and support personnel, supply of adequate space and equipment, etc.). Courts cannot be impartial if judges cannot live decently on their salaries. At the same time as their required qualifications and salaries increase, judges' responsibility should rise and sanctions for inappropriate behavior reinforced. Clear grounds should be legislated for their dismissal from office and an effective disciplinary procedure should be ensured. It should provide any individual with the right to file an appeal with the Disciplinary Committee. Disciplinary proceedings should become transparent and final decisions should be public.

Court proceedings should improve in order to make them more transparent, impartial, and effective. New procedures should be introduced to ensure equal application of the laws by all courts. At present even similar court actions, such as the rejection of a judge, is carried out according to different procedures. A superior court should not return a case to a lower court after an appeal but use its powers to revise the case itself. Where any difference is revealed in the practices of higher courts, the Supreme Court should eliminate them by revising the case.

Alternative ways of dispute resolution must be promoted to reducet the case load at courts, such as: (i) mediation (which is used in most countries of the European Union); (ii) independent arbitration tribunals; and (iii) enhancing the potential of notaries by assigning to them the function of order proceedings in civil proceedings (issuing a court order in the absence of a dispute).

All court proceedings and judgments must be public and all barriers to public access should be eliminated. All judgments should be entered in the Single State Register of Court Judgments within mandated time and made public through the internet. At present the access to court judgments is declared by the Law on Access to Court Judgments, but in practice the Single State Register of Court Judgments, which was introduced in 2006, is far from being complete, has a defective search system and is often out of order. To make sure that cases are being brought to court within reasonable time, the load on courts should be reduced and effective mechanisms for the redress of injury should be introduced. The adversarial principle should be strengthened in criminal justice, and the defense should receive effective capabilities to gather evidence. Trial juries should be launched as established by the Constitution. Effective legal aid should be accessible in all types of proceedings, and low-income individuals should get it on the account of the state. (The Law on Free Legal Aid was adopted in the first reading by the Parliament.)

Improve execution of courts' judgments. Legislative barriers preventing the execution of the courts' judgments against the state, its bodies, institutions, and enterprises should be removed. The state budget should include sufficient resources to cover the execution of courts' judgments.

The role of constitutional justice should be reinforced by renewing a third of the judges of the Constitutional Court every three years. Then the Constitutional Court can be operative all the time. The European Court of Human Rights at the Council of Europe in Strasbourg offers a vital check on the efficacy and quality of Ukrainian courts. The Ukrainian judiciary system should make full use of this corrective to investigate corruption or other miscarriage of justice in the country.

Recommendations

1. *Judicial reform* has long been started, but it *needs to be completed*. A full set of updated and well-coordinated procedural codes are necessary. The judicial division of labor and hierarchy must be clarified. All judgments should be published on the web and the Single State Register of Court Judgments must be considerably improved. Courts and judges require sufficient financing.
2. *The Law on Judicial System and Status of Judges should be refined and adopted*. Training and selection of judges need to be improved, being made more transparent and meritocratic.
3. A package of bills should be submitted to the parliament on *reforming criminal justice and legal aid* (Code of Criminal Procedure, new edition); amendments to the Criminal Code on introduction of criminal offences; the Law on Prosecutor's Office (new edition); the Law on Prejudicial Inquiry Bodies; the Law on the Bar (new edition); and the Law on Free Legal Aid.

A Realistic Anti-Corruption Program

Corruption means the private sale of public services, which distorts the functioning of the state. A high level of corruption can jeopardize the outcome of the best institutional reforms. In Ukraine, this problem is especially severe because of its Soviet past and the protracted post-Soviet chaos that followed the slow reforms. The situation is dire, as shown by the anti-corruption watchdog Transparency International, which ranked Ukraine 146 out of 180 countries on its 2009 corruption perception index.

Pervasive corruption cannot be beaten in one single blow—jailing the main culprits—because endemic corruption is a way of living and doing business. It is rooted in the incentives citizens and officials face. No society is free of corruption. Only through a large number of measures can corruption be controlled. The main effort must be institutional reform of the state from the top, establishing an efficient organization of the state, as suggested above. These reforms should not only halt the growth of corruption but also actually shrink these practices. At the same time, the reforms should be accompanied by systemic, specialized corruption-preventing measures as well as punishment for corrupt practices.

The Law on the Basics of Corruption Prevention and Combating determines the main principles for overcoming the conflict of interests and financial control of civil servants, but this law cannot be very effective without changes in a row of other legal acts concerning selection of applicants for public jobs, monitoring of their incomes, and so on. The 2006 presidential Concept of Combating Corruption on the Way to Integrity suggests suitable preventive measures, concerning selection of civil servants, their career development, salaries, and disciplinary responsibility.

Create an Anti-Corruption Bureau. While law enforcement must not be the main measure, it cannot be excluded. A special anti-corruption body, an Anti-Corruption Bureau, should be created to combat corruption. It must possess a great deal of independence, integrity, and resources. Its responsibility should be to effectively coordinate a comprehensive anti-corruption program, focused on transparency, accountability, deregulation, due process and the orderly functioning of government. Investigation of corrupt activities of top officials and prosecution of them however, should be left to the police Given the pervasiveness of corruption, extremely severe sentences for corruption should be avoided, since it would only increase the level of bribery and public reluctance to report extortion. Often, it is more important that corruption is publicly exposed and the culprit subjected to shame than severely punishing the culprit. Therefore, information campaigns best carried out by free media may be more effective than sentencing corrupt officials, but it must also be clear that the law has some teeth and that corruption can lead to prison sentences.

Recommendation

> *Ukraine should form an independent Anti-Corruption Bureau* with great integrity to effectively coordinate a comprehensive anti-corruption program, focused on transparency, accountability, deregulation, due process and the orderly functioning of government. For this purpose, a Law on Anti-Corruption Bureau should be adopted.

Constitutional Reform

The Constitution of Ukraine has several shortcomings. The fundamental problem is that the division of power between the supreme bodies of state power—is very diffuse. As a consequence, independent Ukraine has suffered from persistent strife between president, prime minister, and parliament over their powers, which has led to political gridlock, little and poor legislation, an inefficient central executive, and a weak judiciary. It has also made it difficult to carry out administrative-territorial reform to form local and regional self-governance.

The amendments to the Constitution in 2004 weakened presidential powers but aggravated the division of power and the stalemate between the different branches of state powers. The state cannot function well without effective organization, which requires clear constitutional principles. These rules can change in several ways. These profoundly political choices go beyond the scope of this expert commission, but they need to be resolved for the successful functioning of the state.

Chapter 3
Macroeconomic Policy: How to Stabilize Ukraine's Finances

During the years of 2000-2007, Ukraine enjoyed high economic growth and reasonable stability, but in the fourth quarter of 2008 a severe financial crisis hit Ukraine hard, with GDP anticipated to decline by no less than 14 percent in 2009.

Today, Ukraine has overcome the worst of the crisis, and it is desirable to draw lessons from this episode and to consider how to conduct macroeconomic policy in the future. A first objective should be to identify the causes of the crisis so that Ukraine becomes more resilient to any new financial crisis. Second, the crisis has caused substantial problems, most notably the deterioration of public finances, which must now be addressed. Third, the speed and scale of the economic decline has been exacerbated by the continuing lack of structural and institutional reforms.

In the medium term Ukraine's economic policy will be determined by the necessity to cope with the aftereffects of the crisis and the need to secure stable growth over the long run, which will require structural and institutional reforms. In other words, future economic policies will consist of two main components. The first can be called the anti-crisis component. It will include measures dealing with monetary and exchange rate policies, fiscal policy, government debt and various distortions stemming from the crisis and state intervention. The second component is a strategic one, dealing with the necessary structural and institutional reforms to secure stable economic growth in the long run. Combining the two components in a balanced way will be a challenging task for the government.

Economic policy in the short run should be based on a clear understanding that the recently achieved stability and early signs of economic recovery remain fragile. Monitoring of national economic developments needs to be reinforced to detect and identify problems early on, making it possible for the authorities to react appropriately to them. For the same reason, economic policy should be based on realistic forecasts of no more than a moderate economic recovery in Ukraine, implying severe limitations on the country's ability to meet its financing needs. Hence, cutting government expenditure is inescapable.

Ukraine's reaction to the crisis should not be restricted to launching measures to improve its current economic situation but should also include reforms to secure the foundations for sustainable long-term growth. These policies should take into account elements such as a major rethinking of the role of the state in the economy, the appropriate degree and format of state regulation, and forms of state support for specific industries. The present circumstances are very challenging for the authorities, but at the same time they provide an all-important opportunity for implementing a set of reforms that could lastingly improve Ukraine's economic position.

Causes of the Economic Crisis in Ukraine

The blow to the economy was very sudden. As late as August 2008 the Ukrainian economy was booming, at an annualized growth rate of 11 percent, but output plummeted in October. By international comparison, only the three Baltic countries faced larger declines in GDP in 2009 than Ukraine. This raises the question why Ukraine was hit so hard by the crisis.

The immediate cause of the economic crisis in Ukraine was international contagion stemming from the global financial crisis. Ukraine was effectively cut-off from international financial markets after global liquidity dried up in September 2008 following the bankruptcy of Lehman Brothers. This is known as a sudden stop, with nobody in the private sector wanting to offer Ukraine any form of financing under any circumstances. The only available source of financing was from the IMF and other international financial institutions (World Bank and European Bank for Reconstruction and Development, EBRD).

The reason why Ukraine was hit much harder than almost all other countries was that the international financial community had no confidence in Ukraine's economic policy. An overheated economy had stoked inflation, which reached a peak of 31 percent on an annual basis in May 2008. Large currency inflows, which contributed to huge increases in the money supply, helped to sustain high inflation. Imports soared, eventually leading to an unsustainable deficit on the current account of the balance of payments of more than 7 percent of GDP in 2008. At the same time Ukraine's foreign debt rapidly accumulated to $103 billion, or 57 percent of GDP in 2008, adding to the country's vulnerability.

The fundamental cause of Ukraine's financial crisis was that the National Bank of Ukraine (NBU) kept the hryvnia de facto pegged to the US dollar under circumstances that called for a change in the exchange rate regime. Ukraine was caught in the "impossible trinity" of trying to combine a fixed exchange rate, free capital flows and an independent monetary policy, but if the exchange rate is fixed and capital moves relatively freely, a country cannot pursue an independent monetary policy, because a tightening of monetary policy by raising interest rates will attract capital inflows, rather than cooling the economy. An example may illustrate this process. Commercial banks in Ukraine could borrow at 6 percent in euros, while they could charge interest of over 50 per cent for certain consumer loans in hryvnia, thanks to a fixed exchange rate. Moreover, the NBU maintained a negative real refinancing rate which further stimulated monetary expansion.

Three additional factors rendered Ukraine vulnerable. First, unlike many Eastern European countries, Ukraine is not a member of the European Union and enjoys no neighborly protection. Second, Ukraine is highly dependent on cyclical steel exports, and it faced a sudden deterioration of its terms of trade. Third, foreign investors have little confidence in Ukraine's policymaking. Its messy politics singled it out as one of the first victims among emerging markets of the international financial crisis.

One of the most serious consequences of the crisis has been the dramatic deterioration of Ukraine's public finances. Traditionally Ukraine ran a small budget deficit of around 1 percent of GDP which kept its public debt at a modest level, but the deep crisis led the deficit to reach around 8.5 percent of GDP in 2009. This unsustainable fiscal position needs to be remedied and public finances to be placed on a sound footing over time.

In sum, Ukraine needs to conduct sensible monetary and exchange rate policies to ensure that a deep financial crisis does not recur. It also needs to eliminate its budget deficit over time to avoid a future fiscal crisis. In addition, supervision of banks and other financial entities needs to be strengthened and financial markets developed further.

Toward Inflation Targeting and an Independent Central Bank

For many years Ukraine pegged its exchange rate to the US dollar. The original purpose of the peg was to have a nominal anchor to contain inflation. However, from 2003 to 2008 inflation rose gradually, eventually reaching a very high rate. All along, the Ukrainian public kept a large share of its savings in dollars and as the exchange rate remained stable it felt no need for a switch into hryvnia. At the same time, bank loans denominated in dollars were cheaper than those in hryvnia, as they carried considerably lower interest rates. Households and enterprises did not fear a rise in the dollar as the exchange rate of the hryvnia had remained unchanged for years. As a consequence, the Ukrainian economy was highly dollarized with the public insisting on maintaining a fixed exchange rate.

By 2008 the persistently high inflation and even higher wage increases, left Ukraine with a very high cost level, making it difficult for the country to compete on the international market, as reflected in a widening gap between imports and exports. When international credit dried up on account of the global financial crisis, Ukraine's large current account deficit could no longer be financed. This left no choice but to devalue the overvalued currency. Being the only sensible solution, the need for a lower exchange rate was incorporated in Ukraine's letter of intent containing its request for a credit from the IMF.

In accordance with the agreement with the IMF, the NBU allowed the exchange rate to fall from 5 hryvnia to 7.70 hryvnia per dollar in October-November 2008. In an attempt to avoid a too rapid depreciation, the NBU continued to intervene by buying hryvnia for dollars from its currency reserves. The free market exchange rate touched 10 hryvnia per dollar in January 2009, but the rate recovered gradually and stabilized at around 8 hryvnia, without the NBU having to intervene. The depreciation was sufficient to restore Ukraine's competitiveness following which the current account turned around swiftly and was almost eliminated. But the depreciation also involved substantial costs. Ukraine's debt in foreign currencies rose sharply in hryvnia and many Ukrainian companies defaulted on their foreign debts.

However, contrary to popular expectations, inflation did not increase but came down to an annual rate of 12 per cent (December 2008 over December 2009) following the depreciation. This was due to the deep recession, a shrinking money supply and a return to a positive real interest rate. Ukraine's external position was further improved as about 80 per cent of its debt service falling due in 2009 was refinanced. With IMF disbursements of $11 billion in a year, Ukraine's reserves could be kept at $27 billion at the end of 2009. Despite these positive developments, Ukraine's financial situation remains fragile.

Ukraine needs to draw three main lessons from this calamitous event. First, Ukraine cannot afford to have a high rate of inflation and has to bring it down gradually to the low single digits by means of a suitably restrictive monetary policy. The inflationary expectations must be broken. Second, Ukraine should permanently abandon a fixed exchange rate system and should maintain a floating exchange rate. Third, the dollarization of the Ukrainian economy should be reduced by the NBU through a combination of a floating exchange rate, an inflation target and an adequate regulation and supervision of banks. This has been done successfully in many other post-communist economies. Poland, the only European country of significant size maintaining economic growth in 2009, provides a good example of a successful monetary and exchange rate policy, combining a floating exchange rate with inflation targeting managed by a fully independent central bank. Inflation targeting and control of inflation are impossible without an independent central bank.

In sum, the old policy of targeting the exchange rate and the associated too loose monetary policy have clearly failed to provide both price and exchange rate stability and needs to be replaced by a new strategy. Intervention in the foreign exchange market should be strictly limited to extraordinary circumstances and should never be used to try to prevent changes in the economic fundamentals from being reflected in the exchange rate. Moreover, to avoid the possibility of undesirable arbitrage the official exchange rate, as established daily by the NBU, should closely reflect the market rate.

Recommendations

1. In order to secure macroeconomic stability, it is essential to minimize potential conflicts between the government and the NBU. *The independence of the NBU needs to be reinforced and its governance improved*, as it is currently seen as being unduly influenced by both commercial and political forces. The NBU Council, whose role is unclear and is dominated by prominent business representatives and politicians, should be abolished in its present form, while the NBU chairman and his/her deputies should be given fixed terms. The political authorities should refrain from enacting legislation that impinges on NBU independence, such as proposals to finance various government expenditures by advancing the payment of NBU profits. The Ukrainian monetary policy should instead be governed by an independent Monetary Policy Committee consisting of independent professionals with well-defined powers and fixed terms. The NBU should also raise its professional quality and include prominent international expertise. A new law on the NBU reflecting these elements should be drawn up and adopted.

2. Ukraine needs to move toward *inflation targeting regime* within the next three years, which presupposes a floating exchange rate. The transition period should offer the NBU enough room to bring down inflation to the 2 to 3 percent range and provide guidance to the public on the future development of the exchange rate, as well as fostering a reduction of dollarization. In the meantime, the NBU should proceed expeditiously with streamlining its monetary policy instruments and its decision-making process.
3. During the financial crisis *currency controls* in Ukraine were reinforced. With the crisis abating, these controls can now be eased. Initially, Ukraine should aim at achieving convertibility of current account transactions, leaving capital transactions aside. However, many of the existing currency regulations contain unnecessary complications which should be abolished.

Balance the Budget in the Medium Term

Because of the financial crisis, Ukraine is facing a large temporary budget deficit, which needs to be eliminated in the next few years. The primary cause of the budget deficit is that tax revenues have fallen even more than GDP, which is natural in such a crisis. Tax revenues increased sharply in 2005 because loopholes in the tax legislation were closed and tax collection improved. A couple of significant loopholes remain, for individual entrepreneurs and agriculture, but Ukraine's corporate tax burden is already very high and tax administration stringent, while individual taxpayers escape thanks to the flat personal income tax of currently 15 percent and the simplified taxes for individual entrepreneurs.

Ukraine's public expenditures, however, have increased as a share of GDP during the crisis, and the political situation has not allowed the necessary fiscal corrective measures. In comparison with other countries at the same level of economic development, Ukraine's public expenditures are very large as a share of GDP.

The most urgent fiscal task is to close the budget deficit in the next few years by cutting unjustified and wasteful public expenditures. Three groups of public expenditures stand out. One is the price subsidies for gas, electricity, and coal, which are aggravating Ukraine's energy dependence, wastage of energy, and corruption. A serious concern is the extraordinarily large public pension expenditures of some 16 percent of GDP, the highest in the world and almost twice as large as the average public pension expenditures in Europe. Moreover, much of these funds are spent on relatively young and healthy people, who would not be entitled to pensions in European countries. A third is enterprise subsidies that are unjustified. If these three problems are successfully resolved, no other cuts in public expenditures would be needed. All politicians must realize that Ukraine has no room for larger social expenditures, and any attempt to raise them will only reduce economic welfare. The key principle of fiscal policies must be to live within own means. Yet direct transfers to citizens are always better than indirect through malfunctioning enterprises.

Another important fiscal task is to improve the tax administration for corporations as a matter of improved governance. According to the World Bank Doing Business index, on the arduousness of paying taxes, Ukraine is deemed to be one of the worst countries in the world. The number of tax payments must be radically reduced and simplified. It should be possible to do tax returns as well as pay taxes electronically.

Given Ukraine's financial requirements and the absence of international financing, the country has no choice but to rely extensively upon international financial organizations, primarily the IMF, in the short run. Since these credits are awarded if a set of specific conditions is met, the IMF has been a driving force behind recent Ukrainian reforms. However, Ukraine can only rely on IMF financing for a limited time, and it needs to prepare itself to this financing ending. When the country becomes financially sustainable, the cost of borrowing for both the government and Ukrainian companies will decline, but again that depends on the ability of the Ukrainian authorities to cut public expenditures.

The quality of the budget process could be seriously improved by expanding the time frame of budget planning. Then policymakers can concentrate on the outcomes of budget spending and make economic policies more result-oriented. International experience suggests that this aim can be achieved by implementing a medium-term expenditure framework. Such a multi-year budgetary approach links planning, budget policies, policy objectives, and budgeting in the medium term. It allows policymakers to balance short-term policy achievements against long-term needs for the country's development and increase the efficiency of the allocation of public funds. The Ukrainian government could prepare a medium-term expenditure framework after the crisis has faded away for the period of 2011-2013.

Recommendations

1. *Ukraine needs to balance the state budget in the medium term by cutting public expenditures.* The government should reconsider the obligations of the state in order to make them financially affordable. The authorities should resist any expansionary fiscal initiatives. Three public expenditures stand out as excessive: price subsidies, enterprise subsidies, and pension expenditures. Price subsidies and enterprise subsidies should be minimized, while pension expenditures need to be brought under control through a profound pension reform. It appears both unrealistic and harmful to try to increase the level of state revenues in Ukraine.
2. The first task of a new government after the presidential elections will be to *adopt a belated state budget for 2010.* For many reasons the budget deficit has to be significantly reduced, and this budget is Ukraine's chance to reduce public expenditures strategically, while the crisis still bites. The most important measure would be to increase gas and heating tariffs to limit the need for government subsidies to Naftogaz and other energy and utility companies to keep them afloat. Another important measure would be to gradually rein in pension expenditures, while improving the targeting of social safety nets to protect the most vulnerable households.
3. *Ukraine should adopt the draft Tax Code*. It is in good shape, and its adoption will bring clarity and stability to the tax system and facilitate tax administration.
4. *Further improvements in tax administration are necessary* more to improve governance than to increase revenue, as suggested by the American Chamber of Commerce and the World Bank Doing Business study. In particular, the management of value-added tax (VAT) refunds for exporters needs to be improved.
5. Ukraine should follow Russia's example of *introducing a unified social tax and include all the social funds in the state budget.* At the same time, the collection of taxes, including the social tax, should be concentrated at the State Tax Administration in order to improve and facilitate tax collection for both the state and taxpayers.
6. *Ukraine should adopt the draft Customs Code.* It is in good shape and its adoption will bring clarity and stability to the otherwise extremely cumbercome customs system and facilitate customs administration.
7. The government should further *expand the tax base by reducing tax privileges*, especially for agricultural producers and wealthy individual entrepreneurs. In particular, the new unified social tax should also apply to these subjects. At the same time, the government must abstain from reintroducing already-eliminated sector privileges.

Reform of the Financial Sector

From 2000 until 2008, Ukraine went through a tremendous monetization. The volume of money (M3) rose from 15 to 54 percent of GDP at the end of 2008. Most of this was bank lending from private banks to Ukrainian corporations and consumers. This big credit boom was the one of the drivers of Ukraine's high economic growth years.

The banking sector went through a major structural transformation as well. Banking requires a lot of capital, and Ukrainian banks did not have all that much capital at hand. Therefore, many big Ukrainian businessmen sold their banks to European and Russian banks. In order to receive a good price, they cleaned up their banks before sales, and the foreign banks improved the banks further. By 2008, foreign banks held about 40 percent of the banking assets. The sophistication of this open and competitive banking system led to Ukraine gaining its highest rank, 30 out of 183, on the World Bank's Doing Business index.

However, both foreign and Ukrainian banks were to a large extent financed through foreign credits. The combination of a sharp credit growth and its financing through foreign borrowing posed major risks to banking-sector stability. The banks as well as their customers suffered from major currency mismatches, with borrowing in dollars and more of the lending and revenues in hryvnia.

Therefore, it was no surprise that the liquidity shock of September 2008 and the ensuing hryvnia devaluation put many banks in jeopardy. Early on, a panic run on the banks took place, but the NBU managed to stall it by prohibiting people from taking out their deposits for two months. A total of eight significant banks have gone under. One was sold to a Russian bank, while the others have been taken over by the state and recapitalized. After the initial crisis the banking system remains under strain, but deposits have stabilized, signaling some return of confidence, while most banks have not resumed their lending. The stabilization at the aggregate level conceals significant differences between the banks—recently recapitalized state- and foreign-owned banks are generally gaining deposits, while domestic banks continue to experience significant outflows. The banks continue to reduce their credit portfolios.

Considering the severity of the financial crisis, it is impressive that the payments system did not break down as was the case for over a month after the Russian financial crash in August 1998. The 17 European banks with subsidiaries in Ukraine have all agreed not only to stay but to recapitalize their Ukrainian banks with $2 billion, and they have done so. The four big Russian banks have taken the opportunity of the crisis to expand their activities in Ukraine. The foreign-owned banks are the main cause of the 80-percent refinancing of Ukraine's foreign debt service in 2009, and they have contributed most of Ukraine's foreign direct investment in 2009.

By May 2009, the banking crisis seemed contained. The gap between lending and borrowing interest rates rose to slightly over 10 percent per annum, which offered the remaining banks excellent profitability with which they could balance their rising credit losses. The tentative outcome of the banking crisis is that of the ten biggest Ukrainian banks, only the largest remains private and Ukrainian-owned. Of the remaining nine, three are state-owned, four owned by European banks, and two by Russian banks. The state and Russia have advanced, while the share controlled by European held up, and private Ukrainian banks have shrunk substantially. So far, the desired consolidation of the Ukrainian banking system has not taken place, and credits are declining, but the banking system has survived.

Despite stabilization of the banking sector with improved liquidity position and restructuring external debt obligations, the banking industry has solvency problems. The ratio of non-performing loans has been growing steadily and might not have reached its peak as yet. Therefore, there is an evident risk of further bank defaults, and the banking sector will need additional capital to withstand the shocks ahead.

In all likelihood, the current crisis will substantially change the Ukrainian banking sector. First, European banks, Russian banks, and the state own a larger share of the banking sector, while Ukrainian-owned banks are largely small and medium-sized. Further consolidation is desired to strengthen the banks in the latter category. Second, the banks will be more concerned about currency mismatches in the future and limit currency lending to entities with no currency revenues. They will also become more cautious in taking foreign loans. Third, it will take some time before Ukraine's credit growth recovers, and a radical shift to lending in national currency is likely.

Many studies have shown that the financial sector plays an important role for economic growth, and it is quite impressive that not one single of Ukraine's 17 foreign banks have withdrawn from the country during the crisis but they have refinanced and recapitalized their subsidiaries in Ukraine, indicating that the widespread foreign bank ownership has been a stabilizing factor.

Further improvement of the banking sector is vital given its great importance in Ukraine, but the substantial improvements in this sector in recent years have almost entirely been driven by market forces in interaction with foreign companies, while the NBU has played a rather passive role. Therefore it would be rash to request that the NBU become all too active, but it does need to perform certain functions.

Stabilization of the financial sector is essential so that banks can restart lending to the real sector. In the medium term, financial-sector reforms should focus on developing local capital markets, consolidating and improving transparency of the banking sector, and unwinding state participation in failed systemic banks.

In the short term, banks remain all-dominant in Ukraine's domestic financial market. In the medium term, however, it is vital to develop Ukraine's stock and bond markets. The insurance market exists but is small, as is leasing. Private equity funds are reasonably large in Ukraine because of the small stock market. The development of domestic financial markets will increase the access of firms to capital for their development and give greater opportunities for investors. By becoming publicly traded at such markets, companies become more transparent and less involved in the shadow economy, thus becoming better taxpayers as well as more socially responsible. Such financial markets attract large foreign portfolio investments, which support economic growth.

Soon after obtaining independence, Ukraine created its own financial markets, but they remain rudimentary with very low liquidity for many reasons. Corporate raiding remains a major concern, and the best way of escaping that problem is not to have any minority owners, but then no stock trading is possible. Therefore, most companies have a very small free float, and the overall free float on the stock market is very small. A major cause of corporate raiding is poor and contradictory commercial legislation, which is why the Economic Code should be abolished and the Civil Code improved. Poor corporate governance in Ukraine allows majority owners to get away with the dilution of the shares of minority shareholders, transfer pricing, and other forms of asset stripping, and minority shareholders cannot be certain of their rights to their just share of the profits or dividends. Therefore, many of the traded Ukrainian stocks pertain to companies majority-owned by the state. Ukrainian companies have made large bond issues, but during the financial crisis scores of them defaulted. In 2009, Ukraine finally enacted the important Law on Joint Stock Companies. Hopefully, it has resolved many of these problems, but its actual effects remain to be seen.

Ukraine has two financial-market regulators, the State Commission for Regulation of Financial Services Markets and the State Commission on Securities and Stock Market. Both are weak, and the government should consider merging them into one single regulator of financial markets and reinforce it with powers and resources. In any case, their political and financial independence should be reinforced and their professional competence enhanced. Until 2009, the stock market was dominated by one stock exchange, which was not very dynamic. Stock market turnover in Ukraine increased substantially when a new stock exchange in Kyiv was established and quickly became the dominant trading center.

All these problems result in very low liquidity of the markets for Ukrainian stocks and bonds. The compounded risks and problems mean that prices of both stocks and bonds are very low, and the market is stuck in a low liquidity trap. When Ukrainian companies have sold their stocks on a stock market, they tend to do so in London, Frankfurt, or Warsaw rather than Ukraine. Ukrainian corporations should certainly be entitled to stock sales abroad, but the domestic regime should be reformed so that the Kyiv stock exchange can attract more stock trade.

Financial markets can improve only gradually, although given their currently depressed level prices may rise quite sharply. After all, the Ukrainian stock indexes doubled in 2009. Currently, gains from investments in stocks and bonds are taxed unlike from bank deposits. This taxation should be leveled, and all capital gains should be taxed equally. After the stabilization of the insurance market, the insurance companies should be taxed as other financial companies.

In the next few years, a large number of financial laws should be amended or adopted, but this is hardly a priority for 2010.

Recommendations

1. *Recently nationalized banks should be privatized.* In the midst of the crisis, the state banks have assisted the government in various rescue operations. This should not remain a practice after the crisis has abated, and the authorities should wind down these emergency measures and let the two old state banks, Oshchadbank and Ukreximbank, revert to their old roles of being specialized state banks. The government should restructure the banks that have been de facto nationalized because of default and prepare them for early privatization after the crisis.
2. An important task is to expand the supply of equities on the Ukrainian stock exchanges. Then the demand for other improvements will follow from the market. The most effective short-term measure might be to *force state corporations to increase their free float to at least 20 percent*. This would increase the supply of stocks and the transparency, and thus increase liquidity, which should result in higher prices as well. Before selling their stocks, however, state corporations should be compelled to improve their governance and subject them to international auditing. As these stock sales would amount to privatization, the government would benefit from more cash from privatization. The overall market value of public companies would rise, which would also facilitate further privatization.
3. The government should consider merging two regulating bodies (the State Commission for Regulation of Financial Services Markets and the State Commission on Securities and Stock Market) into one single regulator of financial markets and reinforce it with powers and resources.

Chapter 4
Microeconomic Policy: How to Improve the Business Environment

After the collapse of the Soviet Union, Ukraine launched its market economic transformation, but the reform process was slow and haphazard. The regulatory system remained incomplete, and the many market distortions bred corruption. The vested interests that thrived on corruption grew entrenched. Consequently, a very poor business environment has been the scourge of the post-Soviet Ukrainian economy.

External Anchor: Advance on the World Bank Doing Business Index by 40 Points!

The World Bank Doing Business index, which assesses the business environment on ten measures, shows this clearly. It ranks Ukraine as low as 142 out of 183 countries, below Ukraine's ranking in terms of wealth and far below its level of human capital. Particularly arduous are construction permits and tax payments, where Ukraine ranks 181st. It also does very poorly on the measures of starting and closing a business, registration of property, and trading across borders, while its labor market functions quite well. Similarly, the anti-corruption watchdog Transparency International ranked Ukraine 146 out of 180 countries on its 2009 corruption perception index.

The Doing Business index offers good advice on what to improve. Ukraine should set the goal for 2010 to advance 40 positions on this index. Several post-Soviet countries have made extraordinary achievements. For many years, Estonia was among the 20 best. Incredibly, Georgia skyrocketed 94 positions in two years from 112 in 2006 to 18 in 2008, while Azerbaijan jumped 59 places in a single year from 97 in 2008 to 38 in 2009. These accomplishments show that post-Soviet countries can advance by leaps and bounds. They also suggest that it is easier to make radical changes than to just tweak old bureaucratic procedures. It is better to abolish a futile routine than to improve it. Such achievements may be simpler in small countries with less complex administration, but the Ukrainian government should concentrate its efforts on Ukraine's six greatest weaknesses: obtaining construction permits, paying taxes, starting a business, closing a business, trading across borders, and registering property.

One of Ukraine's most important and complex tasks today is to complete the institutional reforms to improve the business environment for further economic growth and investment. The regulatory policy should remove existing barriers to business, create attractive conditions, and open the Ukrainian economy to entrepreneurs. These reforms are vital at this stage of economic development, when the promotion of entrepreneurship is crucial to success.

Deregulation: Key to Economic Growth

The Ukrainian business environment is not very attractive because both current legislation and regulatory practices preserve multiple barriers that hinder entrepreneurship. Conflicts of interests between the state bureaucracy and business are strong and pervasive. The bureaucracy has an interest in preserving these barriers because they reinforce the bureaucrats' power and administrative control over enterprises and generate multiple lucrative opportunities for corruption and extortion.

Incumbent businessmen do not necessarily suffer from corruption and obstacles to business. It causes them trouble and costs them money, but it reduces the competition they have to face. Large companies are particularly likely to benefit from the harassment of potential competing startups, which allows them to charge much higher prices.

The big losers are the consumers, who have to pay higher prices because of restricted competition at the same time as their incomes are lagging behind because corruption impedes economic growth. To make a decisive break, the bureaucracy that has a material interest in corruption must be beaten or co-opted. Therefore it is usually easier to carry out a radical deregulation in one area rather than a piecemeal one, but no government can challenge the whole bureaucracy at once.

The barriers to entering the market are multiple. They involve registration, licensing, permits, and outright extortion.

Enterprise registration. In recent years, the system of business registration has improved materially: State registers of entrepreneurs have been created as well as a large network of registration offices. A simplified procedure of document submission for one-stop registration has been launched. However, working hours at registration offices are short, limiting accessibility, and the excessively large list of documents required causes considerable preparatory work for entrepreneurs.

Licensing. The extent of licensing demanded for enterprises remains needlessly wide. Activities that pose no danger to human health or life, environment, or national security are subject to licensing. In many cases, licensing serves purely bureaucratic purposes—to control entrepreneurs to the benefit of the licensing agencies. Complicated procedures and redundant requirements of documents, which entrepreneurs must submit to obtain licenses, aggravate the barriers, hampering the start of a business and breeding corruption.

Permits. A cumbersome system of granting permits is another barrier against starting businesses activities. This is the sphere of the greatest corruption. Current legislation allows multiple public agencies to set individual requirements for the acquisition of a business permit and to determine procedures and timelines for the issuing of permits. Technical regulations sometimes force entrepreneurs to abandon their business activity.

Sales of paid state (administrative) services. In recent years, ministries and other state bodies have developed the practice of delegating powers to various enterprises to "sell" paid services to handle various permits with state agencies. This requirement of a middleman often amounts to legalized extortion. Sometimes public authorities fix the fees for these services, but often private enterprises delivering such services are entitled to set their own prices. The government should not require the use of private middlemen. It should eliminate its demands for such services. If necessary, state agencies should carry them out for fees fixed by the central government. The government's demand for "paid services" increases entrepreneurs' expenditures for starting a business, reduces budget revenues, and breeds corruption.

After a businessman has successfully managed to register and establish his enterprise, he encounters other state impediments such as inspections and poor access to infrastructure.

Inspections. Multiple central and local state agencies are entitled to carry out both planned and unplanned inspections, which have always posed severe problems for entrepreneurs. Therefore, in 2007, legislation was adopted to fundamentally reorganize the supervision of enterprises, but the inspection agencies delayed the preparatory work so that the transition to new inspection standards has not been completed. Because of the economic crisis, the Cabinet of Ministers introduced a moratorium on planned inspections until December 31, 2010 (except enterprises subject to great risks), and unplanned inspections are limited to violations of legislation by an enterprise. However, this solution is only temporary; excessive inspections must be stopped permanently.

Access to infrastructure. State monopolies control enterprises' access to water, sewage, electricity, gas, and railway and pipeline transport. They often refuse access on no legal grounds, unless the enterprises pay up huge bribes.

The entrepreneurs are not altogether defenseless. To date, the best defense has been simple and minimal contact with the authorities, while institutional support and public control remain poor.

Simplified taxation for small entrepreneurs. The most successful deregulation of entrepreneurship has been the widespread system of simplified accounting, reporting, and taxation that was introduced in Ukraine in 1998. Small businessmen pay either a low lump-sum tax or a simple turnover tax. This system applies to millions of small entrepreneurs and their employees, who have thus managed to weather the otherwise arduous business climate. However, many entrepreneurs with substantial incomes also pay very small taxes, implying that the simplified tax system is unfair. Clearly, certain well-paid professional activities should be excluded from the simplified tax system. The lump-sum tax has not kept up with inflation. Most of the entrepreneurs do not pay social security taxes, which means that their future public pensions will be minimal, and the state pension fund is poorly financed. Still, simplified taxation must be maintained on a large scale for small entrepreneurs to safeguard their survival in an otherwise difficult business climate. We recommend establishing a legally binding single list of all the economic activities performed by small enterprises eligible for the simplified taxation and reporting to be approved by a separate law valid for the whole country.

Institutional support. The State Committee of Ukraine for Regulatory Policy and Entrepreneurship has been the driving force behind the liberalization of government regulation of small enterprises as discussed above. It remains the most forceful advocate of small entrepreneurs, and its role in policymaking to their benefit is vital. It should function as the ombudsman of small business both within the government and in relation to other state agencies.

Protests, liability, and public control. Ukrainian businesses have limited possibilities to protest or demand accountability of civil servants in courts or otherwise. Enterprise associations are not part of government policymaking and are not very effective defenders of businessmen. Public discussion of drafts of legislative acts is rare. Entrepreneurs have instead started to take to the streets in protest to defend their interests and pressure officials.

Recommendations

To facilitate entrepreneurship, Ukraine needs to urgently carry out a profound regulatory reform in 2010. The main risk to such reforms is the strength of the corrupt vested interests that benefit from the current environment. Therefore, the focus should be on simple and radical measures in each sphere, drastically reducing contacts between entrepreneurs and bureaucrats, strict regulation without legal ambiguity, and full transparency of all procedures.

1. *Starting a business* currently requires ten procedures that take 27 days, according to the Doing Business in Ukraine report. This process should be reduced to one procedure: registration of the business with the tax authorities and receiving a taxpayer number. It should take only one day and cost nothing as is the case in New Zealand. No enterprise registry beyond the tax authorities is needed. All other procedures should be eliminated.
2. A new law on the *liquidation of enterprises* is needed to minimize the time needed as well as the cost, while maximizing the recovery rate.
3. *The issuance of construction permits* is exceedingly difficult in Ukraine. The aim should be to simplify the process from 30 procedures to a small fraction and reduce the time required from 476 days to a small fraction. Essential permits should issued by the city architect, whose powers should be extended to all city planning functions. A city should provide all necessary services such as electricity, gas, water, and sewage after approval of construction by the city architect. Ukrainian cities need to organize themselves to provide services rather than forcing each applicant to run around trying to organize the city.
4. Procedures for *registering property* can be reduced from ten to probably three. A sales contract of property should include both building and land. The contract should only need notarization and be registered in the real estate property registry and the state land cadastre.

5. The list of economic activities subject to mandatory *licensing* should be minimized to only those that are dangerous to human health and life, environment, or national security. A new Law on Licensing should establish firm legal limits of licensing.
6. The requirement of official *permits* should be reviewed and limited to an exclusive list of economic activities, which should be sanctified by law. Authorization procedures should be simplified for fire safety and construction. As long as they are not too expensive, EU technical standards should be introduced lock, stock, and barrel.
7. The government should sharply *reduce the number of agencies entitled to undertake inspections*. Also the number of legitimate reasons for inspections should be slashed. Essentially, enterprise inspections can be justified only for the purpose of safeguarding life and health. All obsolete, bureaucratic, and unjustified requirements motivating planned inspections should be eliminated.
8. The government should introduce legislation on *equal and non-discriminatory access of entrepreneurs to the services of natural monopolies*, including electricity, gas, water, sewage, railroads, and pipelines. Any baseless rejections would make the culprit legally liable to pay damages.
9. Ukraine needs to adopt a *Law on Limited Liability Companies*.
10. The government should establish a list of all *services* that the authorities are obliged to deliver to entrepreneurs free of charge, which should be freely accessible on the web. Similarly, the government should establish a register of public paid services and their prices or a single methodology of how to calculate their prices.
11. A separate law should *list all the economic activities eligible for simplified taxation, accounting, and reporting*, which will prohibit local self-government authorities and local tax inspectorates to limit the number of activities eligible for simplified taxation, accounting, and reporting at the local level.

Privatization Must Be Revived

Privatization has been one of the most important post-socialist reforms. Arguably, all economic successes of post-Soviet Ukraine derive from the private sector, which has delivered virtually all economic growth and qualitative improvements. But privatization has not been completed. Until 1998, programs of small and mass privatization were carried out. In 2000, the authorities announced the privatization of strategic industries and natural monopolies, which immediately turned into an uncontrolled process of sales of select big state-owned companies to big, politically well-connected domestic businessmen. In recent years the political situation has paralyzed privatization.

Privatization crisis. Privatization in Ukraine has stopped since 2005. In 2004, 1,236 state properties were sold, but only 282 in 2008 and 173 in the first nine months of 2009. Only one strategic company, Kryvorizhstal, was privatized in this period. Most of the privatized property were small enterprises or unfinished construction projects. The focus was on selling state property at high prices, which left unattractive property in state hands: small blocks of shares, loss-making enterprises, and land plots under privatized properties.

Unsatisfactory institutional framework for privatization. Since 1992, the State Property Fund of Ukraine has managed privatization, but it has been operating on the basis of temporary regulations because the parliament has failed to adopt a law on its status. The main problem is that the Fund is subordinate both to the president and the parliament, causing permanent administrative conflicts and leaving the fund without clear responsibilities or accountability. The chairman of the State Property Fund ought to be an ordinary member of the Cabinet of Ministers as in other countries. Another problem is that the Fund is responsible for both privatization and the management of state property, which creates a conflict of interest. While most chairmen have seen themselves as ministers of privatization, others have acted as managers of state property. To speed up privatization and eliminate this conflict of interest, these two functions should be divided.

Increasing national risks from privatization. As privatization proceeds, the share of controversial entities up for privatization increases. They include strategic branches, such as the military-industrial complex, the energy sector, science, natural monopolies (railways, telecommunications, utilities, and postal service), and the social sector (education, health care, and culture). Given weak government regulations, the transfer of such assets to private ownership poses considerable risks to national security, national economic interests, and mass consumption.

Rising investor risks. Privatization in Ukraine has been a permanent political battle. As a consequence, privatization plans are revised all the time, and privatization auctions for strategic enterprises are regularly cancelled. Privatization has lost much of its appeal to both domestic and foreign investors. The demand for property to be privatized, and thus their prices, has fallen as businessmen reckon that the political risks are excessive. Few believe that an announced privatization will actually take place, and even fewer believe that the winner in an actual privatization will be allowed to keep his property.

Other means of seizing state property. While formal privatization has stalled, interest in acquiring state property remains. The state does not actually control most of the formally state-owned property. Often enterprise managers or private businessmen tap the cash flow or strip assets from a state company, leaving even less owned by the state. Such operators seize effective control over the cash rights of the enterprise, but they have no interest in investing in or the future value of the enterprise, since they do not have control rights, that is, they are not allowed to sell the state enterprise to their own benefit. Fictitious bankruptcy of state-owned companies is a common method of finishing this process and transferring the property to the creditors, who are often connected with shadow owners.

Vulnerable property rights. In recent years, the list of commitments demanded from purchasers of state-owned companies in investment tenders has become longer. These commitments are non-transparent since they are difficult to evaluate. Failure to carry out these commitments has legal risks. These requirements undermine the resulting property rights, which can always be questioned, and they reduce the price of properties to be privatized, thus slowing down privatization. Therefore, the conditions posed on a purchaser of privatized property should be reduced to the sheer minimum. Instead of investment tenders, the state should simply auction off property.

Limited property rights in agriculture. Privatization of agricultural land has not been completed because of a moratorium on the private sale of agricultural land. As a consequence of this limitation of property rights, the value of agricultural land is artificially depressed to the benefit of those who now lease large tracts of land, while six million small holders cannot obtain a decent price for their property. Another consequence is that land cannot be used as collateral, which prevents farmers from taking bank loans. Naturally, land transactions are impeded under these conditions, and one-quarter of the agricultural land is allegedly lying fallow, while property conflicts abound. The obvious solution to these unnecessary problems is to finally legalize private sales of agricultural land, which will allow Ukrainian agriculture to flourish.

Recommendations

One of the most important conditions for the renewal of the Ukrainian economy after the crisis is to restart large-scale privatization, which would attract private capital for increased production and investment. It would also decrease the public costs of chronically unprofitable state enterprises, while boosting state revenues through sales but even more so through larger tax payments by well-functioning private companies and their employees. To overcome the crisis in privatization, a political decision should be made to complete it. This goal would be understood by the public and would safeguard the dynamics of privatization.

1. The parliament should *adopt a State Privatization Program for 2010-2012*, amounting to a political decision to complete privatization. The boundaries of the public sector should be defined and all the enterprises and properties singled out for privatization specified. To reduce the risks to national interests, clear lines should be drawn on what must not be privatized.
2. The parliament should *enact a Law on the State Property Fund of Ukraine*, which would separate privatization from state property management into two different bodies, subordinating both solely to the Cabinet of Ministers. A specialized state management agency should be formed that would exercise the powers of the state as an owner.
3. Private sales of agricultural land should be legalized.
4. The time of mass privatization is over, and *future privatizations will have to be through sales.* The state should pose a minimum of demands on investors and avoid special methods of privatization in order to make these sales legitimate and to maximize the possible prices, as well as secure the property rights of the winner. Maximum transparency and publicity should be maintained to reduce corruption. All privatizations should be announced in mainstream media well in advance to offer all investers equal opportunity. Unprofitable enterprises and unfinished construction projects should be auctioned off to the highest bidder without any minimum price, as state ownership of such entities only burdens the state with unnecessary costs. The government must guarantee property rights after a privatization. The reasons for canceling a privatization must be clearly defined in law and such cancellations highly restricted.
5. *Foreign investors should be allowed to participate* in all privatizations that are not specifically restricted by law for national security or public interests.
6. The remaining small state blocks of shares in otherwise privatized companies should be sold off. They could be sold either to the main owners or on the stock market to expand the free float. *The state should sell shares of large state corporations to increase the free float in these companies* to at least 20 percent of all shares to stimulate the domestic stock market, to improve corporate governance and transparency, and to raise the market value of the state companies.
7. *Enterprises and real estate should be privatized together with the land plots* on which they are located. Similarly land plots on which already privatized enterprises are situated should be sold off.

Improve the Management of Public Property

Ukraine's public sector has been formed spontaneously as a residue of privatization. In contrast to many other former socialist countries, Ukraine has no formal concept of what should remain in the public sector. For many years the management of public property aimed primarily at privatization. Only in recent years has public property management become a separate function, and the Law on the Management of State-Owned Property was adopted in 2006. However, this law did not prescribe any specialized management of public enterprises. It only documented the functions and procedures that had emerged spontaneously.

The public sector is too large. State ownership still dominates the military-industrial and energy complexes, the natural monopolies (railways, pipeline transportation, utilities, post, and telecommunications), science, and the social sector, but many other enterprises are also state-owned. The state endures an enormous burden as owner of malfunctioning and loss-making companies. It continually subsidizes chronically unprofitable sectors and many large enterprises. The financial crisis has further expanded the public sector through the nationalization and state recapitalization of banks.

Obsolete governance. No less than 86 percent of all state-owned enterprises are ruled by the old Soviet enterprise statutes. The Soviet state enterprises are a legal relic that should be liquidated. It offers no control over the manager of an enterprise, but the managers are dependent on public servants in the ministerial hierarchies. This system involves no proper supervisory function or transparency. The state has no control and managers cannot be held accountable for economic performance. The Economic Code is built on the old Soviet state enterprises which it conserves and it legalizes and perpetuates arbitrary state intervention in the market. Therefore, it has to be abolished and all the state enterprises have to be transformed into the joint stock companies or limited liabilities companies.

All these state enterprises should be transformed into joint stock companies regardless of whether they stay public or are privatized. The large state corporations that have been transformed into joint stock and holding companies—comprising 60 percent of the state's corporate property—are unmanageable, inefficient, and non-transparent conglomerates. These corporate supervisory boards are populated by civil servants, who sit there ex officio, which involves a conflict of interests, as civil servants are tempted to rule to the benefit of corporate interests.

The remaining state corporations should be given economic freedom and protection against arbitrary administrative interference by prohibiting civil servants from holding positions in the supervisory boards of such corporations. Their clearly stated goals should be to work for profit, while public interests have to be protected through regulatory requirements but not direct intrusion by civil servants into the economic activities of a state corporation. Efficient management of any corporations presupposes a clear division of functions between the supervisory board, which should act in the interest of the owner, the management that should run the company to maximise its profit and value, and state agencies that should regulate it.

Absence of specialized management system. Management of state-owned property is dispersed among multiple public agencies, for which enterprise management is only a secondary function. The combination of the large number of public enterprises and dispersed government responsibility contributes to poor public-sector management.

Conflict of interests. The current public management system does not separate two contradictory powers of the state: 1) as an owner, the state should be interested in the efficiency of these enterprises and the maximization of their revenues and profits; and 2) as the representative of society, it should regulate their behavior in the public interest. The performance of these mutually exclusive functions by one administration body, the absence of effective supervision, and the existence of the Soviet administrative culture result in the dominance of branch interests in management. The main interest of the state should be regulation, not enterprise management. The mixture of management and regulation means that neither function is properly performed.

Poor incentives, no responsibility, and no public control. The state is represented by government officials, for whom oversight and management of state companies is a minor function. They have neither incentive, capacity, nor responsibility to carry out effective oversight. In fact, professional management of state-owned enterprises is absent. Public property is managed with no transparency and little public control. Even large public corporations can refuse to publish annual reports, and no effective requirement for independent audits exists. The public has no access to information about the economic results of public companies and no opportunity to influence the management of large state-owned companies.

Recommendations

The public sector is seriously impeding economic growth in Ukraine and may restrain the pace of economy recovery. It is characterized by minimal incentives for economic efficiency and is closed to private investment. It overloads the state with management and patronage functions, which divert administrative energy and budget resources so that the state cannot carry out its key tasks of economic revival and social reforms. The post-crisis reforms must aim at considerably reducing the size of the public sector. Yet for the remaining state corporations, the state needs to establish an orderly management system. In the first year after the crisis Ukraine needs to develop a concept to reform the public sector and neutralize its most harmful aspects.

1. *The Economic Code should be abolished.*
2. *A concept for the management of state-owned property* needs to be elaborated. It should identify the boundaries of state-owned property and the principles for the management of public enterprises. Limits should be set to protect economic independence and national security. These principles should guide the preparation and adoption of a new Law on State Property Management.
3. The state enterprises that will remain state-owned should *be transformed into either joint stock companies or treasury enterprises*. No enterprise should be left in its old Soviet legal form.
4. *The large state conglomerates Naftogaz Ukrainy and Ukrzaliznytsia need to be restructured.* They should be broken down into manageable entities, which should be corporatized separately. Each joint stock company should be given proper corporate governance with international auditing. A clear policy should be established for what parts of these companies should stay in the state's hand to safeguard consumers and national security. The other parts should be privatized.
5. The *management of state enterprises* should not be political or bureaucratic but a *professional* business activity. Corporate management should be based on EU and OECD standards:
   - to ensure full transparency of the companies and free access for the general public to information about the companies;
   - to introduce independent audits of all public companies, which can arouse public trust in state management;
   - to resolve corporate raiding and prevent state property from being taken over illicitly.
6. *The supervisory boards of large public corporations should be formed by competent professionals* of high standing and should include independent directors who represent the public and are respected within the community.

Level the Playing Field for Competition

The conditions for competition in the Ukrainian market have never been particularly propitious, and public competition policy is lagging far behind market economic transformation. It does not protect or support competition and is incapable of limiting monopolization of many markets. Five risks stand out: private cartel collusion, discretionary state aid, inefficient public procurement, distortive natural monopolies, and misdirected anti-monopoly policy.

High risks of private cartel collusion. Informal cartel agreements are widespread on various goods markets. Big business groups sometimes make such agreements in collusion with the state bureaucracy. Seemingly groundless but synchronized price rises have occurred for fuel, metals, sugar, and in the last two years in private grain storage. Allegations are often made about such monopolist practices but are difficult to prove. The commercial gains of the culprits far exceed the potential costs of sanctions foreseen by legislation, and the risk of punishment is minimal.

State aid. State actions, notably through state aid and public procurement, significantly thwart competition in Ukraine. The country has neither legislation nor any agency to regulate state aid, which is distributed in a haphazard and non-transparent manner. State aid is mostly given as grants and is not audited. Discretionary state aid causes unpredictable burdens on the state budget, while greatly distorting market competition. The government has increased state support significantly during the crisis, as subsidies to usually unprofitable sectors, such as agriculture and coal mining, have increased. The government has also given anti-crisis support to mining, metallurgy, and chemical industries through preferential prices of fuel and energy, which in turn has necessitated financial support to state-owned companies in the fuel and energy sector. Also, armaments and machine-building have received anti-crisis subsidies. This state support has caused a risk of WTO sanctions against Ukraine and anti-dumping investigations in the steel industry. State aid should be quickly reduced as the crisis abates.

Public procurement. The large public sector prompts extensive public procurement. Ukraine's old law on public procurement regulated procurement, but its procedures were far too complicated and generated excessive bureaucracy, which bred corruption. Therefore, it was canceled in March 2008. The *Verkhovna Rada* needs to adopt a new, sensible law on public procurement based on transparency and open competition.

Natural monopolies. The state monopolizes markets even when these markets are not so-called natural monopolies. Strong public companies, which comprise almost all enterprises of one industry, dominate these markets. The two main companies are Naftogaz Ukrainy, which controls almost all production, transportation, and distribution of natural gas and oil, and Ukrzaliznytsia, which runs nearly all rail transportation of freight and passengers.

The distortions caused by the natural monopolies are aggravated by their state monopoly. Regulatory bodies are still missing for transportation and housing utilities, and the existing regulatory agencies are weak, allowing natural monopolies to price their products and services arbitrarily, and cross-subsidization is the rule. These big state companies include a large number of non-core businesses, which artificially extend state monopolies into markets that should be free and competitive. The opacity of these state companies offers their managers unlimited opportunities to reap monopoly rents and transform these profits into private wealth. The natural monopolies rarely transfer any profits to the state treasury as they are supposed to do.

Institutionally weak Anti-Monopoly Committee. Ukraine does not yet have any real competition policy, which is reflected in the actions of the Anti-Monopoly Committee. It mainly issues permits for enterprises with some local economic concentration but no monopoly. This activity amounts to misdirected and harmful bureaucratic interference, which actually reduces competition. Real market distortions and monopolies, by contrast, attract little attention from the Anti-Monopoly Committee, which does not have sufficient powers to reveal or prevent unlawful anti-competitive actions. It reacts only to blatant infringement of competition or acts on instructions from the Cabinet of Ministers of Ukraine to limit price hikes for certain products such as fuel, sugar, and meat.

Recommendations

The main aim of competition policy should be to level the playing field and stimulate competition. Urgent actions in 2010 should be to adopt a law on state procurement and another on state aid to eliminate distortive anti-crisis policies, form a new competition policy, and regulate natural monopolies.

1. The parliament should *adopt a new Law on State Procurement of Goods and Services*, which should incorporate EU requirements and standards. State procurement must be transparent, open auctions. For this purpose, it is vital to develop a modern online system based on the best international practice. An independent state agency should oversee public procurement.

2. The parliament should *adopt a new Law on State Aid*, which should incorporate EU requirements and standards. State assistance should be exclusively in financial form without any interference in pricing by the Cabinet of Ministers or ministries. State guarantees or credits to be reimbursed are preferable to grant assistance.

3. In 2010, the government should rationalize and gradually *phase out its emergency support to various industries* during the economic crisis. First of all, the government should eliminate all

price interference. It should wind down its support for mining and metallurgy. It should start privatizing the remaining state-owned coal mines, while liberalizing coal prices and eliminating state subsidies. Instead, the government should offer social compensation. It should also minimize assistance to the chemical industry because of gas price hikes.

4. Ukraine needs to *form a real competition policy*. A first step would be to prepare and adopt a Code of Competition Procedure, which should integrate and generalize competition policy rules. The competition policy should aim at investigating real monopolies and violation of free and fair competition in both private and public sectors. Enterprises should no longer have to go to the Anti-Monopoly Committee to ask for permission to start operations. The powers and competence of this Committee to investigate anticompetitive behavior should be reinforced, and criminal liability for serious cartelization should be introduced.
5. *Regulation of natural monopolies* is a politically and technically complex process that will take years to complete, but it can be initiated. To begin with, independent regulatory agencies should be formed for all natural monopolies, including transportation and housing utilities. Cross-subsidization of economic activities should be phased out, especially in the energy sector, through price adjustments. Large state corporations should not be allowed to monopolize markets that cannot qualify as natural monopolies.

Chapter 5
Reform of the Energy Sector

The paramount tasks in energy policy are to ensure stable energy supply, develop Ukraine's energy production, raise the country's energy efficiency, and enhance energy security. Accomplishment of these tasks demands a market economic environment in the energy sector, with the transformation of pricing policy, enterprise restructuring, improved governance, and introduction of a competitive market.

The Ukrainian energy sector is riddled with such serious problems that it receives its own chapter in this action program report. First, the Ukrainian economy is one of the most energy intensive in the world because of the very low prices offer no incentives to invest in energy saving. In the next five years, Ukraine should be able to cut its energy consumption by half relative to GDP, as Poland and Slovakia have done. Then, Ukraine would not need to import any natural gas. Second, current energy pricing subsidizes imports and penalizes domestic production, which boosts imports at the expense of domestic energy production. Third, the energy sector has probably been the main source of corrupt incomes in Ukraine. Fourth, because of the poor management of the energy sector, energy supplies are not sufficiently secure. Fifth, Ukraine has been losing transit business because of its poor reputation as a reliable transit country. The worst problems pertain to the gas sector, and the electricity sector is highly dependent on gas supply. The coal sector has its own problems. Oil trade is reasonably free, though oil pipeline transportation, ports, railways and terminals suffer from similar problems as gas pipelines. The energy sector is probably the biggest source of waste and corruption in the Ukrainian economy.

To resolve these problems, a fundamental reform of the energy sector is necessary. The key object of reform must be Naftogaz Ukrainy. Several reforms should be pursued in parallel. Naftogaz Ukrainy should be divided into several separate companies. Production should be separated from transportation. Non-core activities should be sold off. The remaining state companies should be given proper governance with professional, competent supervisory boards, including independent directors, and international auditing of annual reports should be made public. All energy prices should be raised to a level that will cover the costs of production plus a competitive profit margin. All price subsidies and cross-subsidization should cease, while social compensation should be provided for truly needy groups. The pipeline system should offer equal access to all at market-related prices. Over time, producing companies should be sold off. Private investment and competition in the oil and gas sector in Ukraine should be given legal protection. However, all these reforms have to be undertaken gradually and coordinated, as has been proposed by the European Union (EU) because presently, Naftogaz has such large debts and liabilities that it would go bankrupt if it lost its profitmaking parts. Its creditors need to be consulted during its restructuring. Gas reform can deal a major blow to corruption; reduce Ukraine's need for gas imports, turning its current account into surplus; improve state finances; and guarantee Ukraine's energy security.

The energy sector harbors large commercial and bureaucratic interests, and any reform will hurt some of these interests. Therefore, a newly elected president needs to act fast and hard to accomplish energy reform, and Ukraine needs international support to carry out these complex reforms. The EU has engaged very constructively through its agreement with Ukraine on reform and investment in the Ukrainian Gas Transit System. Gas reform should be carried out on the basis of this agreement, which is also supported by all the international financial institutions and the United States. Gas reform should include investment to modernize the Gas Transit System and generate energy savings.

One important purpose of gas transit reform is to make Ukraine attractive as a reliable transit country. Ukraine is making large revenues each year on gas and oil transit, which gives the country a large surplus in its service balance of payments. At present, many pipeline projects are threatening to bypass Ukraine and reduce its market share: Blue Stream-2, Nord Stream, South Stream, and Nabucco for gas and the Baltic Pipeline System for oil. Ukraine has a vital interest in protecting and increasing its transit volumes and therefore income, and it must first prove itself as a reliable transit country.

A patent threat to Ukraine's position as a seller of transit services has been its poor relations with Russian Gazprom. The Ukrainian-Russian ten-year agreement of January 19, 2009, on supply and transit of gas made great advances toward transparency, elimination of a middleman, and market-oriented pricing and thus toward more stable gas relations with Russia. However, the volumes assigned in the agreement were far too large. They have been renegotiated for the first two years of the agreement, but it would be desirable to reach a more stable and flexible solution.

Recommendations for the Entire Energy Sector

1. The government should develop a *realistic energy pricing policy*. The Ukrainian government has agreed with the International Monetary Fund (IMF) that gas prices for all categories of privileged consumers of natural gas, electricity, and coal should be increased by 20 percent a quarter until they reach a cost recovery level. The abolition of all these price wedges will eliminate a major source of corruption, thus laying the foundation for energy efficiency. All energy prices should be brought to the level of full cost recovery plus a profit margin for operators as soon as possible.
2. The Cabinet of Ministers should draft and the parliament adopt the *Law on the National Energy Regulatory Commission of Ukraine* to reinforce and unify the regulation of all natural monopolies in one strong and competent independent regulator. It should control pricing of services provided by all natural monopolies, ensuring a balance of interests between producers, consumers, and state. It should guarantee reliable supply of high-quality services to consumers at fair prices, while making sure that the natural monopolies can make sufficient profits to be able to develop.
3. At the same time as the price hikes, the Cabinet of Ministers should introduce a new *system of targeted social assistance* for the least protected groups of consumers who suffer because of high gas, electricity, and coal prices.
4. *Energy saving.* Ukraine needs to elaborate, adopt, and implement a program for energy saving. The country should continue to engage in the sale of carbon emissions rights under the Kyoto Protocol and encourage investment in energy-saving technologies.
5. *Investment opportunities in the oil and gas sector in Ukraine must improve* for both domestic and foreign investors. At present, only a few, mainly small, private energy companies are producing oil and gas in Ukraine, besides subsidiaries of the state conglomerate Naftogaz Ukrainy. Although Ukraine has substantial oil and gas assets, its oil and gas production has been stagnating for many years. Moreover, vast gas assets are known to exist on the Ukrainian part of the Black Sea and Azov Sea shelves. Ukraine should set the target of doubling its production of oil and gas within a decade and become self-sufficient in energy. Investors and producers must be provided with secure property rights, free market prices, and stable and reasonable rules of taxation.
6. *Open up state oil auctions.* Throughout 2008, the prices at auctions for oil and gas condensate were much lower than market prices because the management of Ukrnafta kept down their prices in the interest of related businessmen, even though the state owns a majority of the shares in Ukrnafta. The Cabinet of Ministers has repeatedly tried to open up these "auctions," most recently with a decree On Amendments to the Regulation on Organization and Implementation of Auctions for Sale of Oil, Gas Condensate, Natural and Liquefied Gas, and Coal, adopted on December 23, 2009. It prohibits related buyers from participating in auctions and sets a minimum price as per world prices. Yet, so far the Cabinet of Ministers has not carried sufficient weight to resolve this problem.

Gas Sector Reform: Crucial for Success

Gas reform is probably the most important reform in the Ukrainian economy. Ukraine's gas sector is the most unreformed, highly monopolized, and non-transparent part of the economy, and it is characterized by extensive corruption. Most prices are far below the market level, as pricing is susceptible to political leverage. In addition, restrictive regulation, poor property rights, and high taxes deprive producers of any economic incentive to increase production of natural gas, invest, or serve their consumers appropriately. Naftogaz Ukrainy, which was formed as late as in 1998 for political reasons, has never functioned acceptably and needs to be broken up.

Gas reform is necessary to ensure stable gas delivery to Ukrainian consumers and enhance the transit of gas through Ukraine to European consumers, increase the sector's efficiency, attract investment for the reconstruction and modernization of the gas transit system, and fulfill its international obligations. The key elements of reform are the creation of a competitive market for natural gas, economically sound gas price policy, and transparency.

Absence of a competitive gas market. The fundamental problem with the Ukrainian gas sector is the nonexistence of a market because of complete monopolization.

Economically unsound control of gas prices. The long-standing political practice of setting natural gas prices for the population, state-funded organizations, and municipal heating enterprises lower than what Naftogaz Ukrainy pays to Gazprom has made Naftogaz incur chronic losses to the tune of $2billion to $3 billion a year. The government has to scramble and exploit every opportunity to find funding for these payments to Gazprom. It has used loans from state-owned banks, IMF funding, international reserves of the National Bank of Ukraine, and advance payments by Gazprom for gas transit to Europe. Naftogaz Ukrainy is heavily indebted and effectively bankrupt if it does not receive large annual allocations from the state budget.

Low tariffs on transportation, distribution, and delivery of natural gas. These low tariffs make it impossible for the operators to maintain or modernize underground storage facilities and gas pipelines. As a consequence, the whole infrastructure is neglected.

Poor payment discipline. During the first eleven months of 2009, Naftogaz Ukrainy was paid for only 87 percent of the natural gas it delivered to its consumers, and its indebtedness rose accordingly.

Non-transparency in the gas sector. Incredibly, although Naftogaz Ukrainy is a state-owned corporation, it publishes no annual report for itself or its many daughter companies. Natural corollaries are non-competitive and expensive procurement and high costs of borrowing.

Significant gaps in legislation. Legislation for the gas sector consists mainly of decrees and regulatory acts and not of laws, which makes enforcing rules impossible.

Poor compliance with international obligations. Ukraine has undertaken extensive international commitments in the gas sector:

- the Joint EU-Ukraine Declaration, which was adopted at the International Investment Conference on the Modernization of the Ukrainian Gas Transit System on March 23, 2009 (the so-called Brussels Declaration);
- the Memorandum of Economic and Financial Policies between the Cabinet of Ministers of Ukraine and the International Monetary Fund of October 26, 2009;
- accession of Ukraine to the Energy Community (on December 18, 2009); and
- commitments to take measures to gradually bring national legislation into compliance with EU legislation in certain areas, including the energy sector, according to Article 51 of the Partnership and Cooperation Agreement between Ukraine and the EU and also its member states as of June 16, 1994.

Ukraine's international commitments in the gas sector consist of specific tasks: harmonizing national legislation with EU legislation; reforming the pricing system; introducing market principles; developing and implementing gas sector reforms, including reforming Naftogaz Ukrainy; improving the independence of the regulatory authority; and preparing an action plan on the renovation and modernization of Ukraine's gas transportation system.

The prerequisite for membership of the Energy Community and candidate status for accession to the EU is implementation of the energy chapter of the *aquis communautaire* in full. This obliges Ukraine to implement the provisions of the EU "third energy package." Three important legislative acts concern an Agency for the Cooperation of Energy Regulators, conditions for access to natural gas pipelines, and common rules for the internal natural gas market.

Ukraine's failure to fulfill its *obligations* to the European Commission, the IMF, and the Energy Community could prevent it from receiving further IMF funding as well as international credits for the reconstruction and modernization of the gas transit system, which would damage Ukraine's international image. But the main thing is that Ukraine would suffer from the absence of real gas reform.

This is also the view of Ukraine's international partners, notably the EU, the IMF the World Bank, and the United States. They all see gas reform as the key condition for Ukraine's economic success. Therefore, they have concluded the three aforementioned agreements with Ukraine on gas reform.

Various Ukrainian bodies have drafted many bills on energy reform, which have tended to stay as drafts and rarely correspond to Ukraine's international commitments. Recently the draft Law on the Principles of Functioning of the Natural Gas Market Functioning of October 22, 2009 was submitted to the *Verkhovna Rada*. It prescribes eliminating the natural gas monopoly, introducing competition in the domestic natural gas market, economically sound pricing, and energy-saving technologies,

Yet there is no need to reinvent the wheel. Ukraine has committed itself to quite specific reforms in its international agreements, which should guide Ukraine's reforms. A key EU directive vital for Ukraine is to separate transportation of natural gas from production as well as distribution. Specifically, the Gas Transit System, that is, the company Ukrtransgaz, should be legally separated into an independent company. The same is true for Ukrtransnafta, the trunk pipeline company. Similarly, the various functions of the company ChornomorNaftogaz should be divided into separate companies—production of oil and gas offshore on the Black Sea and Azov Sea shelves, gas transportation, and storage of gas in Crimea.

The recent EU laws and regulations in the "third energy package" adopted in July 2009 have not been addressed in the draft law. The key issue is the unbundling of natural gas transportation and distribution functions, and the new EU legislation has expanded the legal demands for market creation. The EU member states can choose one of the three options to operate vertically integrated companies. The first option envisages compulsory separation of their property by selling pipelines to an independent operator without right to a controlling interest. The second option allows vertically integrated companies to remain the owner of their pipelines provided they are managed by an independent operator appointed by the national government upon prior approval of the European Commission. The third option foresees the retention of vertically integrated companies, monitored by a special supervisory authority, with an independent subsidiary in charge of daily operation of the pipelines. The vertically integrated company would keep the pipelines as financial assets on its balance sheet.

The current Ukrainian draft law is designed for the second and third options. The Ukrainian parliament has prohibited the privatization of the gas transit system and the gas reservoirs for fear of threats to the country's national security. However, rules ensuring independence of a gas pipeline operator need to be reinforced. The powers and obligations of independent operators of gas pipelines and gas distribution should be explicitly stated. An independent supervisory authority is also necessary. The Cabinet of Ministers should reinforce and reintroduce the Draft Law of Ukraine on Principles of the Natural Gas Market Functioning to bring Ukrainian legislation into full compliance with the provisions of EU gas sector legislation.

Recommendations

1. The Cabinet of Ministers should develop and the parliament adopt a *Program for Gas Sector Reform to be implemented in 2010-2011 in line with the EU-Ukraine Brussels Declaration*. It should aim at restructuring Naftogaz Ukrainy, which should be divided into separate companies specializing in production, transportation, and distribution. Non-core activities should be sold off. Corporate governance should be introduced in the resulting state companies with professional boards consisting of independent directors and public annual reports subject to international audit.
2. The Cabinet of Ministers should develop and adopt a *Concept for Liberalization of the Gas Market in Ukraine*, which should lead to the adoption by parliament of a *Law on Principles of the Natural Gas Market Functioning* to establish the principles for the natural gas market so that it performs transparently and efficiently, and stimulate competition. These principles should harmonize Ukrainian legislation with EU gas directives. This law should ensure legal and organizational independence of the gas transmission operators and prohibit cross-subsidization. The operation of underground gas storage should be separate from gas transportation. All enterprises should be guaranteed non-discriminatory and transparent commercial access to the gas transmission systems and storage. The gas supply and distribution functions should be unbundled.
3. The National Energy Regulatory Commission should propose and the parliament adopt *laws and regulations for the Ukrainian natural gas market*. They should include a Gas Network Code with rules for access to gas pipelines and underground storage, and so on, in line with Ukraine's commitments as a party to the Energy Charter Treaty and its Transit Protocol.
4. In line with the EU-Ukraine Brussels Declaration, the government should develop a plan for the *renovation and modernization of the gas transit system* and attract financing from interested international financial institutions.

Electricity Reform

Ukraine undertook quite far-reaching structural reforms in the electricity sector in the mid-1990s. The power companies were restructured so that a handful of generating companies were created, while each region basically had its own distribution company. A public wholesale market was organized. The problem, however, was that electricity tariffs were controlled by the state at a level that was lower than the recovery cost, and then the wholesale market could not function well. The largely state-owned generating companies make chronic losses and cannot generate any profits for the maintenance and modernization of existing electricity generation or the grid, which threatens stable supply of electric power to consumers. Nor do these conditions offer any incentive to increase efficiency. The whole power sector suffers from excessive wear and tear on equipment.

Excessive price control and growing cross-subsidization. The main problem in the power sector is low, regulated electricity tariffs. An evolving malpractice is to differentiate tariffs by category of consumers, with low tariffs offered to households. These privileges are being financed through cross-subsidies, as industry pays much higher tariffs. The growing number and volume of privileges increases cross-subsidization.

Impeded Wholesale Electric Energy Market Reform. In 2002, the Cabinet of Ministers adopted a Concept for the Ukrainian Wholesale Electric Energy Market, but it could not be implemented because of low state-controlled prices. Increasing cross-subsidization complicates any market development. As a consequence, administrative regulation is increasingly needed for the allocation of electricity. Not surprisingly, the extension of administrative allocation has been accompanied by increasing arrears and indebtedness of power companies.

The government presented a Draft Law on Amending the Law on Electric Power Industry' to the parliament in October 2009, which is supposed to be based on the Concept for the Ukrainian Wholesale Electricity Market. It envisages a new electricity market model used in some EU countries with common rules for domestic electricity markets. However, the draft law differs substantially from the adopted Concept and lacks many of its components. Its lack of provisions necessitates many regulatory acts, which preferably should be inscribed into law to offer clarity and permanence. The Cabinet of Ministers ought to submit a new version of the Draft Law on Amending the Law of Ukraine on Electric Power Industry with all the key elements of the already adopted Concept.

Recommendations

1. A functioning wholesale market should be developed by drafting and adopting a Law on Principles of the Wholesale Electricity Market. The draft law should be based on the Concept for the Ukrainian Wholesale Electric Energy Market Functioning and Development (approved by the Cabinet of Ministers on November 16, 2002) and the Action Plan for the Implementation of the Concept for the Ukrainian Wholesale Electric Energy Market Functioning and Development (approved by the Cabinet of Ministers on November 28, 2007).
2. Privatization of the remaining state-owned electricity generating companies and the regional power distributors should form an important part of the state privatization program. The remaining state-owned power companies and mines should be sold off before the end of 2011. These companies can be easily sold off, as prior privatizations show. Preferably, they should be sold to strategic investors.

Coal Mining Reform: Easy and Beneficial

Ukraine has a viable coal industry, but it has never seen any real reform. However, some coal mines have been privatized sporadically, and private coal mines have expanded their production, while the state-owned ones have shrunk. At present, private enterprises dominates the coal sector. Yet prices remain regulated at too low a level. Coal products are priced on the basis of regulatory acts, not market forces. As compensation for low prices, the state pays all coal mines non-transparent and highly varied subsidies, depending on how much they bargain. Neither the distortion of coal prices nor the extensive state subsidies can be justified, as they do not encourage coal producers to produce more and become more effective.

Ukraine's policy on coal mining has led to most unsatisfactory financial and economic performance. Discretionary state regulation and excessive state ownership are holding back the industry. Coal production has been stagnant. Labor productivity is low and falling, while costs are rising, and some very inefficient mines continue operating. Losses are large and rising, while payment discipline is poor. Many Ukrainian coal mines are suffering from poor safety standards causing the death of many coal miners. Subsidies have increased every year. This is the result of wrong priorities, non-transparency, absence of clear guidance for state support, and the abandoning of basic principles of restructuring.

The main goal of coal sector reform must be a cardinal increase in efficiency. The main tasks of reorganization are: meeting the national economy's needs for domestic coal; cost-effective and secure operation of coal-mining enterprises; and social and economic stability in coal-mining regions.

The best way of doing all this is by privatizing and introducing a competitive coal market. Ukraine can follow the successful Russian coal reform of 1998-99 that was spearheaded by the World Bank. The pillars of reform are privatization of the remaining public coal mines; liberalization of coal prices; simultaneous elimination of coal subsidies; and social support for restructuring. The private Russian coal industry has thrived for a decade after these reforms, developing a vibrant coal market, steadily expanding production, and generating substantial profits.

Recommendation

The Cabinet of Ministers should launch a comprehensive coal industry reform consisting of the following five elements. First, the government should draft and the parliament adopt a Law on State Assistance to the Coal Mining Industry, which should conform subsidies to the terms and conditions common in the EU. Subsidies to the coal industry should be phased out gradually as coal prices are liberalized and chronically loss-making mines closed. Second, coal prices should be liberalized. Third, the government and parliament should also adopt a Law on the Closure of Mining Enterprises, setting the rules for their closure and measures to mitigate the social consequences**.** The government should start selecting coal mines for privatization or closure. Fourth, a Law on Principles of the Coal Market Functioning should establish the rules for a regular market for coal (after price liberalization) and set up an exchange market for the sale of coal products, as well as a direct purchase and sale contract market. Fifth, the privatization of coal mines should form an important part of the state privatization program, and the remaining state-owned coal mines should be sold off.

Chapter 6
Social Sector Reform: Achieving Effectiveness and Financial Balance

During Ukraine's nearly two decades of market economic transformation, the social sector has been only partially reformed. To a considerable extent, it still preserves Soviet characteristics, such as maximum social assistance coverage of the population, many but very small payments, little correlation between payments and needs, public funding unrelated to delivered services, and many unjustified expenditures.

As a consequence, three shortcomings plague the Ukrainian social sector. First, social expenditures as a whole are far too large for a country at Ukraine's level of economic development. In particular, it has the highest public pension expenditures in the world as a share of GDP, no less than 16 percent, a share almost twice as high as in the European Union. Second, the social services are not very efficient, and the population is greatly dissatisfied with the scope and quality of the services delivered. Third, much of the social assistance is being given to people who are not in great need, while those really suffering are not receiving adequate social support.

Therefore, the three overall goals of social reforms should be trimming the excessive pension expenditures, improving efficiency of social services, and targeting social support to those in true need.

For many reasons Ukraine has undertaken only minimum social reforms. Social reforms are always large and complex, involving large bureaucracies and many employees. Frequent elections have prevented the government from taking and implementing necessary but unpopular decisions. Article 22 of the Constitution of Ukraine bans the narrowing down of existing rights and freedoms (including those to social privileges) by adopting new laws.. Budget relations between the central state and local authorities do not encourage the latter to spend funds more efficiently or to improve social services. Neither society nor the state administration has been ready for fundamental changes to the old social system.

But Ukraine cannot neglect social reforms forever. Both demographic and economic forecasts show that further delays will inevitably aggravate current problems. In addition, social reforms, as a rule, bring visible positive results relatively soon, such as greater social justice, better living standards, easier access to and better quality of social services, which increase the population's trust in the authorities. But there is often a time lag before the positive effects are felt, which any political opposition can exploit. Therefore reforms in the social sphere should be a priority as soon as a new president is elected and enjoys great popular trust, while there is time before the next parliamentary elections.

Social reforms require substantial legislative amendments. In particular, part 3, Article 22 of the Constitution needs to be cancelled, as otherwise any restriction of rights, for example to social privileges) will be contrary to the Constitution and could be questioned in courts.

The Constitutional Court guarantees adherence to the Constitution. In order to amend the Constitution the votes of at least 300 parliamentarians are needed in two different sessions of the *Verkhovna Rada*, and since constitutional amendments are required for almost all social reforms, a comprehensive set of reforms appears most promising from a political point of view.

A comprehensive social reform should include reform of the pension system, more effective social protection for the needy, restructuring of minimum state guarantees, accelerated development of social insurance, reform of the health care system, and modernization of the education system.

Reforming the Pension System

The most important component of social protection is the pension system, which badly needs reform. The costs of the Pension Fund of Ukraine, which finances all pensions with revenues from payroll taxes, amount to 16 percent of GDP, the highest in the world. Far too many Ukrainians are pensioners because of low retirement age—55 for women and 60 for men—and numerous professional groups have much lower retirement ages. More than half of the pensioners, including almost all women, receive pensions that are below the minimum standard of living, and public pensions are on the whole highly egalitarian. Yet groups of privileged pensioners receive quite high pensions. Although Ukraine has adopted a law on a mixed pension system, no mandatory funded pension insurance has been introduced so far, and voluntary pension insurance is not properly regulated and thus underdeveloped.

Because of population aging, the fiscal burden on the working population is continuously growing. In January 2009, the ratio of pensioners to the active labor force was 40 percent, and the ratio of pensioners to payers of social security taxes was 88 percent. By January 2030, these indicators would increase to 53 and 103 percent, respectively. Thus, in 20 years, the average working Ukrainian would have to fund one pensioner through his or her social security taxes. Something has to be done.

Ukraine has to reduce its excessive pension costs. Several measures should be taken. First, pensions should be indexed in relation to prices and not to wages. Many different forms of early retirement should be phased out. Over time, Ukraine's very low retirement ages of 55 for women and 60 for men need to be raised, but this has to be done gradually and slowly. Ukrainian women live longer in retirement than in most European countries and the ratio of pensioners to the working population is one of the highest in Europe. Much of the western world now has a retirement age of 67, the same for men and women. It is also worth considering age-specific pension indexation, so that relatively young retirees, most of whom are still working, will get lower pension increases than the most elderly pensioners.

The compulsory social security contributions (which are paid by employers, and thus are often viewed as payroll taxes) are rather high, with the lion's share going to the pension fund. But two things can be done to increase efficiency. First, a unified social contribution could be introduced, as has been done in Russia, which would be collected by the State Tax Administration, Pension Fund or another special body, which will simplify administration and reduce management cost.. Second, the social contributions base could be broadened to cover independent entrepreneurs and agriculture.

Ukraine needs funded pension insurance. Stock and bond prices have plunged during the financial crisis, which should make it easier to introduce mandatory funded pension insurance. This would pose some burden on the budget because of transition costs, but it would form an extremely important source of long-term investment financing. The size of pensions paid from the funded pension system should be rather meaningful, otherwise the idea of such system will be discredited. Therefore it is important that only those people are enrolled into funded pensions, whose retirement is quite far ahead. For the same reason, individuals above a certain age should stay within the existing solidarity pension. Otherwise legislators would be tempted to set a low rate for a long period, rendering the funded pension insignificant. Various professional pensions should be transformed into funded pensions, which would also offer people incentives to work for a longer and retire later, and make employers reduce the number of harmful and dangerous jobs. This is not only a matter of social justice but it would also encourage higher economic activity and legalization of people's incomes.

Recommendations

1. *Pensions should be adjusted to the contributions made, while a minimum public pension would safeguard a minimum living standard.* Conditions should be adjusted to bring self-employed individuals into social security.
2. *Early retirement should be sharply curtailed*, and the compulsory retirement age should be raised gradually. For the sake of gender equality, the retirement age for men and women

should first be equalized at 60 by gradually raising retirement age annually for women, and then gradually raising it for both sexes to 65 years.

3. *A unified social contribution should be introduced,* which should be collected by the State Tax Administration or another relevant agency, ending the collection by the various social funds.

Transforming the Social Protection System

Poverty in Ukraine is relatively shallow because a significant portion of the population is around the poverty line. There is a risk that unemployment caused by the recession may considerably increase poverty, primarily among families that do not receive social transfers. The current paradox is that the risk of poverty has increased primarily among the employable population.

Funding of social assistance has become very difficult because the state budget is overburdened with social expenditures. In the first half of 2009, total social transfers equaled all public salaries, and social insurance contributions payable by employers are already excessive: 36.4 percent of payroll bill. The country cannot afford such expensive social assistance. It is necessary to reduce these expenditures, while ensuring social protection for the truly needy.

A simple adjustment of the current social protection system is not sufficient. The system must be reformed to more effectively support people in need. The social support system also consists of too many small amounts of assistance with too high administrative costs. At the same time, incentives for the employable population to work and pay taxes need to be reinforced.

To ensure just distribution of social support and increase the effectiveness of state aid to the vulnerable strata of society, state social standards and the social insurance system should be transformed.

Recommendations

1. *Social benefits especially designed for certain professional groups should be abolished.*
2. *A universal individual insurance record* should be introduced, and all insured individuals should receive an annual statement on their entitlements and premiums they have paid. Administration of mandatory social insurance must be simplified to reduce its cost. The best way of doing so is to introduce a flat social insurance premium.
4. The methods of computing the costs of living to define *the minimum social guarantees need to become more transparent realistic*. A reasonable relationship should be legislated between minimum salary and minimum pension. Minimum social guarantees should be differentiated in accordance with regional cost of living.
5. Assistance to poor families should be consolidated and based on their net incomes. General family allowances should be maintained to families with special needs children and families with newborn children to encourage procreation.
6. Delivery of some social services could be transferred to nongovernmental organizations with strict government control of quality and price.

Reforming the Health Care System

Poor health and high mortality rates are signs of Ukraine's deep demographic crisis. Ukraine is in the last but one place in Europe with regard to average life expectancy, at only 63 years for men, ahead of only Russia (by 1.9 years for men and 0.6 year for women) and lagging behind Switzerland (by 17 years for men and 10.5 years for women). Only 685 out of 1,000 40-year-old men live until 60 in Ukraine compared with 937 in Sweden. The main reasons for the low life expectancy of especially middle-aged men are an unhealthy lifestyle leading to early mortality caused by cardiovascular diseases (63 percent of deaths), cancer (12 percent), and trauma (8-9 percent).

The high rate of premature deaths has many causes, including harmful environment, often poor quality of food and water, widespread dangerous working conditions, smoking, alcoholism, and high road accident rates. Only 13 percent of Ukrainians exercise compared with 40-60 percent in the European Union and almost 80 percent in Japan. Each year, more than 100,000 Ukrainians die from smoking, with over 10 percent of them suffering from second-hand smoking. According to a 2005 study, 67 percent of Ukrainian men, the highest rate in Europe, and more than 20 percent of women smoke. Every year over 20,000 Ukrainians die from injuries, including over 10,000 deaths in road accidents. In fact, to limit alcoholism, smoking and road accidents are the cheapest ways of increasing life expectancy.

Ukraine is among the world's top consumers of alcohol. Over 40,000 Ukrainians die annually from alcoholism, and more than 700,000 people are registered as alcohol dependent. Beer drinking among school children is also a problem. Drinking alcohol causes not only many diseases but also violence, traumas, and road accidents. In 1986, Mikhail Gorbachev's anti-alcohol campaign drastically increased the average male life expectancy by three years and by one year for women. The current stress caused by unemployment and falling living standards in the wake of the economic crisis will in all likelihood boost alcoholism, violence, drug addiction, and suicide. This risk is especially great among men of working age particularly in eastern company towns.

The quality of medical care in Ukraine is low and often inaccessible to rural residents. Between 1999 and 2008, real health care spending doubled, but neither patients nor medical staff noticed any significant improvement, because Ukraine's health care spending remains very low by international standards. It is necessary to raise public health care funding from 3.5 percent of GDP to 5-6 percent, and at the same time to drastically improve management of health care. Reform should aim at a more efficient and rational use of resources and improve the quality of medical services, while also ensuring equal and fair access for all members of society to medical services.

The government should improve public health in Ukraine through two parallel approaches. One is to improve the resources, efficiency, and quality of the health care system. The other is to launch a major effort to promote a healthier lifestyle.

Recommendations

1. The government needs to elaborate a design of a *reform of the health care system*, which involves many steps. Primary health care should be carried out through polyclinics, and full-service hospitals should concentrate on intensive and specialized care as they do in the West. Financing could be based on services delivered with fixed rates for various standard services combined with necessary rationing. This could be done through state medical insurance or budget funding. It should separate the provision and funding of medical care to establish contractual relations between institutions providing medical care and financing institutions. Private medical practices should be entitled to the same public financing as public providers.
2. *Promotion of a healthy lifestyle*. In parallel to the improvement of medical care, the government should develop a comprehensive program to promote a healthy lifestyle, focusing on children and youth. Through media, the government should advertise a healthy lifestyle, while restricting advertising of alcohol and tobacco. The schools should also propagate a healthy lifestyle, together with disseminating information about the consequences of alcohol and drug consumption as well as smoking. Drinking of hard liquor and smoking should be prohibited in most public places and places of work. Sales of alcohol to children below the age of 21 should be strictly prohibited. Excise duties on tobacco and alcohol beverages, including beer, should be raised.

Modernizing the Education System

The Ukrainian education system has fared much better than other parts of the social sector since the collapse of the Soviet Union. Public funding of education has been growing steadily. It tripled in real terms between 1999 and 2008. In addition, "grey" payments by parents of "charitable contributions," tuition for extra lessons, and other private payments have been extensive.

The problems with education are mainly of quality and efficiency, not resources. The Ukrainian system of education remains largely the same as in Soviet times, though it has undergone a major expansion. According to UNESCO, no less than 73 percent of Ukrainians receive some kind of tertiary education, which puts Ukraine close to the top in the world, but the quality is often lacking. Education resources have been concentrated to higher education, while primary education and particularly preschools have been relatively neglected. According to the World Economic Forum study of competitiveness, Ukrainian primary and secondary education has greatly improved in quality and appears quite competitive. An overall assessment is that Ukrainians invest a lot of public and private money into education, but the return on this investment is much lower than it should be.

In systemic terms, little has changed since Soviet times. The main change is that many private educational institutions have been set up, especially in higher education, and some curriculum diversity has occurred, but vocational training has substantially declined. Basic school education has been extended to 12 years, and higher education has been divided into two stages with a four-year bachelor's degree and a two-year master's degree. Employers complain about an employment-education mismatch. Ukraine has too few graduates with vocational education, while many graduates with higher education have recently experienced difficulties in finding a job.

The goal of the government's education policy should be to raise the quality and efficiency of education by encouraging fruitful competition between private and public institutions, while ascertaining that their standards are appropriate. To raise quality, national and international standards must be incorporated into the education system. Efficiency is best improved through decentralization and deregulation, and as in health care, state financing should be provided for services provided rather than to institutions for their existence. The state should finance universities and schools per student and for research rather than give lump sums to each institution. Ukraine also needs to ensure equal access of the population to lifelong educational services and maintain the values of a multicultural and multiethnic society. Internationalization is crucial for the success of higher education and research. Ukraine has opened up to multiple forms of international cooperation, but these are encumbered by overcentralized bureaucracy, which needs to be eased.

Recommendations

1. The most neglected part of the education system is the *preschools,* which should be given priority in new budget financing. Nongovernmental organizations should be encouraged to run preschools.
2. *National and international standards and independent testing should be established for secondary schools.* Current budget funding of secondary education should be subject to unified norms of education costs per student**.**
3. The quality of learning of the English language must improve substantially, so that students learn to communicate freely.
4. *Vocational training* needs to be revitalized by engaging employers and professional associations, and the supply of vocational training needs to be adjusted to labor market demand.
5. *Reform of higher education*. Universities and other institutions of higher education should be transformed into self-governing institutions governed by independent boards of trustees and with financial freedom from the state. They should be financed with state scholarships, private

tuition fees, and donations. Practical steps should be taken to introduce market-based competition for public funding between universities, closing down or merging the least competitive institutions and promoting top performing universities as international centers of educational and scientific excellence. Ukraine has subscribed to the EU Bologna Process of standardization of European higher education and should fully implement all its requirements, such as recognition of foreign degrees, standardization of licensing, accreditation, and certification of higher education. The government should also assist in the development of a system of student loans for higher education in Ukraine.

Chapter 7
Accelerated European Integration

The most important development in Ukraine's foreign policy in 2010 is likely to be Ukraine's negotiation and hopefully conclusion of an Association Agreement with the European Union (EU). This Association Agreement would also include a substantial deep and comprehensive free trade agreement.

Since 1996, Ukraine has repeatedly stated its desire to become a member of the EU. Article 49 of the EU Treaty affirms that any European country may apply for membership, but the EU has shown little enthusiasm for Ukraine's quest, and the Ukrainian governments have made little progress towards this goal.

The EU took a minimal formal step of cooperation with Ukraine in 1994 when it concluded a Partnership and Cooperation Agreement with Ukraine valid for ten years. When this program of little substance was about to lapse, the EU offered the European Neighborhood Policy in 2003. It was designed both for the EU's eastern neighbors and the countries in North Africa. The Ukrainian government was affronted to be treated as one among many countries, which were not even European, but it used this opportunity to conclude a substantial initial action plan with the EU in February 2005.

In September 2008, Ukraine achieved a major breakthrough with the EU when it offered to negotiate a European Association Agreement. In May 2009, the EU extended its offer to six post-Soviet countries of its Eastern Partnership, also offering them the possibility of concluding deep and comprehensive free trade agreements, but it hardly added anything for Ukraine. In spite of Ukrainian insistence, the EU has yet to offer Ukraine a membership perspective.

Currently, EU-Ukraine relations are in an important transition, as the old Partnership and Cooperation Agreement will soon be replaced by a more comprehensive Association Agreement. Talks on three chapters of the Association Agreement (political, justice and home affairs, and sector cooperation) commenced in the spring of 2007, and they were followed by the launch of negotiations on a deep and comprehensive free trade agreement. The Association Agreement will be a legally binding document that establishes a framework for Ukraine's political association with the EU as well as economic integration with trade liberalization and regulatory harmonization. It may become a comprehensive umbrella for the domestic reform process.

In the meantime, the EU and Ukraine have agreed to set up an Association Agenda—a document that will prepare and facilitate the implementation of the Association Agreement. It focuses on a limited number of priorities and includes Ukraine's commitments under the Partnership and Cooperation Agreement and other existing bilateral agreements with the EU.

Negotiations on several important sector agreements, such as energy and civil aviation, are being finalized. The implementation of these agreements will allow Ukraine's integration into Energy Community and Common Aviation Space, respectively, which should have a positive spillover effect on other sectors.

The year 2010 will be critical for Ukraine's European integration. The government's goal should be to complete negotiations on the EU-Ukraine Association Agreement. It is vital for Ukraine to understand what the nation desires from the EU and what it can achieve. Four important aspects are domestic reform, free trade, prospect of visa-free travel, and cooperation in education and research.

Integration with the European Union: Another External Anchor Benefiting Ukraine

A broad Ukrainian consensus sees European integration as desirable and even as a choice of civilization. The European Choice can also help Ukraine reform its state and build a free and open market economy based on private ownership and the rule of law. Given EU rules, Ukraine can become an EU member in the long term. The country should take clear and coherent steps towards this goal also because they are good for Ukraine in themselves. Ukraine should not see the EU only as a goal but also as a means of its own reform.

Ukraine's integration with the EU must be based on sound assessment of costs and benefits. Ukraine—as a non-candidate country—has the right to choose its degree of compliance with the EU body of common legislation, the *acquis communautaire*, which currently amounts to 125,000 pages. Ukraine should not accept all EU requirements without reservations. On the contrary, the country must be guided by its national interests, taking pragmatic positions in its negotiations with the EU.

European integration should be considered as an *instrument for reform*. Closer alignment with EU norms and standards can help Ukraine reform its state, improve governance and business climate, encourage investment, facilitate reform of the energy sector, and open the borders for Ukrainians to travel, study, and work in the EU. While most EU stipulations might be beneficial to Ukraine, some are not. Notably, the common agricultural and fishery policy as well as EU labor market policy involve harmful overregulation. Other EU policies, such as environmental regulation and the social charter, would be too costly for Ukraine at its current economic level.

State building and better governance. Integration with the EU and adoption of European standards in public administration will allow changing the Ukrainian government machine inherited from the Soviet Union, which is infected with pervasive corruption. It will also make the rules of the game more transparent and acceptable for local and international businesses in Ukraine.

Market access. A deep free trade agreement will greatly increase Ukraine's access to EU's Single Market, which is especially important for Ukraine's steel exports and manufacturing. In addition, liberalization of trade with the EU will improve the business climate, boost investment, and contribute to increasing competitiveness of Ukrainian businesses. By adopting most of the EU *acquis communautaire*, Ukraine will adopt European rules of certification and quality control, competition, and public procurement. This will drastically improve the business environment and create a more favorable investment climate for foreign and domestic businesses alike.

The EU can help Ukraine facilitate *energy reform*. Stable and secure transit of energy through the Ukrainian territory is crucial for the energy security of the EU and its neighborhood. The EU is interested in transparency and efficiency of the Ukrainian energy sector. Ukraine's commitments as a member of the Energy Community may be used as a tool for change and a catalyst for Ukrainian energy reform. On March 23, 2009, the EU and Ukraine agreed on a common reform of the Ukrainian gas transit system, which would amount to a major transformation of the Ukrainian gas sector toward greater transparency and efficiency. Yet failure to reform the critical energy sector would jeopardize Ukraine's future relationship with the EU.

Travel. Europe should open up to the Ukrainians. The current state of EU-Ukraine relations can be described as slight disillusion. Ukraine is not as welcomed to the EU as it desires. The implementation of EU's commitments within the existing Visa Facilitation Agreement followed by the introduction of a visa-free regime (via the Roadmap) will help regenerate trust among Ukrainians towards the EU.

Education. Closer EU-Ukraine integration in education will contribute to the general improvement of the quality of Ukrainian education. It will also increase the access of Ukrainians to EU educational programs and scholarships and the recognition of Ukrainian diplomas in EU member-states. Consequently, the Ukrainian labor force will become more competitive both in the EU and on the global market.

Twinning of state agencies. An Association Agreement will change the quality of interaction between Ukraine and the EU. Although it does not offer a clear perspective of membership of the EU, the agreement offers other advantages. Since independence, Ukraine has received technical assistance from the EU, but the EU's greatest strength in assistance is when state agencies in individual member states work with their colleagues in another state to improve their work, which is called twinning. Formally, Ukraine has been eligible for EU twinning since it concluded its initial action plan with the EU within the EU European Neighborhood Policy in February 2005, but in reality little has happened. When Ukraine subscribes to a larger share of the *acquis communautaire,* both sides have greater incentive for closer cooperation with more effective twinning.

The next 300 days. The purpose of this report is to highlight priorities for the next 300 days. The most important issue in Ukraine's cooperation with the EU is the conclusion of an Association Agreement including a deep and comprehensive free trade agreement. A second important issue is the EU-Ukraine gas reform agreement, which we discuss in a separate chapter. For Ukrainians in general, the greatest interest in the EU is visa-free travel. Although that is not on offer within the next year, the Ukrainian government needs to do what it can to make that feasible in the near future. Another aspect of European integration is domestic education reform and scholarships abroad. To accomplish all this, Ukraine needs to coordinate its EU integration policy through a sufficiently strong policymaking body.

Recommendations

1. *Ukraine should aim at concluding an Association Agreement with the European Union before the end of 2010.* This agreement includes a deep and comprehensive free trade agreement.
2. *Ukraine needs to improve its technical standards* to facilitate both the functioning of the domestic market and foreign trade liberalization. The best way of doing so is to adopt EU standards.
3. *The EU twinning of state agencies* in one member country and in an accession country has proven one of the most effective means of reforming state agencies in post-communist countries. This is one of the best means available for Ukraine to reform its state administration.

Conclusion of a Deep and Comprehensive Free Trade Agreement

The most important step in 2010 is the conclusion of a deep and comprehensive free trade agreement with the EU. It will provide Ukraine with access to the EU's internal market and offer opportunities for real economic integration with the Union. It will require significant institutional and legislative changes, but in the long term it should make domestic producers more competitive. The government's commitments to implement the reform required by the Association Agreement and the deep and comprehensive free trade agreement will raise the confidence of foreign investors in the Ukrainian economy and spur foreign direct investment and Ukraine's integration into the global economy.

Customs reform. An important part of the free trade agreement is to improve the operation of the customs service, which is persistently identified as one of the most corrupt institutions in Ukraine, as evident from the Doing Business index. According to a World Bank study on Ukraine's trade policy, the main obstacles in Ukraine's customs regime are customs clearance, customs control, customs service fees, and customs permits to process raw materials abroad. Current free trade negotiations offer an excellent opportunity to take a big step towards reducing corruption at Ukraine's border crossings. The main solution should be the adoption of a new Customs Code, which has been drafted. Simplified customs procedures are extremely important, and Ukraine could use the EU's experience of optimizing customs clearance of goods in its customs reform. To increase the efficiency of Ukrainian customs operations, the government should implement a comprehensive strategic plan based on the EU Modernized Customs Blueprints.

Public procurement is one of the most corrupt operations in Ukraine. The rules and principles of procurement are not transparent, and a new, improved law on procurement is needed. The harmonization of Ukraine's legislation to EU standards and rules would make it possible to introduce transparent rules for public procurement and to level the playing field for those who participate in tenders. An important EU requirement is the establishment of an independent control authority with sufficient administrative capacity. Ukraine already has its Auditing Chamber, which should be reinforced.

State aid is one of the most urgent and contradictory issues in the negotiations with the EU. For Ukraine, a priority should be the harmonization of national legislation on state aid with EU rules. Ukraine's Finance Ministry and Anti-Monopoly Committee currently share the responsibility for state aid policy in Ukraine. To facilitate the reform process, a single government institution responsible for state aid policy should be identified.

Intellectual property rights. Ukraine has adopted rather advanced legislation for intellectual property rights. In practice, however, the authorities fail to effectively combat piracy and counterfeiting of goods and trademarks. Enforcement of existing laws needs to be improved. Because of this lack of enforcement of intellectual property rights, foreign hi-tech companies are reluctant to work in Ukraine in spite of its substantial human capital, for example, in information technologies.

Technical barriers and regulations. After import duties have been eliminated, the main obstacles to the rapid growth of Ukraine's foreign trade will be technical barriers such as different standards and product specifications. The harmonization of internal Ukrainian standards with EU standards is vital.

Food safety or sanitary and phytosanitary standards are an important part of the free trade negotiations. To raise the quality of food products, a comprehensive strategy for reform of food safety and quality control should be developed. Ukrainian food safety rules need to be reviewed and made to comply with EU requirements. The government needs to identify a single institution responsible for these functions, which are currently divided between the Ministry of Agriculture, the Veterinary Service of Ukraine, and the Ministry of Health, and reinforce its capacity.

As a rule, most agricultural products are excluded from free trade agreements between the EU and third countries, but the EU-Ukraine Free Trade Agreement could boost the competitiveness of Ukraine's agricultural products though harmonization with EU standards. Yet the free trade agreement itself is likely to cover only a few agricultural products. Most important for Ukraine is establishment of a free trade regime for grain, as it will remain the main Ukrainian agricultural export to the EU. The Ukrainian government should try to negotiate a gradual opening of the EU market for animal products as the country raises it standards to the EU level.

We propose that Ukraine in its coming free trade negotiations with the EU endeavors to abolish all barriers for the exports of Ukrainian agricultural products to the EU market, except for phytosanitary and technical requirements. Both sides are assumed to liberalize as much as 95 percent of the trade, leaving restrictions mainly for agricultural products. This would prevent Ukrainian agro-products to reach EU market and would seriously reduce the perspective for development of Ukrainian agriculture. The production of Ukrainian agriculture can double and even triple according to FAO and World Bank studies, and free trade between Ukraine and the EU without exemptions for agricultural goods could unleash this potential. Ukraine could once again become the granary of Europe. Access to the EU market would require considerable investments to ensure conformity to EU sanitary, phytosanitary, and technical regulations. Ukraine can request asymmetric treatment in the access to its food market for the most sensitive products during transitional periods, which the EU used to grant in its Association Agreements with Central European countries in the early 1990s.

A proper business environment is vital to ensure Ukraine's recovery from the economic crisis and further economic growth. It is also necessary for economic and political integration with the EU. The steps needed are discussed in other parts of this report. They include reduction of the number of tax payments, licenses, and permissions required for doing business in Ukraine. The procedures for opening/closing a business in Ukraine should also be simplified. And corruption must be reduced.

The Future: Visa-Free Travel

The abolition of Schengen visas for Ukrainians cannot be accomplished in the short term, but Ukraine must work on making it a reality. This will not be a purely political decision but will require that Ukraine fulfill several criteria. Ukraine should insist on getting a roadmap for a visa-free regime with the EU. For the time being, the EU has specified three major barriers to a successful visa dialogue: demarcation and management of Ukraine's borders, introduction of biometric passports, and creation of a single migration agency. Ukraine needs to work on these tasks to render visa-free travel possible in the future.

Border demarcation. The demarcation of borders is outstanding with Belarus, Russia, and Moldova. Belarus and Ukraine finalized talks on their border demarcation in the fall of 2009. The Belarusian side promised to ensure the ratification of the agreement in the near future, but it may be delayed until the 2010 presidential elections and may be held hostage to the settlement of Ukraine's old debt to Belarus. Russia is delaying the demarcation of its border with Ukraine. The main reasons are political because of the poor relations between Russia and Ukraine, and the demarcation of borders depends on an improvement of these relations. The decision on the Transnistrian part of Ukraine-Moldova border depends on the resolution of the status of Transnistria. Ukraine needs to continue working on a resolution of these three problems and should request EU support for its endeavors.

Biometric passports. The Visa Facilitation Agreement between the EU and Ukraine came into force in January 2009. Even so, the number of refusals of Schengen visas to Ukrainians remains high. The refusals could be reduced if Ukraine introduced biometric passports, according to the relevant EC Regulation. A national electronic database of citizens should be created to prevent citizens from obtaining several passports with different names.

If talks on a visa-free regime with the European Union are to progress, Ukraine needs to create a *single agency for migration policy*. Since June 2008, the government has repeatedly attempted to create such a state migration agency, but the president has persistently vetoed these attempts.

Human Capital Development

One of the great opportunities of Ukrainian cooperation with the EU lies in higher education. The EU can assist both with reform of the Ukrainian system of higher education and with education of thousands of Ukrainian students.

At present, Ukraine has almost 2 million students, approximately 27,000 of whom are studying abroad. Rough estimates suggest that only 2,000 of them are receiving scholarships from governments of EU member states or the European Commission. Unfortunately, the Ukrainian education system remains largely unreformed since Soviet times, and it is not able to provide local students with all the education and skills demanded by the ever more sophisticated labor market.

Bologna Process. Ukraine has joined the EU Bologna Process of harmonization of higher education. The EU and cooperation with universities in EU countries offer ideal opportunities to reform the Ukrainian system of higher education. A first step must be the recognition of European degrees of higher education within the Ukrainian state system and of teaching in foreign languages.

Erasmus Program. Studies abroad tend to open students' minds. The EU has developed a huge program for undergraduate studies abroad, the Erasmus Program. The Ukrainian government should open up the Erasmus Program to Ukrainian students and increase the number of scholarships for Ukrainian master's and PhD students offered by the European Commission and EU member states. It should also create a Scholarship Fund for Eastern Partnership countries.

Recommendation

European integration is also an important means of improving Ukrainian education. If Ukraine were allowed to join the Erasmus Program, it would offer thousands of Ukrainian students the possibility of studying at EU universities. Ukraine has subscribed to the Bologna Process of European education standardization but not done much. Ukraine needs to be fully engaged in this process to improve higher education in the country.

Coordination of European Integration: At the Highest Level

The year 2009 saw significant changes to domestic institutions that promote European integration. The Cabinet of Ministers of Ukraine revived the post of Deputy Prime Minister for European and International Integration. In July 2008, a Coordination Bureau for European and Euro-Atlantic Integration was set up within the Secretariat of the Cabinet of Ministers.

Since European integration is a matter of not only foreign policy but also domestic reform, Ukraine has had a European integration secretariat at the Cabinet of Ministers under political leadership of a deputy prime minister since 2007. This has helped to implant European integration issues into the government's domestic reform agenda. This function is vital and needs to be maintained and reinforced.

European integration requires a special body at the level of the Cabinet of Ministers headed by the deputy prime minister, in the same way as economic reforms do, because the purpose of European integration is not only international integration but also domestic reform. Therefore, the institutional set up under the deputy prime minister should be strengthened. A single coordinating commission should be created directly under the deputy prime minister and staffed with top-notch professionals with strong analytical and managerial abilities as well as excellent language skills.

ACKNOWLEDGEMENTS

The purpose of this International Commission of Independent Experts is to formulate an action program for reforms in Ukraine the first 300 days after the presidential elections. We have tried to reflect the public Ukrainian consensus about what should be done and the current state of affairs, while pairing these tasks with the best international expertise.

The result has been an interactive process with many institutions and people involved that deserve our thanks. When the commission was launched on September 28, 2009, at a meeting at the Cabinet of Ministers of Ukraine, we brainstormed about topics to focus upon: The obvious conclusion was the following six themes: reform of the state, macroeconomic stability, microeconomic policy, energy reform, social reforms, and European integration. We intentionally tried to focus rather than broaden the agenda in line with our ambition to single out the most urgent and essential for immediate action.

The co-chairmen invited commissioners and lead authors. The commissioners were selected by the criteria: outstanding experts on topics of relevance to the report, half Ukrainians and half foreigners.

The 23 members of the Commission have been (in alphabetic order): Professor Anders Åslund, Senior Fellow, Peterson Institute for International Economics, Washington, D.C.; Dr. Torbjörn Becker, Director, Stockholm School of Economics; Dr. C. Fred Bergsten, Director, Peterson Institute for International Economics, Washington, D.C; Professor Ihor Burakovsky, Kyiv-Mohyla Academy, Director, Institute for Economic Research and Policy Consulting; Oleksandr Chalyi, Extraordinary and Plenipotentiary Ambassador, former First Deputy Minister for Foreign Affairs of Ukraine; Edward Chow, Senior Fellow, Center for Strategic and International Studies, Washington, D.C.; Professor Marek Dabrowski, President of the CASE Management Board, Center for Economic and Social Analysis (CASE), Warsaw, Former First Deputy Minister of Finance of Poland; Dr. Johannes de Beaufort Wijnholds, former Executive Director of the International Monetary Fund, Washington, D.C.; Dr. Mikhail Dmitriev, Director, Center for Strategic Problems, Moscow, Former First Deputy Minister of Economy of Russia; Professor Sergei Guriev, President of the New Economic School, Moscow; Dr. Ihor Koliushko, Head of the Centre for Political and Legal Reforms; Professor Ella Libanova, Director, Institute for Demography and Social Studies of the National Academy of Sciences of Ukraine; Vira Nanivska, Head of the City Institute, Lviv;Dr. Irina Paliashvili, Attorney at law, Co-Chair, RULG-Ukrainian Legal Group, P.A. Professor Oleksandr Paskhaver, President, Centre for Economic Development; Dr. Volodymyr Saprykin, Director, Energy programmes, Razumkov Center, Kyiv; Olga Shumylo, Director, International Centre for Policy Studies, Kyiv; Marcin Swiecicki, Director, Blue Ribbon Analytical and Advisory Center, Kyiv, former Minister of Foreign Trade of Poland; Oleksandr Todyichuk, President of the Kyiv International Energy Q-Club: Professor Aleh Tsyvinski, Department of Economics, Yale University: Lidia Verkhovodova, Vice President, Centre for Economic Development, Kyiv; Professor Charles Wyplosz, Graduate Institute for International Studies, Geneva; Dr. Valentin Zelenyuk, Associate Professor of Kyiv School of Economics and Kyiv Economics Institute, Kyiv.

Anders Åslund and Oleksandr Paskhaver drafted the introduction and Chapter 1. Ihor Koliushkov drafted Chapter 2 on the state, Ihor Burakovsky Chapter 3 on macroeconomic policy, Lidia Verkhovoda Chapter 4 on microeconomic policy, Volodymyr Saprykin Chapter 5 on energy reform, Ella Libanova Chapter 6 on social policy, and Olga Shumylo Chapter 7 on European integration.

All the authors presented drafts of their chapters that were discussed intensely in six working group meetings in Kyiv on December 8-10, 2009. Each working group had about a dozen participants, representing a broad spectrum of interested think tanks and associations. Half the commissioners participated in the working group meetings, and representatives of a large number of organizations participated actively, including the International Center for Policy Studies, the Center for Economic Development, the Institute for Economic Research and Policy Consulting, the Razumkov Center, the Foundation

for Effective Governance, the Kyiv Economic Institute, the European Business Association, the American Chamber of Commerce, Institute for Euro-Atlantic Cooperation, Democratic Initiatives Foundation, East Europe Foundation, Delegation of the European Union to Ukraine, Institute of Sociology of the National Academy of Sciences of Ukraine and others.

After the working group discussion, the chapters were revised and the whole report edited for substance by the co-chairmen. The draft report was circulated to the whole Commission, and their many comments have been incorporated by the co-chairmen. Work has been highly interactive and it has proceeded in parallel on a Ukrainian and an English master copy. Madona Devasahayam has language edited the English version and Oleksandr Shevtsov the Ukrainian version. Mr.Shevtsov has also synchronized the content in the two language versions.

The Commission has also informed and consulted the International Monetary Fund, the United Nations Development Program, the European Commission, the World Bank, and the European Bank for Reconstruction and Development.

The Commission adopted the final report at a whole-day plenary meeting on February 2, 2010, in Kyiv. It intends to publicize and present the report as soon as the outcome of the presidential election is clear and recognized.

The Commission's work has been financed by generous matching grants from the Swedish and Netherlands Ministries for Foreign Affairs. In addition, we have greatly benefited from many services offered by the UNDP in Kyiv. Without their generous contributions, this report could not have been produced. In particular, we want to thank Swedish Ambassador Stefan Gullgren, Netherlands Ambassador Pieter Jan Wolthers, and UNDP Resident Representative Oliver Adam.

The International Center for Policy Studies in Kyiv has acted as the secretariat of the Commission, and we are most grateful to its Director Olga Shumylo and her assistant Maria Gutsman, who has acted as the secretary of the Commission. In Washington, Anna Borshchevskaya has provided research assistance.

Finally, we want to thank the government of Ukraine for its openness, helpfulness, and support of the work of our Commission.

The Commission has adopted this report with consensus, and our intention is to compose a report that reflects a broad consensus on what Ukraine needs to do, thus avoiding the most controversial and divisive issues. We have talked and listened to both the government and the opposition to present a balanced analysis, but we are reserving our right as independent experts to point out what is truly necessary.

Kyiv, February 2, 2010

Anders Åslund
Co-Chairman

Oleksandr Paskhaver
Co-Chairman

APPENDIX 1
INTERNATIONAL INDEPENDENT EXPERT COMMISSION FOR UKRAINE: REFORM PROPOSALS

The purpose of the Commission is to offer an action program for the new president. This report has three goals. First, it offers a narrative explaining why reforms are necessary and what reforms need to be undertaken. Second, it specifies a limited number of top priorities in the order of importance, which we have summarized in Reform Priorities for Ukraine in 2010. The list of reform proposals below is broader and includes all the recommendations in the report. Third, it specifies in a separate appendix legislative acts that need to be undertaken and their key content.

A New Wave of Reforms Is Critically Needed

- *A Reform Commission* should be formed at the Cabinet of Ministers headed by a Deputy Prime Minister entitled to give order to other ministers. The Commission should be provided with adequate financial and human resources, including high quality experts. The Reform Commission would work in parallel to the European Integration secretariat.

How to Reform the State

The greatest concern in Ukraine is that the state does not work efficiently. Problems plague all major elements of the state: the legislative process, the execution of laws, regional and local government, and the judicial system. Reforms need to start from the top.

- *Open party lists* with not only party choice but also personal choice in parliamentary elections should be introduced through amendment of the election law.
- *Transparency of party financing* should be improved by demanding that all political contributions be made public.
- *Ordinary parliamentary decisions should require only a simple majority of those present.* The legislative process must be simplified and tightened. It contains too many steps, and the changes that can be undertaken in any step are too great. These rules should be set through the adoption of a Law on the *Verkhovna Rada* Regulations.
- *Ukraine should adopt a Law on Ministries and Other Central Executive Agencies and a new version of the Law on State Service to pursue a civil service reform.* This law should separate political and civil service functions. To ensure professionalism of public service, all civil servants should be recruited through competitive entrance exams based on merit, and their advancement should also be determined on merit. Their salaries should be market-related and competitive to minimize the temptation of corruption. Political neutrality of public service should be ensured by banning civil servants from engaging in political activities up to a ban on membership in political parties for top civil servants. Legislation should be adopted to establish professional ethics for civil servants and to monitor their property, incomes, and expenditures to combat corruption.
- *A reform of regional and local self-government needs to be initiated.* It should contain four major elements. First, the units at the two lowest levels of the administrative hierarchy (communities and districts) need to be merged and the number sharply reduced to become viable; the number of oblasts seems fine. Second, a large number of functions should be decentralized. Third, oblasts, districts, and communities should all receive larger direct tax revenues so that they do not have to depend almost completely on the central state treasury and are not tempted to expand their

revenues in harmful ways by extracting penalties through damaging inspections. Fourth, the reform should follow the principles of the European Charter of Local Self-Government that Ukraine has ratified.

- *Ukraine should adopt an Administrative-Procedural Code* guaranteeing the rights of the individual in relation to the state administration.
- *A Law on Public Information should be adopted.* All state information should be available to the public, as far as possible free of charge through the internet, apart from three kinds of information: national security issues, strictly private matters such as medical records, and commercial matters.
- Ukraine has started developing *e-government*, but much more must be accomplished. Most government formalities should be possible to carry out on the internet, from enterprise registration to tax administration. The aim should be to standardize and minimize contacts between the state and entrepreneurs and to make remaining contacts as impersonal as possible to minimize corruption. Estonia appears the most successful example of e-government.
- *The powers and resources of the Auditing Chamber should be reinforced*.
- *Effective disciplinary and criminal responsibility of public officials for non-compliance with the law should be introduced*.
- *Judicial reform* has long been started, but it *needs to be completed*. A full set of updated and well-coordinated procedural codes are necessary. The judicial division of labor and hierarchy must be clarified. All judgments should be published on the web and the Single State Register of Court Judgments must be considerably improved. Courts and judges require sufficient financing.
- *The Law on Judicial System and Status of Judges should be refined and adopted*. Training and selection of judges need to be improved, being made more transparent and meritocratic.
- A package of bills should be submitted to the parliament on *reforming criminal justice and legal aid* (Code of Criminal Procedure, new edition); amendments to the Criminal Code on introduction of criminal offences; the Law on Prosecutor's Office (new edition); the Law on Prejudicial Inquiry Bodies; the Law on the Bar (new edition); and the Law on Free Legal Aid.
- *Ukraine should form an independent Anti-Corruption Bureau* with great integrity to effectively coordinate a comprehensive anti-corruption program, focused on transparency, accountability, deregulation, due process and the orderly functioning of government. For this purpose, a Law on Anti-Corruption Bureau should be adopted.

Macroeconomic Policy: How to Stabilize Ukraine's Finances

The fundamentals of macroeconomic policy must be improved to secure financial stability and make sure that the recent financial crisis is not repeated. Exchange rate policy and inflation control are crucial, and they can be combined into inflation targeting with a floating exchange rate and the aim of low inflation, but that requires an independent and professional central bank. The state budget must be balanced in the medium term, primarily through cuts in public expenditures. Ukraine finally needs to adopt a tax code to stabilize the tax system, and tax administration requires serious improvements to ease the burden on corporate taxpayers. The financial crisis prompted strict currency regulations, which can now be eased to facilitate business.

- In order to secure macroeconomic stability, it is essential to minimize potential conflicts between the government and the NBU. *The independence of the NBU needs to be reinforced and its governance improved*, as it is currently seen as being unduly influenced by both commercial and political forces. The NBU Council, whose role is unclear and is dominated by prominent business representatives and politicians, should be abolished in its present form, while the NBU chairman and his/her deputies should be given fixed terms. The political authorities should refrain from enacting legislation that impinges on NBU independence, such as proposals to finance various government expenditures by advancing the payment of NBU profits. The Ukrainian monetary policy should instead be governed by an independent Monetary Policy Committee consisting of independent professionals with well-defined powers and fixed terms. The NBU should also raise its professional quality and include prominent international expertise. A new law on the NBU reflecting these elements should be drawn up and adopted.

- Ukraine needs to move toward *inflation targeting regime* within the next three years, which presupposes a floating exchange rate. The transition period should offer the NBU enough room to bring down inflation to the 2 to 3 percent range and provide guidance to the public on the future development of the exchange rate, as well as fostering a reduction of dollarization. In the meantime, the NBU should proceed expeditiously with streamlining its monetary policy instruments and its decision-making process.
- During the financial crisis *currency controls* in Ukraine were reinforced. With the crisis abating, these controls can now be eased. Initially, Ukraine should aim at achieving convertibility of current account transactions, leaving capital transactions aside. However, many of the existing currency regulations contain unnecessary complications which should be abolished.
- *Ukraine needs to balance the state budget in the medium term by cutting public expenditures.* The government should reconsider the obligations of the state in order to make them financially affordable. The authorities should resist any expansionary fiscal initiatives. Three public expenditures stand out as excessive: price subsidies, enterprise subsidies, and pension expenditures. Price subsidies and enterprise subsidies should be minimized, while pension expenditures need to be brought under control through a profound pension reform. It appears both unrealistic and harmful to try to increase the level of state revenues in Ukraine.
- The first task of a new government after the presidential elections will be to *adopt a belated state budget for 2010.* For many reasons the budget deficit has to be significantly reduced, and this budget is Ukraine's chance to reduce public expenditures strategically, while the crisis still bites. The most important measure would be to increase gas and heating tariffs to limit the need for government subsidies to Naftogaz and other energy and utility companies to keep them afloat. Another important measure would be to gradually rein in pension expenditures, while improving the targeting of social safety nets to protect the most vulnerable households.
- *Ukraine should adopt the draft Tax Code*. It is in good shape, and its adoption will bring clarity and stability to the tax system and facilitate tax administration.
- *Further improvements in tax administration are necessary* more to improve governance than to increase revenue, as suggested by the American Chamber of Commerce and the World Bank Doing Business study. In particular, the management of value-added tax (VAT) refunds for exporters needs to be improved.
- Ukraine should follow Russia's example of *introducing a unified social tax and include all the social funds in the state budget.* At the same time, the collection of taxes, including the social tax, should be concentrated at the State Tax Administration in order to improve and facilitate tax collection for both the state and taxpayers.
- *Ukraine should adopt the draft Customs Code.* It is in good shape and its adoption will bring clarity and stability to the otherwise extremely cumbercome customs system and facilitate customs administration.
- The government should further *expand the tax base by reducing tax privileges*, especially for agricultural producers and wealthy individual entrepreneurs. In particular, the new unified social tax should also apply to these subjects. At the same time, the government must abstain from reintroducing already-eliminated sector privileges.

- *Recently nationalized banks should be privatized.* In the midst of the crisis, the state banks have assisted the government in various rescue operations. This should not remain a practice after the crisis has abated, and the authorities should wind down these emergency measures and let the two old state banks, Oshchadbank and Ukreximbank, revert to their old roles of being specialized state banks. The government should restructure the banks that have been de facto nationalized because of default and prepare them for early privatization after the crisis.
- An important task is to expand the supply of equities on the Ukrainian stock exchanges. Then the demand for other improvements will follow from the market. The most effective short-term measure might be to *force state corporations to increase their free float to at least 20 percent*. This would increase the supply of stocks and the transparency, and thus increase liquidity, which should result in higher prices as well. Before selling their stocks, however, state corporations should be compelled to improve their governance and subject them to international auditing. As these stock sales would amount to privatization, the government would benefit from more cash from privatization. The overall market value of public companies would rise, which would also facilitate further privatization.
- The government should consider merging two regulating bodies (the State Commission for Regulation of Financial Services Markets and the State Commission on Securities and Stock Market) into one single regulator of financial markets and reinforce it with powers and resources.

Microeconomic Policy: How to Improve the Business Environment

The overall aim must be a major improvement of the business environment, which should entail the strengthening of the legal base and property rights. A comprehensive deregulation of enterprise should be undertaken to raise Ukraine 40 positions on the Doing Business index in 2010. The state's interaction with private enterprises needs to be reduced. Privatization should proceed, and remaining state enterprises should be equipped with proper governance.

- *Starting a business* currently requires ten procedures that take 27 days, according to the Doing Business in Ukraine report. This process should be reduced to one procedure: registration of the business with the tax authorities and receiving a taxpayer number. It should take only one day and cost nothing as is the case in New Zealand. No enterprise registry beyond the tax authorities is needed. All other procedures should be eliminated.
- A new law on the *liquidation of enterprises* is needed to minimize the time needed as well as the cost, while maximizing the recovery rate.
- *The issuance of construction permits* is exceedingly difficult in Ukraine. The aim should be to simplify the process from 30 procedures to a small fraction and reduce the time required from 476 days to a small fraction. Essential permits should issued by the city architect, whose powers should be extended to all city planning functions. A city should provide all necessary services such as electricity, gas, water, and sewage after approval of construction by the city architect. Ukrainian cities need to organize themselves to provide services rather than forcing each applicant to run around trying to organize the city.
- Procedures for *registering property* can be reduced from ten to probably three. A sales contract of property should include both building and land. The contract should only need notarization and be registered in the real estate property registry and the state land cadastre.
- The list of economic activities subject to mandatory *licensing* should be minimized to only those that are dangerous to human health and life, environment, or national security. A new Law on Licensing should establish firm legal limits of licensing.
- The requirement of official *permits* should be reviewed and limited to an exclusive list of economic activities, which should be sanctified by law. Authorization procedures should be simpli-

fied for fire safety and construction. As long as they are not too expensive, EU technical standards should be introduced lock, stock, and barrel.

- The government should sharply *reduce the number of agencies entitled to undertake inspections*. Also the number of legitimate reasons for inspections should be slashed. Essentially, enterprise inspections can be justified only for the purpose of safeguarding life and health. All obsolete, bureaucratic, and unjustified requirements motivating planned inspections should be eliminated.
- The government should introduce legislation on *equal and non-discriminatory access of entrepreneurs to the services of natural monopolies*, including electricity, gas, water, sewage, railroads, and pipelines. Any baseless rejections would make the culprit legally liable to pay damages.
- Ukraine needs to adopt a *Law on Limited Liability Companies*.
- The government should establish a list of all *services* that the authorities are obliged to deliver to entrepreneurs free of charge, which should be freely accessible on the web. Similarly, the government should establish a register of public paid services and their prices or a single methodology of how to calculate their prices.
- A separate law should *list all the economic activities eligible for simplified taxation, accounting, and reporting*, which will prohibit local self-government authorities and local tax inspectorates to limit the number of activities eligible for simplified taxation, accounting, and reporting at the local level.
- The parliament should *adopt a State Privatization Program for 2010-2012*, amounting to a political decision to complete privatization. The boundaries of the public sector should be defined and all the enterprises and properties singled out for privatization specified. To reduce the risks to national interests, clear lines should be drawn on what must not be privatized.
- The parliament should *enact a Law on the State Property Fund of Ukraine*, which would separate privatization from state property management into two different bodies, subordinating both solely to the Cabinet of Ministers. A specialized state management agency should be formed that would exercise the powers of the state as an owner.
- *Private sales of agricultural land should be legalized.*
- The time of mass privatization is over, and *future privatizations will have to be through sales.* The state should pose a minimum of demands on investors and avoid special methods of privatization in order to make these sales legitimate and to maximize the possible prices, as well as secure the property rights of the winner. Maximum transparency and publicity should be maintained to reduce corruption. All privatizations should be announced in mainstream media well in advance to offer all investers equal opportunity. Unprofitable enterprises and unfinished construction projects should be auctioned off to the highest bidder without any minimum price, as state ownership of such entities only burdens the state with unnecessary costs. The government must guarantee property rights after a privatization. The reasons for canceling a privatization must be clearly defined in law and such cancellations highly restricted.
- *Foreign investors should be allowed to participate* in all privatizations that are not specifically restricted by law for national security or public interests.
- The remaining small state blocks of shares in otherwise privatized companies should be sold off. They could be sold either to the main owners or on the stock market to expand the free float. *The state should sell shares of large state corporations to increase the free float in these companies* to at least 20 percent of all shares to stimulate the domestic stock market, to improve corporate governance and transparency, and to raise the market value of the state companies.
- *Enterprises and real estate should be privatized together with the land plots* on which they are located. Similarly land plots on which already privatized enterprises are situated should be sold off.

- *The Economic Code should be abolished.*
- *A concept for the management of state-owned property* needs to be elaborated. It should identify the boundaries of state-owned property and the principles for the management of public enterprises. Limits should be set to protect economic independence and national security. These principles should guide the preparation and adoption of a new Law on State Property Management.
- The state enterprises that will remain state-owned should *be transformed into either joint stock companies or treasury enterprises*. No enterprise should be left in its old Soviet legal form.
- *The large state conglomerates Naftogaz Ukrainy and Ukrzaliznytsia need to be restructured.* They should be broken down into manageable entities, which should be corporatized separately. Each joint stock company should be given proper corporate governance with international auditing. A clear policy should be established for what parts of these companies should stay in the state's hand to safeguard consumers and national security. The other parts should be privatized.
- The *management of state enterprises* should not be political or bureaucratic but a *professional* business activity. Corporate management should be based on EU and OECD standards:
    - ◊ to ensure full transparency of the companies and free access for the general public to information about the companies;
    - ◊ to introduce independent audits of all public companies, which can arouse public trust in state management;
    - ◊ to resolve corporate raiding and prevent state property from being taken over illicitly.
- *The supervisory boards of large public corporations should be formed by competent professionals* of high standing and should include independent directors who represent the public and are respected within the community.
- The parliament should *adopt a new Law on State Procurement of Goods and Services*, which should incorporate EU requirements and standards. State procurement must be transparent, open auctions. For this purpose, it is vital to develop a modern online system based on the best international practice. An independent state agency should oversee public procurement.
- The parliament should *adopt a new Law on State Aid*, which should incorporate EU requirements and standards. State assistance should be exclusively in financial form without any interference in pricing by the Cabinet of Ministers or ministries. State guarantees or credits to be reimbursed are preferable to grant assistance.
- In 2010, the government should rationalize and gradually *phase out its emergency support to various industries* during the economic crisis. First of all, the government should eliminate all price interference. It should wind down its support for mining and metallurgy. It should start privatizing the remaining state-owned coal mines, while liberalizing coal prices and eliminating state subsidies. Instead, the government should offer social compensation. It should also minimize assistance to the chemical industry because of gas price hikes.
- Ukraine needs to *form a real competition policy*. A first step would be to prepare and adopt a Code of Competition Procedure, which should integrate and generalize competition policy rules. The competition policy should aim at investigating real monopolies and violation of free and fair competition in both private and public sectors. Enterprises should no longer have to go to the Anti-Monopoly Committee to ask for permission to start operations. The powers and competence of this Committee to investigate anticompetitive behavior should be reinforced, and criminal liability for serious cartelization should be introduced.
- *Regulation of natural monopolies* is a politically and technically complex process that will take years to complete, but it can be initiated. To begin with, independent regulatory agencies should

be formed for all natural monopolies, including transportation and housing utilities. Cross-subsidization of economic activities should be phased out, especially in the energy sector, through price adjustments. Large state corporations should not be allowed to monopolize markets that cannot qualify as natural monopolies.

Reform of the Energy Sector

Energy reform is key to Ukraine's success. The greatest problems persist in the gas sector, which must be profoundly reformed to reduce fiscal costs, enhance efficiency, and improve governance. The coal sector also requires reforms, but that is easier.

- The government should develop a *realistic energy pricing policy*. The Ukrainian government has agreed with the International Monetary Fund (IMF) that gas prices for all categories of privileged consumers of natural gas, electricity, and coal should be increased by 20 percent a quarter until they reach a cost recovery level. The abolition of all these price wedges will eliminate a major source of corruption, thus laying the foundation for energy efficiency. All energy prices should be brought to the level of full cost recovery plus a profit margin for operators as soon as possible.
- The Cabinet of Ministers should draft and the parliament adopt the *Law on the National Energy Regulatory Commission of Ukraine* to reinforce and unify the regulation of all natural monopolies in one strong and competent independent regulator. It should control pricing of services provided by all natural monopolies, ensuring a balance of interests between producers, consumers, and state. It should guarantee reliable supply of high-quality services to consumers at fair prices, while making sure that the natural monopolies can make sufficient profits to be able to develop.
- At the same time as the price hikes, the Cabinet of Ministers should introduce a new *system of targeted social assistance* for the least protected groups of consumers who suffer because of high gas, electricity, and coal prices.
- *Energy saving.* Ukraine needs to elaborate, adopt, and implement a program for energy saving. The country should continue to engage in the sale of carbon emissions rights under the Kyoto Protocol and encourage investment in energy-saving technologies.
- *Investment opportunities in the oil and gas sector in Ukraine must improve* for both domestic and foreign investors. At present, only a few, mainly small, private energy companies are producing oil and gas in Ukraine, besides subsidiaries of the state conglomerate Naftogaz Ukrainy. Although Ukraine has substantial oil and gas assets, its oil and gas production has been stagnating for many years. Moreover, vast gas assets are known to exist on the Ukrainian part of the Black Sea and Azov Sea shelves. Ukraine should set the target of doubling its production of oil and gas within a decade and become self-sufficient in energy. Investors and producers must be provided with secure property rights, free market prices, and stable and reasonable rules of taxation.
- *Open up state oil auctions.* Throughout 2008, the prices at auctions for oil and gas condensate were much lower than market prices because the management of Ukrnafta kept down their prices in the interest of related businessmen, even though the state owns a majority of the shares in Ukrnafta. The Cabinet of Ministers has repeatedly tried to open up these "auctions," most recently with a decree On Amendments to the Regulation on Organization and Implementation of Auctions for Sale of Oil, Gas Condensate, Natural and Liquefied Gas, and Coal, adopted on December 23, 2009. It prohibits related buyers from participating in auctions and sets a minimum price as per world prices. Yet, so far the Cabinet of Ministers has not carried sufficient weight to resolve this problem.
- The Cabinet of Ministers should develop and the parliament adopt a *Program for Gas Sector Reform to be implemented in 2010-2011 in line with the EU-Ukraine Brussels Declaration*. It should aim at restructuring Naftogaz Ukrainy, which should be divided into separate companies specializing in production, transportation, and distribution. Non-core activities should be sold off. Corporate

governance should be introduced in the resulting state companies with professional boards consisting of independent directors and public annual reports subject to international audit.

- The Cabinet of Ministers should develop and adopt a *Concept for Liberalization of the Gas Market in Ukraine*, which should lead to the adoption by parliament of a *Law on Principles of the Natural Gas Market Functioning* to establish the principles for the natural gas market so that it performs transparently and efficiently, and stimulate competition. These principles should harmonize Ukrainian legislation with EU gas directives. This law should ensure legal and organizational independence of the gas transmission operators and prohibit cross-subsidization. The operation of underground gas storage should be separate from gas transportation. All enterprises should be guaranteed non-discriminatory and transparent commercial access to the gas transmission systems and storage. The gas supply and distribution functions should be unbundled.
- The National Energy Regulatory Commission should propose and the parliament adopt *laws and regulations for the Ukrainian natural gas market*. They should include a Gas Network Code with rules for access to gas pipelines and underground storage, and so on, in line with Ukraine's commitments as a party to the Energy Charter Treaty and its Transit Protocol.
- In line with the EU-Ukraine Brussels Declaration, the government should develop a plan for the *renovation and modernization of the gas transit system* and attract financing from interested international financial institutions.
- A functioning wholesale market should be developed by drafting and adopting a Law on Principles of the Wholesale Electricity Market. The draft law should be based on the Concept for the Ukrainian Wholesale Electric Energy Market Functioning and Development (approved by the Cabinet of Ministers on November 16, 2002) and the Action Plan for the Implementation of the Concept for the Ukrainian Wholesale Electric Energy Market Functioning and Development (approved by the Cabinet of Ministers on November 28, 2007).
- Privatization of the remaining state-owned electricity generating companies and the regional power distributors should form an important part of the state privatization program. The remaining state-owned power companies and mines should be sold off before the end of 2011. These companies can be easily sold off, as prior privatizations show. Preferably, they should be sold to strategic investors.
- The Cabinet of Ministers should launch a comprehensive coal industry reform consisting of the following five elements. First, the government should draft and the parliament adopt a Law on State Assistance to the Coal Mining Industry, which should conform subsidies to the terms and conditions common in the EU. Subsidies to the coal industry should be phased out gradually as coal prices are liberalized and chronically loss-making mines closed. Second, coal prices should be liberalized. Third, the government and parliament should also adopt a Law on the Closure of Mining Enterprises, setting the rules for their closure and measures to mitigate the social consequences**.** The government should start selecting coal mines for privatization or closure. Fourth, a Law on Principles of the Coal Market Functioning should establish the rules for a regular market for coal (after price liberalization) and set up an exchange market for the sale of coal products, as well as a direct purchase and sale contract market. Fifth, the privatization of coal mines should form an important part of the state privatization program, and the remaining state-owned coal mines should be sold off.

Social Sector Reforms: Efficiency and Financial Balance

Ukraine's social sector is very inefficient. Social transfers, specifically pensions, are too large, while health care and education are poorly financed. All reforms are complicated by the 1996 Constitution, which essentially prohibits any deterioration of social benefits. The most urgent need is to rein in the excessive pension costs. The best way of doing so is to gradually raise the extremely low retirement age and end even lower special retirement ages. In health care and education, the financing system should be oriented toward paying for delivered services rather than the maintenance of real estate and staff. Social benefits should no longer be privileges for the well off but transformed to target those in true need. The social delivery systems need to be decentralized and given proper governance.

- *Pensions should be adjusted to the contributions made, while a minimum public pension would safeguard a minimum living standard.* Conditions should be adjusted to bring self-employed individuals into social security.
- *Early retirement should be sharply curtailed*, and the compulsory retirement age should be raised gradually. For the sake of gender equality, the retirement age for men and women should first be equalized at 60 by gradually raising retirement age annually for women, and then gradually raising it for both sexes to 65 years.
- *A unified social contribution should be introduced,* which should be collected by the State Tax Administration or another relevant agency, ending the collection by the various social funds.
- *Social benefits especially designed for certain professional groups should be abolished.*
- *A universal individual insurance record* should be introduced, and all insured individuals should receive an annual statement on their entitlements and premiums they have paid. Administration of mandatory social insurance must be simplified to reduce its cost. The best way of doing so is to introduce a flat social insurance premium.
- The methods of computing the costs of living to define *the minimum social guarantees need to become more transparent realistic*. A reasonable relationship should be legislated between minimum salary and minimum pension. Minimum social guarantees should be differentiated in accordance with regional cost of living.
- Assistance to poor families should be consolidated and based on their net incomes. General family allowances should be maintained to families with special needs children and families with newborn children to encourage procreation.
- Delivery of some social services could be transferred to nongovernmental organizations with strict government control of quality and price.
- The government needs to elaborate a design of a *reform of the health care system*, which involves many steps. Primary health care should be carried out through polyclinics, and full-service hospitals should concentrate on intensive and specialized care as they do in the West. Financing should be based on services delivered with fixed rates for various standard services combined with necessary rationing. This could be done through state medical insurance or budget funding. It should separate the provision and funding of medical care to establish contractual relations between institutions providing medical care and financing institutions. Private medical practices should be entitled to the same public financing as public providers.
- *Promotion of a healthy lifestyle.* In parallel to the improvement of medical care, the government should develop a comprehensive program to promote a healthy lifestyle, focusing on children and youth. Through media, the government should advertise a healthy lifestyle, while restricting advertising of alcohol and tobacco. The schools should also propagate a healthy lifestyle, together with disseminating information about the consequences of alcohol and drug consumption as well as smoking. Drinking of hard liquor and smoking should be prohibited in most public places and places of work. Sales of alcohol to children below the age of 21 should be strictly prohibited. Excise duties on tobacco and alcohol beverages, including beer, should be raised.
- The most neglected part of the education system is the *preschools,* which should be given priority in new budget financing. Nongovernmental organizations should be encouraged to run preschools.

- *National and international standards and independent testing should be established for secondary schools.* Current budget funding of secondary education should be subject to unified norms of education costs per student.
- The quality of learning of the English language must improve substantially, so that students learn to communicate freely.
- *Vocational training* needs to be revitalized by engaging employers and professional associations, and the supply of vocational training needs to be adjusted to labor market demand.
- *Reform of higher education*. Universities and other institutions of higher education should be transformed into self-governing institutions governed by independent boards of trustees and with financial freedom from the state. They should be financed with state scholarships, private tuition fees, and donations. Practical steps should be taken to introduce market-based competition for public funding between universities, closing down or merging the least competitive institutions and promoting top performing universities as international centers of educational and scientific excellence. Ukraine has subscribed to the EU Bologna Process of standardization of European higher education and should fully implement all its requirements, such as recognition of foreign degrees, standardization of licensing, accreditation, and certification of higher education. The government should also assist in the development of a system of student loans for higher education in Ukraine.

Accelerated European Integration

To Ukraine, European integration represents a choice of civilization and a means of reforming the state.

- *Ukraine should aim at concluding an Association Agreement with the European Union before the end of 2010.* This agreement includes a deep and comprehensive free trade agreement.
- *Ukraine needs to improve its technical standards* to facilitate both the functioning of the domestic market and foreign trade liberalization. The best way of doing so is to adopt EU standards.
- *The EU twinning of state agencies* in one member country and in an accession country has proven one of the most effective means of reforming state agencies in post-communist countries. This is one of the best means available for Ukraine to reform its state administration.
- European integration is also an important means of improving Ukrainian education. If Ukraine were allowed to join the Erasmus Program, it would offer thousands of Ukrainian students the possibility of studying at EU universities. Ukraine has subscribed to the Bologna Process of European education standardization but not done much. Ukraine needs to be fully engaged in this process to improve higher education in the country.

References

Akimova, Iryna, and Gerhard Schwödiauer. 2004. Ownership Structure, Corporate Governance, and Enterprise Performance: Empirical Results for Ukraine. *International Advances in Economic Research* 10, no. 1: 28-42.

Anderson, James H., David S. Bernstein, and Cheryl W. Gray. 2005. *Judicial Systems in Transition Economies: Assessing the Past, Looking to the Future*. Washington: The World Bank.

Anderson, James H., and Cheryl W. Gray. 2006. *Anticorruption in Transition 3: Who Is Succeeding … and Why?* Washington: The World Bank.

Åslund, Anders. 2007. *How Capitalism Was Built: The Transformation of Central and Eastern Europe, Russia, and Central Asia*. New York: Cambridge University Press.

Åslund, Anders. 2009. *How Ukraine Became a Market Economy and Democracy*. Washington: Peterson Institute for International Economics.

Åslund, Anders, and Georges de Ménil, eds. 2000. *Ukrainian Economic Reform: The Unfinished Agenda,* Armonk, N.Y.: M. E. Sharpe.

Åslund, Anders, and Michael McFaul, eds. 2006. *Revolution in Orange: The Origins of Ukraine's Democratic Breakthrough*. Washington: Carnegie Endowment for International Peace.

Blue Ribbon Analytical and Advisory Centre (2009) *One Year of Ukraine's Membership in WTO*, Kyiv: May.

Blue Ribbon Commission for Ukraine (2005) *Proposals for the President. A New Wave of Reform*, Kyiv.

Blue Ribbon Commission for Ukraine *(2006) The State and the Citizen: Delivering on Promises,* Kyiv.

Blue Ribbon Commission for Ukraine *(2009) Policy Recommendations on Economic and Institutional Reforms*, Kyiv.

Centre for European Policy Studies (CEPS). 2006. The Prospect of Deep Free Trade between the European Union and Ukraine. Report prepared for European Commission's Directorate-General for Trade. Brussels: Centre for European Policy Studies.

Commission of the European Communities (2004) "European Neighborhood Policy. Country Report. Ukraine," Commission Staff Working Paper. Brussels: May 12, http://ec.europa.eu/world/enp/pdf/country/ukraine_enp_country_report_2004_en.pdf

Cramon-Taubadel, Stephan, and Iryna Akimova, eds. 2002. *Fostering Sustainable Growth in Ukraine*. Heidelberg: Physica-Verlag.

D'Anieri, Paul. 2006. *Understanding Ukrainian Politics: Power, Politics, and Institutional Design.* New York: M.E. Sharpe Publisher.

De Souza, Lúcio Vinhas, Rainer Schweickert, Veronika Movchan, Olena Bilan, and Igor Burakovsky. 2005. *Now So Near, and Yet Still so Far: Economic Relations between Ukraine, and the European Union*. Kiel Discussion Paper 419. Kiel: Institute für Weltwirtschaft.

Deutsche Beratergruppe Wirtschaft bei der Ukrainischen Regierung. 2001. *Die Ersten 365 Tage: Ein Konstruktiver Ruckblick auf die Wirtschaftsreformen in der Ukraine in Jahr 2000.* Kyiv: Deutsche Beratergruppe Wirtschaft

European Bank for Reconstruction and Development (2005) *Transition Report 2005: Business in Transition*, London: European Bank for Reconstruction and Development.

European Bank for Reconstruction and Development (2006) *Transition Report 2006: Finance in Transition*, London: European Bank for Reconstruction and Development.

European Bank for Reconstruction and Development (2007) *Strategy for Ukraine. As approved by the Board of directors 18 September 2007*, London.

European Bank for Reconstruction and Development (2007) *Transition Report 2007: People in Transition*, London: European Bank for Reconstruction and Development.

European Bank for Reconstruction and Development (2008) *Transition Report 2008: Growth in Transition*, London: European Bank for Reconstruction and Development.

European Bank for Reconstruction and Development (2009) *Transition Report 2009: Transition in Crisis?* London: European Bank for Reconstruction and Development.

European Business Association (2004) *Barriers to Investment in Ukraine*. Kyiv: April.

European Business Association (2007) *Barriers to Investment in Ukraine*. Kyiv: August.

European Business Association (2009) *Overcoming Obstacles to Business Success*. Kyiv: June.

European Commission (2009) *External Energy Policy, Key institutional decisions 2006-2008*, Conference brochure, EU-Ukraine: Partners for securing gas to Europe conference, Brussels: March 23, http://ec.europa.eu/external_relations/energy/events/eu_ukraine_2009/eu_ukraine_partners_en.pdf

European Commission (2009), E*U-Ukraine: Partners for securing gas to Europe conference*, conference brochure, Brussels: March 23, http://ec.europa.eu/external_relations/energy/events/eu_ukraine_2009/eu_ukraine_partners_en.pdf

European Court of Auditors (2008) *The Effectiveness of EU Support in the Area of Freedom, Security and Justice for Belarus, Moldova and Ukraine*. Special Report No. 9, Luxemburg, http://eca.europa.eu/portal/pls/portal/docs/1/2362310.PDF

Foundation for Effective Governance (2008) *Ukraine's Economic Development Agenda for 2008-2015. Preliminary version for discussion*. Kyiv: April 9, http://www.feg.org.ua/docs/ua_economics_en.pdf

Foundation for Effective Governance (2009a) *The Ukrainian Competitiveness Report 2009*. Kyiv.

Foundation for Effective Governance (2009b) *Modernizatsiya Ukrainyy: Vyznacheniya priorytetiv reform (Modernization of Ukraine: Priorities for Reform)*. Kyiv.

Geletukha, Georgiy (2006) "Overview on Renewable Energy in Agriculture and Forestry in Ukraine," Institute for Economic Research and Policy Consulting in Ukraine, Berlin/Kyiv: November http://ierpc.org/ierpc/papers/agpp6_en.pdf

German Advisory Group on Economic Reforms with the Ukrainian Government. 1999. *The Next 1000 Days: an Economic Reform Agenda for Ukraine*. Kyiv: German Advisory Group on Economic Reforms.

Grygorenko, Yegor, Yuriy Gorodnichenko, and Dmytro Ostanin. 2006. *Relative Property Rights in Transition Economies: Can the Oligarchs Be Productive?* Economics Education and Research Consortium Working Paper no. 4. Moscow: EERC.

Guicci ,Ricardo, Robert Kirchner, and Vitaliy Kravchuk (2008) "Learning to float: Recommendations on Exchange rate policy in Ukraine during the transition period towards inflation targeting. " Policy Paper Series PP/ 01/2008, German Advisory Group, Institute for Economic Research and Policy Consulting in Ukraine, Berlin/Kyiv: June, http://ierpc.org/ierpc/papers/pp_01_en.pdf.

Handrich, Lars, and Oleksandra Betliy (2008) "Principles and methods of targeted social assistance: Policy recommendations for Ukraine," Policy Paper Series PP/ 07/2008, German Advisory Group, Institute for Economic Research and Policy Consulting in Ukraine, Berlin/Kyiv: October, http://ierpc.org/ierpc/papers/pp_07_en.pdf

Hess, Sebastian, Bernhard Voget and Anna Kuznetsova (2009) "European Markets for Meat: Real Opportunities for Ukraine?" February Policy Paper Series AgPP/ No. 24 German-Ukrainian Policy Dialogue in Agriculture, Institute for Economic Research and Policy Consulting in Ukraine, Berlin/Kyiv: February, http://ierpc.org/ierpc/papers/agpp24_en.pdf

International Centre for Policy Studies (1999) "Ukraine's Future: A plan for the President". *Policy Studies*, November 1999: 1, http://www.icps.kiev.ua/files/articles/32/35/ps_eng_199911_09.pdf

Joint EU-Ukraine International Investment Conference on the Modernisation of Ukraine's Gas Transit System (2009), *Joint Declaration* between government of Ukraine, the European Commission, the European Investment Bank, The European Bank for Reconstruction and Development, and the World Bank , Brussels:23 March, http://ec.europa.eu/external_relations/energy/events/eu_ukraine_2009/joint_declaration_en.pdf

Kirchner, Robert, Enzo Weber, and Ricardo Guicci (2008) "Inflation in Ukraine: Results and Policy Implications of an Empirical Study," Policy Paper Series PP/ 05/2008, German Advisory Group, Institute for Economic Research and Policy Consulting in Ukraine, Berlin/Kyiv: October, http://ierpc.org/ierpc/papers/pp_05_en.pdf

Lekhan, V.M. and V.M. Rudiy, eds. (2007) *Key Strategies for further development in the health care sector in Ukraine.* Joint report, Ministry of Health of Ukraine, Ministry of Economy of Ukraine, The World Bank, European Commission, Swedish International Development Cooperation Agency, Rayevsky Scientific Publishers: Kyiv, Ukraine.

Organization for Economic Cooperation and Development (2004) *Improving the Conditions for Enterprise Development at the Investment Climate for Domestic and International Investors in Ukraine. Legal Issues with regard to Business Operations and Investment*, Paris: September.

Organization for Economic Cooperation and Development (2004) Questionnaire Reponses, OECD Project "Improving the Conditions for Enterprise Development and the Investment Climate for Domestic and International Investors in Ukraine," Paris.

Organization for Economic Cooperation and Development (2007) *Agricultural Policies in Non-OECD Countries. Monitoring and Evaluation, Paris.*

Organization for Economic Cooperation and Development (2008) *Ukraine- Peer Review of Competition Law and Policy*. Country Study, Paris.

Organization for Economic Cooperation and Development (2009) *Agricultural Policies in Emerging Economies. Monitoring and Evaluation. Highlights*, Paris, http://www.oecd.org/dataoecd/54/30/42347206.pdf

Organization for Economic Cooperation and Development *Ukraine (2008). 2008 Survey on Monitoring the Paris Declaration: Making Aid More Effective by 2010*, Paris, http://www.oecd.org/dataoecd/58/41/41202121.pdf

Organization for Economic Cooperation and Development (2009) *Agricultural Policies in OECD Countries. Monitoring and Evaluation. Highlights*, Paris, http://www.oecd.org/dataoecd/37/16/43239979.pdf

Paskhaver, Alexander, and Lidiya Verhovodova. 2006. *Privatizaciya do i posle oranzhevoy revolucii (*Privatization before and after the Orange Revolution). Kyiv: CASE Ukraine.

Pavel, Ferdinand (2007) "Energy Price Shocks and Market Reforms: A quantitative Assessment," Institute for Economic Research and Policy Consulting in Ukraine, Berlin/Kyiv: May, http://ierpc.org/ierpc/papers/w3_en.pdf

Pavel, Ferdinand, and Inna Yuzefovych (2008) "How to deal with 'European gas prices' in Ukraine?" Policy Paper Series PP/06/2008, German Advisory Group, Institute for Economic Research and Policy Consulting in Ukraine, Berlin/Kyiv: October http://ierpc.org/ierpc/papers/pp_06_en.pdf

Ryshkova, Mariya, Sebastian Hess, and Bernhard Voget (2008) "The EU Dairy Market – Real Opportunities for Ukraine?" Policy Paper Series AgPP/ No. 19, German-Ukrainian Policy Dialogue in Agriculture, Institute for Economic Research and Policy Consulting in Ukraine, Berlin/Kyiv: September, http://ierpc.org/ierpc/papers/agpp24_en.pdf

Tetiana Polyvana (2009) "Joining the Energy Community: A way for Ukraine to secure gas supplies?" Policy Brief, Kyiv: International Centre for Policy Studies, December.

American Chamber of Commerce for Ukraine (2009), *Country Profile,* Kyiv, Ukraine.

The American Chamber of Commerce for Ukraine (2009), *Partnership for Successfully Competing in the Global Economy*. Kyiv, Ukraine.

The Cooperation Council. Partnership Between The European Union and Ukraine (2005), *EU-Ukraine Action Plan to be adopted through a Recommendation of the Cooperation Council*. Brussels: February 21.

The European Commission (2006) *European Neighbourhood and Partnership Instrument (2006) Ukraine*. Country Strategy Paper. 2007-2013. http://ec.europa.eu/world/enp/pdf/country/enpi_csp_ukraine_en.pdf

The International Monetary Fund (2008) *Ukraine: 2008 Article IV Consultation—Staff Report: Staff Statement; Public Information Notice on the Executive Board Discussion: and Statement by the Executive Director for Ukraine.* IMF Country Report No. 08/227, Washington, DC: July.

The International Monetary Fund (2008) *Ukraine: Request for Stand-By Arrangement—Staff Report; Staff Supplement; Press Release on the Executive Board Discussion, and Statement by the Executive Director for Ukraine.* IMF Country Report No. 08.384, Washington, DC: December.

The International Monetary Fund (2008) *Ukraine: Selected Issues*, IMF Country Report No. 08/228, Washington, DC: July, http://www.imf.org/external/pubs/ft/scr/2008/cr08228.pdf

The International Monetary Fund (2009*) Ukraine: First Review Under the Stand-By Arrangement, Requests for Waivers of Nonobservance of Performance Criteria, and Rephasing of Purchases Under the Arrangement*. Staff Report, Staff Supplement; *Press Release on the Executive Board Discussion,* IMF Country Report No. 09/173, Washington, DC: May, http://www.imf.org/external/pubs/ft/scr/2009/cr09173.pdf

The International Monetary Fund (2009*) Ukraine—Stand-By Arrangement—Review Under the Emergency Financing Mechanism,* IMF Country Report No. 09/17, Washington, DC: January, http://www.imf.org/external/pubs/ft/scr/2009/cr0917.pdf

The World Bank (2004) *Ukraine. Building Foundations for Sustainable Growth. A Country Economic Memorandum: Volume 1*. Country Study. Washington, DC: August revision.

The World Bank (2007) *Ukraine: Poverty Update*, Washington, DC: June 20.

The World Bank (2008) "Challenges and Opportunities of EU-Ukraine Free Trade Agreement for the Development of Securities Markets and Non-Bank Financial Institutions in Ukraine"*,* Working paper, Washington, DC: October.

The World Bank (2008) *Status of Projection in Execution-FY 08. Europe and Central Asia Region. Country: Ukraine.* Operations Policy and Country Services, Washington, DC: October 11.

The World Bank (2009), *An Avoidable Tragedy: Combating Ukraine's Health Crisis. Lessons from Europe*, Washington, DC.

The World Bank (2009), *Ukraine. Labor Demand Study*, Washington, DC.

The World Bank and the International Finance Corporation (2007) *Business Environment in Ukraine*, Washington, DC.

The World Bank and the International Finance Corporation (2008) *Country Profile 2008*, Washington, DC.

The World Bank and the International Finance Corporation (2008) *Technical Regulations in Ukraine: Ensuring Economic Development and Consumer Protection*, Washington, DC.

The World Bank and the International Finance Corporation (2008), Doing Business 2009. Country Profile for Ukraine, Washington, DC, http://www-wds.worldbank.org/servlet/main?menuPK=64187510&pagePK=64193027&piPK=64187937&theSitePK=523679&entityID=000333038_20081013024959

The World Bank and the International Finance Corporation (2009) *Doing Business 2010*. Ukraine, Washington, DC. http://www.doingbusiness.org/Documents/CountryProfiles/UKR.pdf

The World Bank and the International Finance Corporation (2009) *Investment Climate in Ukraine as Seen by Private Businesses,* Washington, DC: October.

UNDP Blue Ribbon Analytical and Advisory Centre (2007) *Economic Impacts of WTO Accession by Ukraine: Assessment of Price Competitiveness*, Kyiv.

UNDP Blue Ribbon Analytical and Advisory Centre *(2009) Analytical Note. Life Expectancy at official retirement age, deductions for pension provision, and retirement age increase in various countries of the world*, *Prepared at the request of the Minitry of Labour and Social Policy of Ukraine*, Kyiv: May.

UNDP Blue Ribbon Analytical and Advisory Centre (2009) *Policy Recommendations on Economic and Institutional Reforms 2009,* Kyiv: April.

Whitmore, Sarah. 2004. *State Building in Ukraine: The Ukrainian Parliament, 1990-2003*. New York: Routledge.

Wilson, Andrew. 2002 [2000]. *The Ukrainians. Unexpected Nation*. New Haven: Yale University Press.

Wilson, Andrew. 2006. *Ukraine's Orange Revolution.* New Haven: Yale University Press.

World Bank. 2005. Growth, Poverty, and Inequality: Eastern Europe and the Former Soviet Union. Washington: The World Bank.