

Blue Ribbon Commission for Ukraine

**PROPOSALS FOR THE PRESIDENT
A NEW WAVE OF REFORM**

2005



The analysis and policy recommendations of this Report do not necessarily reflect the views of the United Nations Development Programme. This Report is the fruit of a collaborative effort by a team of eminent advisors. The United Nations Development Programme accepts no responsibility for any views presented here nor for any error or misrepresentation contained in this report.

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Members of the Blue Ribbon Commission

Iryna Akimova

Anders Åslund, co-chairman

Dan Bilak

Ihor Burakovsky

Oleksandr Chalyi

Keith Crane

Marek Dabrowski

Adrian Karatnytcky

Ihor Koliushko

Oleksandra Kuzhel

Dmytro Leonov

Georges de Menil

Kalman Mizsei

Vira Nanivska

Jerzy Osiatynski

Oleksandr Paskhaver, co-chairman

Oleksandr Rohozynsky

Oleksandr Shevtsov, coordinator

Ben Slay

Executive Summary

Never in its history has Ukraine had as favorable a position as it has today. The purpose of this report is to assist the next Ukrainian administration by formulating proposals for a new wave of reforms designed to achieve a rapid and sustainable economic growth that serves to raise the standard of living of the entire Ukrainian population. The primary goal is to sustain an average economic growth rate of 8 percent per year for the next decade. The ultimate aim of economic policy is to improve living conditions for the whole population. This approach reflects the spirit of the eight Millennium Development Goals adopted by the United Nations and endorsed by Ukraine.

The Blue Ribbon Commission was created at the initiative of Kalman Mizsei, Assistant Secretary General of the United Nations and Assistant Administrator of the United Nations Development Programme (UNDP). The UNDP office in Kiev organized the commission's work, and UNDP provided all the funding for the project. A first meeting of the Commission was held in Kiev on 21-22 July. On 14 October, the Commission held its second and final meeting, at which members discussed the full report and adopted all its recommendations. The Commission enjoyed complete editorial independence in conducting its analysis and setting its recommendations.¹

The Commission was co-chaired by Anders Åslund and Oleksandr Paskhaver. The other members of the Commission were Iryna Akimova, Dan Bilak, Ihor Burakovsky, Oleksandr Chalyi, Keith Crane, Marek Dabrowski, Adrian Karatnytsky, Ihor Koliushko, Oleksandra Kuzhel, Dmytro Leonov, Georges de Menil, Kalman Mizsei, Vira Nativska, Jerzy Osiatynski, Oleksandr Rohozynsky, Oleksandr Shevtsov, and Ben Slay.

Today, it is rather obvious what a vision for Ukraine looks like. A broad consensus acknowledges a number of common values. Ukrainians desire democracy and a state that is controlled by its citizens. They believe in the necessity of the rule of law and a market economy based on private property. At the same time, they want a market economy with a strong social orientation that provides a strong education system, good health care for all, and the limitation of poverty. Ukrainians also believe in an open world offering free movement of ideas, people, and trade. The dominant political forces have summarized these aspirations as Ukraine's "European Choice." This does not mean that Ukrainians want everything to be exactly as it is in the European Union, but it implies a strong commitment to most of the basic values and principles embraced by Europe. Europe stands as an ambitious norm against which Ukraine can measure its achievements, not only in the economic sphere but even more so in the spheres of democracy, governance, and law.

The best proven way to achieve rapid economic growth is to develop a reasonably free and open market economy based on private ownership and the rule of law. The Commission's challenge has been to identify the critical vulnerabilities or bottlenecks in the economic and social system and assess how they can be eliminated quickly to sustain economic growth and social development. Our purpose is not to address all the problems that Ukraine faces, but rather to point to crucial challenges that need to and can be solved. We are realistic problem solvers. We have focused on what can be done immediately or initiated within the first year of a new administration.

¹ The Blue Ribbon Commission has functioned as an independent body of eminent advisors. Whilst UNDP has supported its work financially and administratively, the Commission has exercised complete editorial independence, and the analysis, views and recommendations in this Report are entirely those of the Commission, and do not necessarily reflect the official position of UNDP or of the United Nations.

We propose five priority areas for reform. First, the fundamental problem in Ukraine, as in other postcommunist countries, is that the state rules its citizens, rather than serving them. The relationship between state and citizens must change. To win the confidence of its citizens, the state machinery must become efficient and effective through real control by society and law. Second, citizens need to have adequate living conditions, so that society can enjoy stability and security. Third, the tax system and the legal base of the financial system need to be improved to stimulate economic growth. Fourth, a clear line must be drawn between state and private enterprise, so that property rights can be fully guaranteed. The relations between entrepreneurs and the state should be clearly defined in law and reinforced by an impartial and competent judiciary. Fifth, Ukraine's integration into the world economy must be facilitated through early accession to the World Trade Organization (WTO). Progress in these key areas will allow the country to flourish as it should.

Our Key Recommendations

This report contains over one hundred specific recommendations that we urge the new President of Ukraine to enact, or at least initiate work on, within one year of his inauguration. Some recommendations are more important than others; here we identify the top priorities.

Most fundamental is political reform. The details are controversial, but the guiding principles are clear. First, a clear division of responsibility and accountability is vital. Second, the rulers must ultimately be responsible to society. Third, to enforce accountability, transparency is necessary. Fourth, government must be monitored through effective, professional, and independent auditing.

Ukraine's current economic achievements all rest on fiscal and monetary stability. This stability must be maintained in the future, as a necessary precondition for sustainable economic growth. The independence of the National Bank of Ukraine should be strengthened, and the central bank should focus on maintaining price stability. Recent excessive and populist expenditures are worrisome and must be reined in after the elections. The danger of overheating is evident and must be checked.

Specific recommendations are provided in the six chapters that follow, along with a rationale for reform. In distilled form, our twelve most urgent reform recommendations are:

1. To enact an administrative reform to make government more efficient and responsive;
2. To reform the justice system to make judges independent and courts more efficient;
3. To enact a territorial-administrative reform to revive local government;
4. To introduce mandatory public medical insurance to finance health care;
5. To enact a liberal tax code;
6. To reduce public expenditures substantially, and target social benefits to the truly needy;
7. To improve corporate legislation;
8. To abolish the anachronistic Economic Code and improve the market-oriented Civil Code;
9. To end the moratorium on the sale of agricultural land and develop a property registry;
10. To abolish regulatory discrimination and halt subsidies to favored enterprises;
11. To join the WTO in 2005; and
12. To adopt European legal standards and forge a free-trade agreement with the EU.

Foreword

This report of our Blue Ribbon Commission, working under the deft leadership of Anders Åslund and Oleksandr Paskhaver, was in the final stages of editing when the second round of the presidential elections took place in Ukraine. Its contents thus predate the unprecedented outpouring of civic activism that prompted the Ukrainian authorities to schedule a fresh round of voting for 26 December. The peaceful determination that Ukrainian civil society has shown to defend freedom and the right to free and fair elections is to be commended.

The recent political upheaval in Ukraine does nothing to tarnish the findings of this report. On the contrary, it underscores the accuracy of its diagnosis of the ills that trouble Ukraine, particularly in the relations between citizens and the state, and it heightens the relevance of the report's prescription for a "new wave of reform." Moreover, the emergence of a newly self-confident civil society in Ukraine increases the chances that the Blue Ribbon Commission's recommendations can be put into practice.

That this report has proved so prescient is testament to the collective wisdom of its authors, a diverse group of international and Ukrainian specialists on economy, government, law, and social policy who have contributed their keen insights to this vital undertaking. UNDP expresses deep appreciation to the authors for this timely contribution to policy debate in Ukraine. It supports the report's call for a "new wave of reform" aimed at helping the country sustain rapid economic growth, improve social welfare and fight poverty, enhance economic integration, and achieve the Millennium Development Goals. The report, in UNDP's view, is an exemplary work of impartial and professional analysis that provides practical solutions to pressing problems. UNDP recommends the report for the early attention of the new President and the new Government, and stands ready to support them in enacting a new wave of reform.

Kalman Mizsei

Assistant Secretary General of the United Nations

Assistant Administrator of the United Nations Development Programme (UNDP)

10 December 2004

About the Blue Ribbon Commission

The Blue Ribbon Commission was formed at the initiative of Kalman Mizsei, Assistant Secretary General of the United Nations and Assistant Administrator of the United Nations Development Programme (UNDP).² The Commission's work has been financed entirely by UNDP.

A first meeting of the Commission was held at the UN House in Kiev on 21-22 July. Members agreed on the structure of the report, appointed coordinators for the chapters, and assigned drafts to be written by nineteen different authors. Drafts were produced in the course of August and in early September, while most of September was devoted to assembling the sections into chapters and editing. During the first half of October, group meetings were held to discuss the essence of the various chapters and the entire report. On 14 October, at its second and last meeting, the Blue Ribbon Commission discussed the report as a whole and adopted all its recommendations. After this meeting the report underwent final editing in line with the Commission's decisions.

As a result of substantial editing and collective decisions, the report has changed shape very considerably from the original section drafts. Chapter coordinators were Oleksandr Paskhaver (Chapter 1), Vira Nanivska (Chapter 2), Oleksandr Rohozynsky (Chapter 3), Iryna Akimova (Chapters 4 and 5) and Ihor Burakovsky (Chapter 6). The various sections were drafted by Oleksandr Paskhaver and Marek Dabrowski (Chapter 1); Vira Nanivska, Dan Bilak, Anatolyi Maksyiuta, and Ihor Koliushko (Chapter 2); Oleksandr Rohozynsky, Tetyana Andreeva, Oksana Ovcharuk and Georges de Menil (Chapter 3); Sergei Yurzelevich, Dmytro Leonov, Anatolyi Fedorenko, and Jerzy Osiatynski (Chapter 4); Iryna Akimova, Oleksandr Paskhaver, Oleksandra Kuzhel, and Oleksandr Shevtsov (Chapter 5); and Ihor Burakovsky (Chapter 6). After editing by the chapter coordinators, the entire report was edited by Anders Åslund, Ben Slay, and Louisa Vinton. The report has benefited greatly from the comments of the members of the Commission and a large number of other specialists, notably Robert Conrad, Valeryi Heyets, Anatolyi Kinakh, Ella Libanova, Bjorn Markstedt, Branko Milanovich, Irina Paliashvili, Edilberto Segura, Ihor Shumilo, Volodymyr Sidenko, Oleksandr Suhoniako, Yuri Yakusha, and Yuri Yekhanurov.

The Report has drawn on the substantial relevant literature. It has benefited in particular from a number of recently drafted programs and analyses. The most similar to our report is the World Bank Country Economic Memorandum, *Building Foundations for Sustainable Growth* (draft, 2004). Its policy line is similar to that of the Blue Ribbon Commission report, but its choice of topics differs slightly; it is a larger, more analytical work aimed at an audience of civil servants. The Cabinet of Ministers Program of Activity, *Consistency, Efficiency, Responsibility* (2004), is broader than our program. It is essentially a list of proposed measures without any text explaining the rationale for this choice. The United Nations Country Team's *Common Country Assessment for Ukraine* (draft, 2004) is devoted to four core UNDP topics: Human development from a human rights perspective, good governance and the rule of law, the HIV/AIDS epidemic, and the challenge of ensuring a sustainable environment. The two first themes partially overlap with this report. The International Monetary Fund (IMF) produces regular country economic reviews and staff reports on Ukraine, with a focus on macroeconomics. This topic is not central to our report, owing to Ukraine's considerable macroeconomic achievements.

² The UNDP office in Kiev organized the Commission's work, first under the leadership of Manoj Basnyat, acting UNDP Resident Representative, and later under Francis M. O'Donnell, newly appointed Resident Coordinator of the United Nations and UNDP Resident Representative in Ukraine.

Two other studies from 2004, both dealing with the investment climate, bear mentioning. One is an OECD study, *Improving the Conditions for Enterprise Development and the Investment Climate for Domestic and International Investors in Ukraine: Legal Issues with Regard to Business Operations and Investment*. The other is a European Business Association (in Ukraine) report, *Barriers to Investment in Ukraine*. In addition, we have drawn on the ample literature available on current economic issues in Ukraine. Of special note is the empirical literature from the World Bank, the International Finance Corporation (IFC), the Institute for Economic Research and Policy Consulting (IER), the International Center for Policy Studies (ICPS), and the Center for Economic and Social Analysis in Kiev.

The Blue Ribbon Commission has functioned as an independent body. While UNDP has supported its work financially and administratively, the Commission has exercised complete editorial independence, and the analysis, views and recommendations in this Report are entirely those of the Commission.

Chapter 1. Ukraine's Need for a New Wave of Reforms

1.1. The Purpose of the Second Wave of Reforms

Never in its history has Ukraine had as favorable a position as today. It has enjoyed several years of solid macroeconomic stability. The economy is booming, with growth accelerating from 9.4 percent last year to 13.4 percent during the first nine months of 2004. Growth is driven by both exports and investment. Exports surged by no less than 51 percent during the first half of 2004. The country has significant surpluses in both its foreign trade and its foreign account, and international reserves are bigger than ever. Ukraine has never seen a boom like this. If this is the beginning of a great long-term boom—and it could be—the country's main aim should be to achieve rapid economic growth of at least 8 percent per year. Rapid growth is the best means to reduce poverty and other social ills.

The purpose of this report is to assist the next Ukrainian administration by formulating proposals for a new wave of reforms. These would help achieve rapid and sustainable economic growth that serves to raise the standard of living of the entire Ukrainian population. As our starting point, we take the values that are shared by the two leading presidential candidates, according to their published programs. The primary goal is to sustain average annual economic growth of 8 percent per year for the next decade. Ireland, a much richer country, has successfully maintained a growth rate of 7 percent per year over the last decade, and it should be easier for a poorer country like Ukraine to grow fast—provided it gets its policies right. For the last four years, the entire region of the Commonwealth of Independent States (CIS) has maintained a growth rate of 8 percent per year.

The ultimate aim of economic policy is to improve living conditions for the entire population. Ukraine has subscribed to the eight Millennium Development Goals adopted by the United Nations: namely, to eradicate extreme poverty and hunger, achieve universal primary education, promote gender equality and empower women, reduce child mortality, improve maternal health, combat HIV/AIDS, ensure environmental sustainability, and build a global partnership for development.

The best proven way to achieve rapid economic growth is to develop a reasonably free and open market economy, based on private ownership and the rule of law. Although Ukraine's current growth rate exceeds any reasonable target, vulnerabilities are apparent. The challenge is to identify the critical weaknesses or bottlenecks in the economic and social system and assess how they can be eliminated quickly to sustain economic growth and social development. Our purpose is not to address all the problems that Ukraine faces, but rather to point to crucial challenges that need to and can be solved. We are realistic problem solvers. We focus on what can be done immediately or initiated within the first year of a new administration.

Ukraine has witnessed the formulation of many reform programs, and the immediate question is what we can add to what has already been accomplished. We want to formulate a practical vision for Ukraine. Our aim is to write a program that is readable and aimed not just at civil servants, but also at a broader intellectual and political elite. We are not pursuing any particular organizational agenda. We have selected five broad areas for reform because they are critical to sustaining economic growth, both now and over the coming year. We want to present not just a list of proposed measures, but also a concise explanation of our choices and how they can be enacted. Ideally, we would like to provide the new administration with a concrete program for the very short term.

Today, it is rather obvious what a vision for Ukraine looks like. A broad consensus acknowledges a number of common values. Ukrainians desire democracy and a state that is controlled by its citizens. They believe in the necessity of the rule of law and a market economy based on private property. At the same time, they want a market economy with a strong social orientation that provides a superior education system, good health care for all, and the limitation of poverty. Ukrainians also believe in an open world offering free movement of ideas, people, and trade. The dominant political forces have summarized these aspirations as Ukraine's "European Choice." This does not mean that Ukrainians want everything to be exactly as it is in the European Union (EU), but it implies a strong commitment to most of the basic values and principles embraced by Europe. Europe stands as an ambitious norm against which Ukraine can measure its achievements, not only in the economic sphere but even more so in the spheres of democracy, governance, and law.

1.2. Ukrainian Reforms in a Postcommunist Perspective

Ukraine is a country with many gifts. It has a large and well-educated population of 48 million. It is located in the center of Europe with ample access to the Black Sea coast. Its land is among the most fertile in the world, and it has long and diverse industrial traditions. It suffered immensely under communism and Nazi occupation, but it has now peacefully emerged as a united and independent nation. With the adoption of its Constitution of 1996, Ukraine has assumed all the attributes of a sovereign state.

Ukraine's transition to a market economy has been one of the most difficult of those experienced by former communist countries. Economically and socially, the first decade of independence was plagued by inordinate hardship. According to official figures, GDP fell for ten years straight, dropping by 54 percent between 1989 and 1999—the worst recession experienced by any transition country not marred by war. The official decline was no doubt exaggerated, but even the real decline might have been by about half. The standard of living fell less dramatically, because the share of consumption in GDP rose sharply. But poverty deepened more sharply, owing to rising inequality.

The economic decline had many causes. The old socialist economic system left a disastrous legacy. It produced the wrong products; quality was poor; inefficiency was vast. Whatever methods were chosen to dismantle the old system and build a new one, the costs of adjustment would have been great. Unfortunately, the transition policies adopted in Ukraine only made those costs worse. A slow and inconsistent approach to reform prolonged the country's already lengthy output decline.

During the early years of Ukrainian independence (1991-1994), market transition made little progress. Political energy was focused on the transformation of former Soviet institutions into national Ukrainian institutions. Populism warped economic policy: standard measures included the granting of new but unfinanced social entitlements, price controls, large enterprise subsidies, credits to loss-making state-owned enterprises, huge fiscal deficits, multiple exchange rates, netting-out operations (*vzaimozachety*), and money printing. As a result, Ukraine suffered from hyperinflation of over 10,000 percent in 1993, which demoralized and disorganized society.

Privatization was put on hold and the deregulation of trade and prices was delayed, so a real market was very slow to take shape. The old system had ceased to exist without a new system to replace it, and money did not work. The old state enterprises continued to operate under their old managers, who were lost in the new situation. Enterprises were left rudderless without real masters. In its overall transition progress, Ukraine lagged behind not only the Baltic states but also Russia and smaller CIS countries such as Kyrgyzstan, Armenia, Moldova, and Georgia.

The July 1994 presidential elections spurred the first comprehensive attempt to speed up the transition process. In the fall of 1994 Ukraine concluded its first program with the International Monetary Fund (IMF), which became an anchor for macroeconomic stabilization. Prices were liberalized, the exchange rate was unified, and trade was somewhat liberalized. The fiscal deficit and credit expansion were curbed, and in September 1996 a new permanent national currency, the hryvnia, was introduced. At long last, a mass privatization program with vouchers was launched. This burst of reform petered out after about a year, however, and output continued to drop.

Ukraine was badly shaken by the financial crash in Russia in 1998. External credit dried up; foreign trade in the region contracted sharply, and the international financial institutions tightened their demands. Ukraine hovered on the brink of external default in 1999, after having been forced to enact a substantial devaluation. This financial crisis showed that prior fiscal adjustment had been insufficient, and that exchange rate and price stability was unsustainable. The macroeconomic fragility of the second half of 1990s had deep microeconomic, structural, and institutional roots. Slow privatization, soft budget constraints, a lack of payment discipline (particularly in the energy sector), arbitrary taxation, wage and pension arrears, widespread barter and clearing operations, and multiple privileges of the well-connected rendered economic growth nearly impossible.

Fortunately, people learned. By the end of the 1990s, virtually everybody agreed. "We cannot go on living like this." ("Tak dalshe zhit' nelzya.") After the crisis, macroeconomic stabilization was accomplished with a minimal budget deficit and strict monetary policy. Inflation fell and the exchange rate stabilized. Most enterprises had been privatized, creating a critical mass of private enterprise. A real market economy had been formed. The pressures of the financial crisis forced the Ukrainian government to clean up its own act, improve budget and payment discipline, reduce enterprise subsidies, balance the budget, and cleanse the economy of barter. The government also carried out a land reform, introducing private ownership of agricultural land. A simplified tax regime and some deregulation fostered the development of small and medium-size enterprises and persuaded many small businesses to legalize unregistered economic activity. Privileges of the large financial-industrial groups were reduced, and the playing field became more level. Ukraine attained not only macroeconomic stability but also almost 6 percent economic growth in 2000. The country appeared to have turned the corner.

Since 2000 the Ukrainian economy has been thriving. Economic growth reached 9.4 percent in 2003 and was on course to hit at least 13 percent in 2004. The high rate of economic growth has been combined with a stellar macroeconomic performance, the fruits of which include a nearly balanced budget, low inflation, a steady exchange rate, a large positive current account balance, surging exports, swiftly expanding international reserves, and a declining ratio of public debt to GDP. However, inflation has surged again recently, approaching a double-digit annual level, and public expenditures have spiked dangerously during the presidential election campaign.

Ukraine's growth started with export industries, primarily steel, food processing, light industry, and telecommunications, and then spread to agriculture, machine building, and construction. The extraordinary economic boom is driven by many factors, notably high global steel prices, robust demand from rapidly growing markets in Russia and China, substantial free capacity, and ample underutilized human capital. The benefits of rapid growth have been widely felt: although inequality has remained roughly constant, the share of Ukrainians living in poverty has dropped.

Ukraine has undertaken substantial reforms in recent years, but they remain a patchwork. In the early 2000s, much of Ukraine's metallurgy, chemical, and petrochemical industries and part of the energy distribution network were privatized. However, these transactions were not open or transparent, and the beneficiaries were predominantly Ukrainian and Russian oligarchs. A large part of the Ukrainian economy remains in state hands, and is thus an easy target of rent extraction, as well as creating bottlenecks in some important sectors, notably telecommunications, energy production, and transportation. Ukraine's tax system has been substantially reformed, most recently with the introduction of a flat personal income tax of 13 percent from the beginning of 2004. These reforms have made the tax system more business-friendly, but further change is needed to simplify taxation and fight corruption.

A handful of large financial-industrial groups has come to dominate the Ukrainian economy. These groups are well represented in parliament and government. Although they are highly dynamic and competitive among themselves, they thrive in close collusion with the state and benefit from discretionary fiscal and regulatory privileges—what amounts to “state capture”. The challenge for the future is to discipline their behavior through market competition and a legal leveling of the playing field.

Ukraine's economic situation has never been brighter, but there is no room for complacency. Looking ahead, the key concern is to sustain high rates of economic growth, without forgetting the risk of overheating. Other transition countries have experienced several years of respectable economic growth, only to encounter both slumping growth rates and new macroeconomic problems. The first years of recovery growth may be relatively simple, because of ample idle capacity and a pent-up demand for investment. Possibly the exceptional length and magnitude of the output decline in Ukraine left more room for a catch-up recovery than it did in most other transition countries—but this impulse will eventually exhaust itself. Ukraine has already experienced the beginning of an investment boom, but there is no guarantee this will last.

To sustain robust growth, Ukraine, like other CIS countries, urgently needs a second wave of reforms to address the country's main institutional and structural problems. These must go well beyond a purely economic agenda, encompassing legal, administrative, and political reforms as well. Such reforms are necessary to create a healthy business environment, and integrate Ukraine properly into the global economy and the international community. Failure to design, launch, and resolutely implement such reforms could undermine prospects for economic growth over the medium and long term.

1.3. The Essence of Ukraine's Troubled Transformation

Despite nearly five years of vigorous growth, Ukraine remains one of the poorest and socially most unfortunate countries of Europe. Therefore, Ukraine's ability to ensure sustained rapid economic growth and the associated rise in living standards over 15-20 years is critical for the country's future, for its place in the world system, and even for its existence as an independent state.

One challenge is to create incentives for the self-development of social forces (salaried employees, entrepreneurs, politicians, students, and other groups) while at the same time building an efficient state. Society needs to restrain the state from misusing its monopoly of power, while the state needs to act in the public interest to set limits for the activity of the country's diverse social forces.

Such a model has evolved over the course of the development of European civilization. Ukraine now has a chance to embrace this model. Four objectives are key: the formation of a law-governed democratic state, a political nation, a civil society, and a market economy. The challenge is to achieve quickly and simultaneously what other countries have taken centuries to accomplish.

Ukraine's postcommunist transformation was spurred by external rather than internal events, namely the collapse of the Soviet Union and the worldwide disintegration of the communist political and economic system. These events determined the starting point, the direction, and the pace of Ukraine's transformation. The lack of internal stimulus meant that the country embarked on a new era without any influential social forces that saw their self-interest in embracing a market transition or providing political support for the systematic implementation of necessary reforms.

Under these conditions, Ukraine failed to provide an immediate and full-fledged democratic alternative to the political power of the Communist Party. The bureaucracy filled the vacant political niche. From the outset of independence the bureaucracy functioned not as an instrument of political power, but rather as the sole subject of power. Having usurped power, the bureaucracy downplayed the need for change, and it did so with great success. It managed to retain the old Soviet personnel and the values and administrative techniques of the Soviet system.

Rather than attempting to complete the transition to a market economy, the bureaucracy preserved many features of the Soviet state machinery: the blurred line between the state and enterprises, resulting in ambiguous and insecure property rights; the overregulation of the economy, limiting economic freedom; the artificial monopolization of markets; a discretionary economic policy providing selective support to favored branches and enterprises; a policy of low accountability of well-connected economic entities; and a selective application of punitive actions. The bureaucrats ruled, working to maximize their own discretionary powers while minimizing their responsibility. Lacking a developed ideology and free of democratic political control, the bureaucracy spontaneously privatized the functions of the state. The result was an explosion of corruption.

Thus, the problems Ukraine has been facing in its economic development should not be seen as accidents, rather as logical consequences of bureaucratic rule. In their relations with newly emerged private business, corruption has not been just an additional tax levied by the bureaucracy on entrepreneurship, but also a form of private business selection. Bureaucrats, each at his own level of power, have battled for the right to decide who may, and who may not, possess capital, to restrict the activities allowed, and to set limits on growth. This bureaucratic selection has rendered capital "black" and distorted competition among enterprises. Rather than efficient and competitive companies, businessmen who have good connections with bureaucrats have thrived. This explains why a few large financial-industrial groups have benefited at the expense of small and medium-size businesses. The thresholds for going into business were set high, effectively barring small firms.

This interaction between the bureaucracy and private capital has led to the formation and consolidation of financial-industrial groups around regional seats of power. As the economic power of regional clans has grown, the relationship between the bureaucracy and large business operations has changed, and the large business groups have taken the lead. Yet the commonality of interests persists, and small and medium-size businesses continue to suffer as a consequence.

Collusion between big business and the bureaucracy is the reason Ukraine's business environment is so difficult. According to a regular poll of enterprises conducted by the International Financial Corporation in 2002,³ interference by the authorities is viewed as a major impediment to the development of business: 40 percent of respondents complained about the local authorities and 35 percent about the central authorities. Corruption was a significant obstacle for 51 percent of respondents. More than a quarter reported that each regulatory procedure (certification, licensing, registration, and customs) had to be paid for "privately", and 40 percent said they had to pay privately for every mandatory permit to commence operations (from the fire services, sanitary and epidemiological services, and state labor safety supervision authorities). Fifty-six percent are significantly hampered by unfair competition. Most entrepreneurs blame the authorities; only 20 percent of respondents believed that the authorities ensure fair business conditions.

Yet the state bureaucracy is not ideologically opposed to reform. On the contrary, it flourishes in a period of transition because the nontransparent and indeterminate state offers ample opportunities for rent seeking. Indeed, the post-Soviet bureaucracy has enacted reforms, provided that changes have served its personal interests. The bureaucracy sees its interest in prolonging the transformation process, even as its efforts retard and distort proper reform. If reforms are to reflect broader social interests and serve the goal of economic growth, one of two strategies needs to be followed: either the bureaucracy is brought under political control, or the interests of the bureaucracy are coopted.

Reforms have caused painfully high social costs in Ukraine because they have been so inconsistent and unsystematic. Economic changes have not been accompanied by adequate social reforms or reforms of the political and administrative system. The judicial system does not yet function well, and checks and balances remain ineffective. Most of the population accepts neither the methods nor the substance of the changes that have occurred, distrusting politicians, bureaucrats, businessmen, and government institutions. An ineffective state machinery mistrusted by society has become the main obstacle to further progress. In order to proceed with reforms, the authorities must find solutions to these problems. It is vital to rebuild public confidence and restore the legitimacy of the transformation process, of state power, of new social forces, and most of all of private capital.

The transformation crisis has forced Ukrainian society and state to face countless social, environmental, economic, and political challenges. Examples are the polarization of wealth and poverty, the epidemics of AIDS and tuberculosis, the inability of many working people to support their families or to buy a dwelling, pensioners' inadequate nutrition, and health care patients' inability to pay for complex treatment and costly medicines. The scope of these problems exceeds the limited capability of the state machinery. The key to a solution appears to lie in the nurturing of public confidence and the mobilization of social forces that see a personal interest in the modernization of the society and the state. If the public can be convinced to engage in reform as an active advocate, reforms can both pick up pace and more accurately reflect social needs.

1.4. What Should Be Done: A Vision for Ukraine

In our view, the shared vision of a European Choice contains the solutions Ukraine needs: a free and open market economy, based on private ownership and the rule of law as well as the ideal of social solidarity. Our focus on practical measures that can be implemented immediately or initiated within the first year of a new administration means that we stay away from certain issues. Ukraine has made great strides in macroeconomic stabilization; problems may arise

³ *Business Environment in Ukraine*, International Financial Corporation, September 2003, pp. 10, 24, 104.

anew, but at present these do not appear critical. Other issues, notably political reform, breed political controversy. This reform must take place, but we eschew the details and stick to general principles, since details are inevitably partisan. We focus instead on outlining solutions to major obstacles to Ukraine's near-term economic development.

We propose five priority areas for reform (each of which is the subject of a chapter in this report). First, the fundamental problem in Ukraine, as in other postcommunist countries, is that the state rules rather than serves its citizens. The relationship between state and citizen must change. To win the confidence of its citizens, the state machinery must become efficient and effective through real control by society and law. Second, citizens need to have access to adequate living conditions, so that society can enjoy stability and security. Third, the tax system and the legal base of the financial system need to be improved to stimulate economic growth. Fourth, a clear line must be drawn between state and private enterprise, so that property rights can be fully guaranteed. The relations between entrepreneurs and the state should be clearly defined in law and reinforced by an impartial and competent judiciary. Fifth, Ukraine's integration into the world economy must be facilitated through early accession to the World Trade Organization (WTO). Progress in these key areas will allow the country to flourish as it should.

The first area of priority reforms includes political reform, administrative reform, reform of relations between the central state and local governments, and judicial reform. As described in detail in Chapter 2, the following steps should be carried out immediately.

- *Execute political reform.* This reform should make the government institutionally accountable to the will of its citizens, introduce effective mechanisms of political checks and balances, and create procedures for peaceful conflict resolution in society. If enacted successfully, these reforms should help citizens gain confidence in their political institutions.
- *Conduct administrative reform.* Administrative reform must ensure the subordination of the state bureaucracy to democratically elected politicians, lead to a fundamental renewal of the bureaucratic system, make civil servants personally responsible and accountable for the results of their actions (or inaction), and ensure the consistency of bureaucratic procedures. The criterion for success of the administrative reform should also be improved public confidence in the executive. A clear line should be drawn between the state and private business. Political, administrative, and entrepreneurial activities should be clearly separated, and lobbying should be legalized and laid open to public scrutiny and control.
- *Make the government open and transparent.* The best means of transparency is the principle of full public access to all information that is not of a strictly personal nature or pertains to the nation's external security. This change can be executed in a single law.
- *Enact judicial reform.* Courts and judges require institutional independence from executive power, while judges' organizations need to exercise better disciplinary control over judges. Success would be measured in enhanced public confidence in the judiciary.

Social reforms are a second priority area. Ukraine spends a comparatively large share of its GDP on social expenditures, but such spending is inefficient and huge sums are wasted. Health care and municipal housing stand out as the most backward sectors (see Chapter 3).

- *Reform health care financing.* The situation in health care is the most sensitive issue for the population. The Soviet system of free health care has deteriorated seriously. The

state lacks the resources needed to maintain free-of-charge prophylactic examinations and treatment of diseases, but no alternative model has been created. Payments under the table have become the norm for medical services. Not only poor people, but also the vast majority of households cannot afford necessary medicines. Immediate measures are required to introduce a mixed state and private insurance system to finance health care, which should be adequate to the population's actual incomes. Vital medicines must be affordable.

- *Facilitate access to housing.* Most citizens—86 percent according to the Institute of Society of the National Academy of Sciences—are in no position to purchase a new dwelling. Housing expenses are perceived as a high, unjustified tax, causing great discontent, particularly among young families and pensioners. A great deal can be done promptly to alleviate these hardships. Legislation on mass mortgage credit lending should be completed and implemented. Non-state housing construction should be stimulated through generous tax rules for amortization. The housing maintenance system should be de-monopolized; competition should both improve services and reduce costs.

A third priority area consists of further tax reform and the development of the financial sector (see Chapter 4). A great deal has been accomplished in these spheres, but Ukraine needs a fully modernized tax system to maintain its economic momentum. The financial system has developed very quickly in recent years, but its legal foundations are still rudimentary. This shortcoming impedes the evolution of many financial services that are vital to further economic development.

- *Streamline the tax system.* The Ukrainian tax system has undergone steady improvement and liberalization, moving in the direction of fewer taxes, lower rates, and simpler procedures. Alas, the tax system remains a patchwork of inconsistent legislation. The first priority is to adopt a normal tax code that unifies the tax system. The second task is to make sure that refunds of value-added tax (VAT) for exporters actually work, so that they are not being punished with an unlawful levy of no less than 20 percent. The number of taxes should be further reduced. In particular, the four social taxes (the purported social insurance contribution) should be combined into a unified social tax. The payroll tax and the profit tax should be the first to be reduced. Tax collection should be carried out by a single State Tax Administration to avoid competition among revenue services. The arbitrary powers of the tax authorities should be checked, by decriminalizing most tax violations. In the medium term, the total tax burden should be reduced from the current high level of 39 percent of GDP to a more moderate 25-30 percent of GDP, by cutting unjustified or even harmful social expenditures. Any tax reduction should be matched by a corresponding expenditure cut or elimination of tax exemptions (see Section 4.1).
- *Enact sound financial legislation.* Ukraine's financial markets are developing very fast, especially commercial banking. The market structure is surprisingly sound, with many healthy and competitive private banks, although the legal basis is both rudimentary and contradictory. In particular, the Economic Code adopted in 2003 should be abolished, because it contradicts the simultaneously adopted Civil Code and represents a return to Soviet economic concepts. Normal laws on joint-stock companies and other legal forms of enterprises are needed. A number of laws need to be promulgated on basic financial concepts. In property registration, legislation as well as practices are lagging behind and impeding the development of property markets. A single strong regulatory body for financial markets should be developed. Currency regulations should be eased to facilitate the inflow of foreign investment, especially into the financial sector (see Section 4.2).

The fourth priority area targets the traditional Russian and Soviet disrespect for private property – something that has been perpetuated by the current relations between the state and private business in post-Soviet Ukraine (see Chapter 5). This is the principal obstacle to the development of entrepreneurship, improvement in the country's investment rating, and the attraction of large foreign investments. If left unchecked, this condition could paralyze resurgent economic growth.

- *Finish privatization.* Completion of the privatization process in the medium term is a key priority. Every effort should be made to make privatization transparent. However, the continued presence of a large number of “state” enterprises that are really rudderless and without masters entices big businessmen to influence the state unduly to pick up these tasty morsels at little cost. The large amount of state property is demoralizing and corrupting in itself (see Section 5.1).
- *Eliminate red tape.* A major problem of postcommunism has turned out to be excessive bureaucratic intervention in private enterprises, through subsidies, licensing, regulation, inspection, and extortion. The source for these hazards is that state officials do not respect the integrity of private property, that state agencies suffer from underfunded mandates, and that businessmen as well as individuals have few means to defend themselves (see Section 5.2).
- *Promote competition effectively.* One means of countering the barriers to competition is competition and antimonopoly policy. This should be clearly focused on real monopolies, especially in network industries, and the regulatory organs should be both independent and strong, while subject to control so that they do not succumb to corruption (see Section 5.3).

The fifth priority area is Ukraine's international integration, which is vital for the country's economic development. All economies that grow quickly do so through expansion of their exports. Ukraine needs to integrate both to the East and to the West (see Chapter 6).

- *Join the WTO.* The critical hurdle that Ukraine needs to overcome is to accede to the WTO, and this goal is within reach. WTO membership will help Ukraine to defend itself against anti-dumping cases and other protectionist measures by trade partners.
- *Negotiate free trade with the EU.* Ukraine should negotiate an initial action plan with the EU that leads to a free trade agreement and makes the option of EU membership a real possibility. At the same time, Ukraine should work to facilitate the right of Ukrainian citizens to travel abroad for education, work, and tourism. The accession of ten new member states to the EU made the issue of trade, economic, and political relations with the EU even more important for Ukraine, which became a direct and important neighbor. EU enlargement has brought Ukraine both new risks (visa requirements and some new trade barriers) and opportunities (greater interest by new EU members in expanding relations with Ukraine and other CIS countries).
- *Pursue free trade in the CIS.* On the basis of WTO membership, Ukraine should breathe life into its free trade agreement with other post-Soviet countries.

However resolutely and promptly the measures listed above are taken, years will pass before their full positive impact can be felt, and the steps needed to achieve them will arouse fierce conflicts of interests. But credible signals that the government has adopted a reform course will resonate immediately with the public. If this policy is pursued honestly, understandably, and consistently, public confidence in the government will grow. Such confidence will mobilize society, and also facilitate the execution of a wider range of reforms, creating an innovative model of development and bringing the Ukrainian economy from the world's periphery to the center of its dynamism.

Our Key Recommendations

This report contains over one hundred specific recommendations that we urge the new President of Ukraine to enact, or at least initiate work on, within one year of his inauguration. Some recommendations are more important than others; here we identify the top priorities.

Most fundamental is political reform. The details are controversial, but the guiding principles are clear. First, a clear division of responsibility and accountability is vital. Second, the rulers must ultimately be responsible to society. Third, to enforce accountability, transparency is necessary. Fourth, government must be monitored through effective, professional, and independent auditing.

Ukraine's current economic achievements all rest on fiscal and monetary stability. This stability must be maintained in the future, as a necessary precondition for sustainable economic growth. The independence of the National Bank of Ukraine should be strengthened, and the central bank should focus on maintaining price stability. Recent excessive and populist expenditures are worrisome and must be reined in after the elections. The danger of overheating is evident and must be checked.

The most urgent specific reform recommendations are:

1. To make government more effective and efficient, an administrative reform is needed. Its goals should include greater accountability, transparency, professionalism, the protection of ordinary citizens, and a clear distinction between political appointments and a professional civil service.
2. To secure access to effective and efficient justice, a judicial reform is essential, both to make judges independent and impartial, and to make the court administration more efficient.
3. To improve the delivery of public services, a territorial-administrative reform should be enacted. This would make the lowest administrative levels financially viable, while decentralizing powers and financing from the central government to regional and local governments.
4. To enhance the efficiency and quality of health care, mandatory public medical insurance should be introduced, using a multi-level insurance-based approach for health care financing that provides for competition among care providers.
5. To encourage Ukrainians to work legally and stimulate economic growth and investment, a liberal tax code should be enacted. This would reduce the number of taxes, lower the tax rates, eliminate exemptions, decentralize the tax system, and eliminate competing revenue services.
6. Public expenditures should be reduced substantially over the next five years. Non-essential and harmful spending, such as enterprise subsidies that impede structural reform, should be cut. Social transfers to the wealthy should end; social spending should target poverty reduction.
7. To resolve conflicts among shareholders, secure the rights of minority shareholders, and attain transparency of ownership, corporate legislation needs to be improved. A modern Law on Joint-Stock Companies and other legal company forms needs to be adopted.
8. To resolve the conflict between two contradictory legislative frameworks, the Economic Code, which hails from the old command economy, should be abolished, while the Civil Code, which provides a legal foundation for a normal market economy, should be developed.

9. Proper property markets need to be established, primarily by abolishing the moratorium on the sale of agricultural land and by establishing a functioning, unified property registry.
10. A level playing field for economic activity should be created, through the abolition of regulatory discrimination and subsidies directed to enterprises. Discretionary state intervention in pricing, trade, and enterprise should be prohibited except where regulated by law.
11. To achieve true integration with the world economy, Ukraine should join the WTO in 2005.
12. Ukraine should make the European Choice a reality by adopting European legal standards. Agreement should be reached with the European Union on an initial action plan that will pave the way to a free trade agreement and make future membership of the EU a real opportunity.

Chapter 2. State and Citizen: Improvement of the State

2.1. The Relationship between State and Citizen

Persisting Mutual Distrust between Citizen and State

The fundamental problem with the government in Ukraine is that its activities are based on the old Soviet concept of paternalism. The government and the state authorities, as a whole, are supposed to take care of the rest of population. Since the central state is responsible for everything, over-centralization is a natural consequence. If the people are not perceived as fully responsible, transparency and checks and balances make no sense, because the government does not trust the people. Since the government has to take responsibility for everything, it becomes overburdened and does not have sufficient time to deal with policy. It easily looks like a fire brigade, preoccupied with the latest crisis rather than with long-term strategy. Strategic tasks are neglected or left unattended.

In these circumstances, the government is unable to undertake effective political reforms or to implement strategic priorities for national development. The most serious problem is that most people have lost confidence in the government. The people are striving to separate their lives from the public authorities and try to solve their problems with little consideration to the rules set by the state. Independent organizations and enterprises do the same. They do not want to entrust the solution of any problems to government institutions because of their lack of transparency. They do not like to pay taxes and other duties to the state of their own free will, since they do not believe in the state's ability to solve their problems. The state has become a burden rather than a problem solver.

The systems of oversight and accountability are largely internal to the administration and are directed towards satisfying the demands of the executive. State officials are generally impervious to attempts to supervise or challenge their actions by the judiciary, non-judicial oversight institutions (such as the Human Rights Ombudsman of the *Verkhovna Rada*, the Supreme Accounting Chamber, or Committees of the *Verkhovna Rada*), or by civil society organizations (through the demands of media and civic and professional associations). The problem of building an independent judiciary in Ukraine has proved particularly acute. Burdened by poor pay and training, by pressure from state authorities (over whom they should be exercising control), and by weak laws and traditions regarding judicial control over state administration, Ukraine's judges are often unable or reluctant to review, alter, or set aside the improper or unlawful actions of state bodies. As a result, the application of Ukraine's Constitution and the European Convention on Human Rights often seems erratic and inconsistent.

The lack of external influence over the administration is reflected in Ukrainian society's frustration with the failure of the state to realize the common democratic values that lie at the core of the rule of law. Surveys indicate that many Ukrainians remain cynical and skeptical of the law as a brake on state power and as a protector of their rights. These perceptions are substantiated by the essentially unreconstructed condition of legal education and the weakness of the legal profession in Ukraine. These factors reinforce a legal culture where lawyers are often seen, and often see themselves, primarily as servants of the state. Thus, the Soviet-era notion that the powers of the state take precedence over the rights of the citizen is at times perpetuated by the very profession that should be exerting the greatest pressure to demand that the state perform its obligations to the citizen. Under these circumstances, citizens are denied an effective voice in how they are governed.

Combined with political and institutional resistance to reforms, these issues can serve to undermine Ukraine's process of democratic transformation. Unchecked, this could further erode the citizen's trust in the state and imperil the consolidation of Ukrainian democracy.

A New Relationship between State and Citizen

Ukraine has with great vigor declared its European Choice. One of the most important aspects of this choice is to form a new relationship between state and citizen. To a large extent, not only the success of Ukraine's European integration aspirations, but its whole development, will be determined by how the Ukrainian state deals with its citizens. European democracies mediate the relationship between the citizen and the state through a system of democratic governance based on the principles of the rule of law. These are a set of overarching principles and common values based on notions of individual freedom, fairness, and justice and encompass respect for fundamental human rights, equality before the law, and the right of citizens to a voice in how they are governed. These are the organizing principles of a liberal democracy. They make the state accountable before its citizens by limiting state power in favor of protecting citizen rights. They also ensure that all actions by state officials respect citizen rights and are taken according to fair and transparent procedures.

The universality of rule of law principles is well established in European and international law and has been embodied in the Statute of the Council of Europe and its European Convention on Human Rights. Ukraine has ratified both conventions, whose provisions now have the force of domestic law. Rule of law principles are also explicitly entrenched in Ukraine's Constitution and meant to permeate all aspects of the citizen's intersection with the state: the provision of quality health care services, education, adequate social benefits, pensions and employment opportunities, the establishment of a system of equitable taxation, a transparent privatization process, an independent and unbiased judiciary to adjudicate challenges to state authority, and the transparent and fair regulation of property rights within a market economy.

Democratic governance is therefore essential to confronting Ukraine's many challenges, including preventing poverty, fostering economic growth, honing its international competitiveness, and integrating into the broader European community. Successive Ukrainian governments have developed legislative and administrative platforms to promote economic, social, judicial, and administrative reforms.

Ukraine has adopted the normative basis to develop a state governed by the rule of law, although the transition process has been complicated by a "command-administrative" tradition of governance that emphasizes the perpetuation of the power of the state over the protection of the rights of individuals. The challenge today is to overcome the still overwhelming state interference in the activities of citizens, an over-concentration of discretionary power in the hands of state officials, and an opaque and exclusive decision-making process. The institutions of civil society need to be strengthened and the rights of citizens reinforced.

An effective system of democratic governance restrains the behavior of government institutions through strict external oversight and control. The judicial review of administrative action is the most vital component of this system. By efficiently and expeditiously assessing the legality of administrative acts and resolving disputes, the judiciary brings governments to heel, protects citizen rights against violations, promotes certainty in legal relations, and enhances the credibility of state institutions in the eyes of citizens.

By establishing a state-citizen dynamic based on the dignity and security of the person, a system of democratic governance promotes social and political stability, strengthens sustainable, equitable economic growth, promotes human security and development, facilitates the development of common societal ideals and values, and contributes to regional stability and

security. The establishment of such a system is therefore essential to Ukraine's democratic transformation and the attainment of its national objective of integration into Europe's political, economic, and security architecture.

Certain key measures should initiate this process:

1. *Complete the process of administrative reform and improve the quality of the state administration.* The principles of paternalism should be replaced by democratic principles of administration. Transparency, accountability, and respect for citizen rights should become the essential characteristics of the work of all state bodies at every level of government. It is therefore essential to adopt open and efficient procedures governing the issuance, review, and appeal of all administrative (including normative) acts, especially where bureaucratic discretion is involved. Measures include: the adoption of new accountability-related legislation (new codes of administrative procedures, ethics for civil servants, and strict conflict-of-interest legislation), and the implementation of transparent procedures and regulations governing the cabinet decision-making process. (Section 2.2 elaborates on this topic.)
2. *Start a territorial-administrative reform.* Authority should be devolved from central bodies of executive power to lower levels of government that are closest to the citizen and best positioned to deliver vital public services (health care, education, employment assistance). This will require a clarification of the respective roles of the different levels of government with a view to determining how to deliver services most effectively to the citizen (e.g., ministries should focus on policy development, the setting of standards for services, and the enforcement of standards and inspections to protect the public; regional and local governments should focus on the actual delivery of the services), as well as considerable reform of the budget system to finance adequately the delivery of services by municipalities. (Section 2.3 discusses this issue.)
3. *Enact judicial reform to hold state bodies accountable.* This can be achieved by strengthening external mechanisms of oversight and control to protect and enforce the rights of citizens in their dealings with state bodies. In addition, the *Verkhovna Rada* should adopt the Draft Administrative Court Procedure Code currently under consideration. The role of the Human Rights Ombudsman of the *Verkhovna Rada* should be strengthened and the Permanent Committees of the *Verkhovna Rada* could be provided with greater powers of inquiry of the executive. (This is discussed in Section 2.4.)
4. *Enhance civil society participation in the governance process.* At the core of every democracy, and the strongest bulwark against corruption, is a robust and politically aware community that is able to keep state officials at all levels honest and accountable. The inclusion of citizens in the decision-making process will help facilitate the emergence of common social values around which public policy can be made and which ensure transparency, accountability, and better service delivery by state agencies at every level. Further, the ability of citizens to protect their rights will improve governance: concerned by the effectiveness of citizen challenges to government actions, state officials will be motivated to make better decisions. The principal measures are obvious: to guarantee free expression and media freedom; to facilitate the emergence of a new rights-based culture in civil society by promoting awareness among citizens of remedies to violation of their rights by state bodies; and to create mechanisms for effective citizen participation in the decision-making process (legislation that would improve access to information, open budget hearings at the local level, public consultations).

2.2. Vital Administrative Reform

As a constitutional and democratic state, Ukraine needs a full-fledged administrative reform. The system that underpins the organization and operation of public authorities, in particular executive public authorities and local self-governments, must meet the requirements of proper governance. This implies respect for democratic values, rule of law, and legality principles, as well as an efficient and effective public administration.

Achievements of Public Administration Reform

The attitude toward administrative reform in Ukraine changed with the adoption of the Constitution in 1996. The Constitution left unsettled several matters related to the functioning of executive authorities, however, and these had to be regulated by new laws. In order to implement the provisions of the Constitution, several draft laws were developed (concerning the Cabinet of Ministers and the local State Administrations).

However, the failure of the Ukrainian political elite to secure approval of these draft laws led to the establishment of a State Commission on Administrative Reform under a presidential decree adopted on 7 June 1997. In 1998 the Commission adopted a Concept of the Administrative Reform in Ukraine (Presidential Decree #810/98, 22 July 1998), which established guidelines for public administration reform, with the following goals:

- Shifting the role of the government from economic management to public policy;
- Introducing a new government mission, ensuring the realization of human rights and freedoms and the provision of public services;
- Transforming public service into an independent apolitical institution capable of efficient implementation of public policy; and
- Increasing public engagement in government policy, and introducing a system of control over executive authorities by society through parliamentary democracy.

In the fall of 1999 administrative reform became a topic in the presidential election campaign. As a consequence, immediately after the December 1999 elections, three systemic presidential decrees were signed: on the System of Central Executive Authorities, on Changes in the System of Central Public Authorities, and on the Composition of the Cabinet of Ministers of Ukraine. These acts marked a new way of thinking about internal transformations of government organizational structures, and of procedures for public policy development. The most important changes declared by the decrees were:

- Increasing the role of ministers;
- Making the Secretariat of the Cabinet of Ministers functional rather than sectoral;
- Introducing government committees as working bodies of the cabinet in order to improve the efficiency of the cabinet's work and coordinate the central executive authorities; and
- Introducing a new procedure for the harmonization of the content of draft legal acts by central executive authorities.

In 2001-2002 administrative reform dealt with the planning system at the central government level and communication with the public in the course of policy development. The adoption of a Budget Code of Ukraine introduced new approaches to the planning of goals and expenses of executive authorities (21 June 2001, #2542-III). Several presidential decrees were issued to ensure the openness and transparency of public authorities, and the realization of

citizens' right to participate in public governance and to free access to information related to the activity of public authorities (17 May 2001, #325; 1 August 2002, #683).

In 2004 important declarations and strategic documents were made in the sphere of public service. The President issued a decree on the Strategy of the Reform of Public Service (14 April 2004, #599) and another decree on the Concept of Adaptation of Public Service Institutions to EU Standards (#278/2004). Though none of these has led to much change as yet, they have promoted a new type of public discourse on public service that is likely to influence future reforms.

The adoption of these important decrees has had little impact on the functioning of the government. Granted, ministers have become politicians rather than civil servants, but no clear line has been drawn between politicians and civil servants. This failure was reflected in the abolition of the purportedly permanent State Secretaries, who were supposed to have been the highest-ranking civil servants. The cabinet model of government work, including political accountability to the parliament and the public, has not been institutionalized. By 2001, nearly all the steps taken with the 1999 decrees had been rolled back. The problem was not that attempted reforms went in the wrong direction but rather that steps taken towards public administration reform were inconsistent. As a result, the effort fell short of a consistent new system of administration.

Problems with the Current Administration

As a result of this abortive reform, most of the old problems persist, and the defects in Ukraine's system of public administration impede social and economic transformation. The key flaws are an inability to initiate and pursue reforms; a deficient response by the authorities to problems; a lack of respect for the rights of citizens; corruption and bureaucratization; and inefficient use of public resources.

The problems of the Ukrainian administration have their roots in communist rule. The fundamental problem is that the President and the presidential administration have assumed the role previously played by the Central Committee of the Communist Party. They intervene everywhere in the executive without legitimacy, transparency, or accountability. In effect, all executives suffer from a parallel subordination to the presidential administration and the government. Another communist legacy is excessive centralization, which overburdens all top officials with routine administration and leaves them little time for actual policymaking. For the same reason, the government has too many central bodies, and coordination among them is poor. Although officials have low salaries, top figures have access to many fringe benefits. Corruption is universal.

The key problems needing resolution include:

Unclear division of powers between the President and the Cabinet of Ministers. The presidential administration exceeds its powers, by issuing regulations concerning economic matters, organization of public authorities, and local self-governance, among others, and by appointing deputy heads of central executive authorities. Many strategic, political, and staffing decisions are *de facto* taken in the presidential administration, while political and legal responsibility for such decisions falls to the government.

Ineffective decision-making procedures within the Cabinet of Ministers. The government is overburdened with administrative functions. Political and long-term strategic matters are given secondary importance. Government decisions are often excessively collective, since too many signatures and formal approvals are required.

Irrational system of central public executive authorities. The number of central public executive authorities is growing steadily (they number 60 today, although the crucial decrees of 1999 had reduced them to 47), and their status in effect rivals that of ministries. Many central public executive authorities are directly subordinated to the President rather than to the government. Horizontal coordination is weak, and centralization is excessive, especially as most central authorities develop their own vertical administrations rather than delegating to local authorities.

Inefficient internal organization of ministries. There is no separation between the political and administrative leadership of ministries. The post of minister is the only political position in a ministry, yet civil servants often fulfill political functions. Ministers are overburdened with administrative issues that should rightly be delegated.

Politicized civil service system. Hiring and promotion in the civil service take place on a personal basis rather than through exams. The civil service is not protected from political influence. It is also unstable, especially as civil servants of high rank fulfill political functions, and are often drawn into election and other political campaigns. Not surprisingly, civil servants can be dismissed without explanation. Corruption is a serious problem, not least because of low salaries.

Vulnerability of citizens in dealings with authorities. No general law regulates administrative procedures. Instead, officials are often presumed to be in the right in any dispute. Public administration lacks transparency, and judicial protection is not effective.

Recommendations

The administrative reform should aim at eliminating these deficiencies, as well as their causes. The task is to expunge communist legacies from the administration and transform it into a modern, European, and democratic administration. Some of the actions proposed below should be initiated within the new administration's first 100 days in office, and most of them should be completed by the end of 2005.

1. *Make the government political.* The government must be political and take political responsibility, by being formed as a coalition by parliamentary factions through the mediation of the President.
2. *Focus on strategy and policy.* The government shall focus its work on strategic issues, mainly the conduct of reforms, which should be concentrated in a government program, which will govern policy. Routine administration should be delegated to line government institutions and local authorities.
3. *Make a vice premier responsible for administrative reform.* One member of the government (a deputy prime minister without portfolio) should be put in charge of administrative reform.
4. *Restructure the cabinet of ministers.* Administrative reform must start at the top, namely with the cabinet. The government should concentrate its activities on strategic matters, primarily on reforms. All government policy spheres should be entirely divided among members of the cabinet of ministers, so that each and every policy issue is included among the responsibilities of one of the cabinet members. Ministers should also be able to hold the title of deputy prime ministers, whose main responsibility would be to chair the government committees.
5. *Reform the secretariat of the cabinet of ministers.* The functions and structure of the secretariat of the cabinet of ministers should change. In addition to being the chancellery that formally prepares meetings of government committees and the cabinet, the

secretariat should become the prime minister's chancellery, analyzing government policy decisions developed by the ministries. The secretariat should also monitor the ministries' progress in implementing the government's program.

6. *Make ministers responsible.* The current practice of collecting dozens of signatures on every document needs to cease. Instead, each minister needs to assume true responsibility for a discrete and coherent set of topics. Currently, the cabinet makes too many decisions to be able to discuss policy sufficiently. Most decisions now undertaken by the cabinet as a whole need to be delegated to individual ministers.
7. *Change the work of the ministries.* To assume new responsibilities and take such decisions, the structure and principles of each ministry's work need to change. Ministries should become functional rather than branch-oriented.
8. *Finance the government in full.* One major cause of corruption is unfinanced mandates, that is, proclaimed government programs that are not financed from the government budget. At the same time, detailed government budgets specify exactly on what kind of costs everything should be spent. As a result, state agencies of all varieties seek their own sources of financing, often through illicit fees. All regulatory agencies should be given appropriate budgets for their expenditures and sufficient discretion to use their funds to support the work of their agency. No regulatory agency should be allowed to extract additional revenues from enterprises or individuals. By contrast, real service providers, delivering education, health care, and cultural services, should be allowed to attract additional private funds by selling services that go beyond the minimum of state-financed social services or by attracting donations.
9. *Distinguish political appointees from civil servants.* Top ministerial posts should be divided into two categories: political and administrative. Deputy ministers should be regarded as political appointees, and their number should be limited.
10. *Introduce transparency.* Ukraine suffers badly from corruption. The best means to fight corruption is transparency. Ukraine should adopt the Scandinavian type of freedom of information act, which states that all public documents that do not compromise national security or incriminate individuals inadvertently are open to any member of the public. All laws, decrees, and court judgments as well as the state budget and statistics should be made publicly available on the Internet, free of charge.
11. *Review the functions of ministries,* as well as offices and institutions subordinated to them. Such a functional review should be used as the basis for the decentralization and deconcentration of governance functions and powers, aimed at putting the system of executive authorities and their territorial structure and internal organization in good order.
12. *Abolish redundant inspection and revenue agencies.* One aim of a functional review is to abolish redundant bodies. An outstanding example is the tax police. Revenue collection should be the task of a single state agency, with rare exceptions (such as the customs service). The current four social funds should be deprived of any revenue-collecting function, and this should be transferred to the State Tax Administration.
13. *Reform the civil service.* A fundamental reform must be initiated swiftly, even though it will take time to show results. It should embody the following principles:
 - a) Formation of a politically neutral civil service;
 - b) Political neutrality for entry into the civil service;
 - c) Guaranteed rights and duties of civil servants, including safety of employment regardless of political conviction and promotion based on merit rather than political views or favoritism;

- d) Competitive exams based on merit for entry into the civil service;
 - e) A clear definition of corruption combined with a prohibition against it;
 - f) Strict ethics rules to prevent conflicts of interest, prohibiting the combination of business activities and government office.
14. *Reduce the power of civil servants.* As the very term implies, civil servants should serve the people rather than behaving like their masters. The formal power of civil servants should be reduced to help them to gain the respect of the people. No government servant, including policemen, should be allowed to charge any fine on the spot. All payments of penalties should be made through formal channels. The power of government authorities to arrest people should also be reduced, notably for so-called economic crimes and especially for tax violations, most of which should be decriminalized. Increasingly, the government should be forced to go to civil court rather than having the right to prosecute people.
 15. *Raise salaries and reduce numbers of civil servants.* It makes no sense to employ many civil servants with vast powers and pay them poorly. Civil servants, especially senior officials, should be able to live on their salaries, which means salaries must be substantially higher. Selection on merit will help reduce the bloated bureaucracy to a reasonable size.
 16. *Transform privileges in kind into money.* While civil servants should be given substantial salary increases, most benefits in kind should be abolished, because they are arbitrary and non-transparent. As a transitional measure, all in-kind privileges should initially be transformed into monetary benefits.

2.3. Relations Between Central And Local Authorities

Previous attempts to reform the relations between central and local authorities and create real local self-government in Ukraine have failed. The uneasy coexistence of Soviet traditions of administration with democratic governance principles, as well as a lack of consistency and determination have further complicated these relations. The division of powers and responsibilities between central and local authorities, and the issue of financing, are especially problematic. The Constitution of 1996 did not significantly improve the situation; on certain issues, in fact, it made the confusion even worse.

The Constitution failed to provide answers to a number of fundamental questions. What is local government? Is it local self-government or only a decentralization of the central state government? Is it an authority formed by the members of the territorial community or a power delegated by the state? And what is the territorial community? Is it a form of organization of the public authority or a form of self-organization of the population to solve issues related to the inhabitants of specific territory?

The recently adopted Budget Code has clarified some issues related to financing, but the code itself could not resolve the complex of problems at the core of the concept of local governance in Ukraine and how it relates to central state governance.

Due to the accumulated number of problems the state is unable to engage the potential of local government to provide services of good quality to the population. The bodies of local government are unable to form strategies for their development because too much depends on capricious decisions by the central government. The overall effect is that local government uses its resources inefficiently and provides badly inadequate services in education and medical care, as well as in housing and communal services. These shortfalls arouse popular dissatisfaction with both central and local governments.

One of the main problems with local self-governance is that there are no less than 12,000 self-governing communities, most of which lack the ability to manage their own affairs, especially financial responsibilities. The country's 490 districts look to be more functional entities, but district local self-governments have no executive bodies. Moreover, district authorities bear no responsibility to voters, as the local state administrations are the executive authorities.

A Reform Proposal for Intra-Governmental Relations

A reform of the relations between the central, regional, and local governments needs to be based on five principles, and these underpin our five main recommendations in this area.

1. *Separate clearly the functions and powers of the three levels of government.* To clarify responsibility between the central, regional, and local authorities, a clear division of powers and functions is needed. These relations are most clear in the Budget Code, which separates sources of financing and sets rules for transfers. The Budget Code has preserved the norms and logic of the Constitution, the Law on Local Governing and related branch legislation of that time. However, the Budget Code regulates only financial issues, without touching upon ownership, public authority, or how public services should be provided. In fact, the code separated expenditures between budget levels, but not functions and powers. This should be done in the Law on Local Governing and in the Law on Local State Administrations.
2. *Consolidate the number of local communities.* Before a major reform of intra-governmental relations can take place, however, the very subjects of government need to be clarified. At present, Ukraine has far too many local units. The number and size of oblasts appear appropriate for the medium term. By contrast, the number of self-government units is far too large, therefore a major merger of villages and settlements is needed. This requires substantial study. Districts also vary widely in size.
3. *Decentralize powers.* Excessive centralization undermines the quantity, quality, and distribution of public services. The power of oblasts should be strengthened at the expense of the central government. The oblast-level state administration should be preserved, but exclusively as a representative of the central government in the region working to control the observance of legislation and general state interests. Many government functions should be decentralized to the lowest level, that is, to local governments. For instance, schools, land, real estate, housing, local infrastructure, and targeted social assistance to the needy are typical tasks of local government, while defense and law enforcement (with the exception of local police) are typically assigned to the central government. Medical care is often a task of regional bodies, but primary care could also be allocated to local government. Other functions are by necessity divided between all three levels, notably the building of infrastructure, which is usually split into projects of local, regional, and national significance, respectively. The central state should set standards for the provision of services that have been delegated to local governments. Indeed, it is much easier for the central state to control the quality of the delivery of services if it is not delivering these services itself. If services provided do not satisfy the standards, the state should earmark additional resources or reduce the volume of services.
4. *Ensure adequate financing.* Financing remains a key challenge. The Budget Code demarcates incomes and expenditures between different levels of the budget. It also introduces the concept of transparent calculation of transfers, and it outlines principles of budget relations between central and local authorities. The fundamental dilemma is that the central government does not provide funds for all the tasks it requires regional and local authorities to perform, while not allowing local bodies to finance themselves (at

least not through legal means). Local taxes and levies account for only about 3 percent of local budgets. As a result, local government bodies become more and more dependent on transfers from the central state power, which account for an ever-growing share of local budget revenues. A natural consequence is that the regional authorities have a far greater interest in serving the central government than in serving the citizens of their region.

This problem needs to be resolved in two ways. First, the share of taxes at the disposal of regional and local government needs to rise: a reasonable target is 30 percent of total tax revenues. The most obvious local taxes are taxes on land and real estate as well as small enterprise taxes. Personal income taxes are an obvious target for greater decentralization, as they tend to be more evenly distributed through the country than corporate taxes, and they can be divided between all three levels of government depending on need. Value-added taxes, excise taxes, foreign trade taxes, and social taxes, by contrast, should be allocated to the central government to avoid distortions.

Second, the current system of inter-budgetary transfers is in need of reform. Such reallocation, which shifts resources from the center to poorer regions and localities, is a practice that most states pursue. To achieve this end, however, the reallocation system needs to meet several requirements. Transfers should be related to objective criteria that reflect the greater social needs of a smaller tax base—and not a better ability to lobby for resources. That said, they should not be reduced if one region or locality manages to collect more taxes or cut its expenditures. If a local authority manages to save resources, it should be entitled to maintain the surplus for future needs.

Delegation of powers to regional and local governments does not mean that the central government abdicates its responsibilities. In any country, the central government regulates many activities of regional and local governments through law. Indeed, it is often easier for the central government to monitor the execution of government functions if a lower level of government is the executor. A good example is education, where standards are monitored through standardized central tests.

With regard to finances, the Ministry of Finance and the Auditing Chamber have a direct responsibility to control the effective and efficient usage of government funds. Any supervision should be formalized and transparent, to protect local authorities from arbitrary administrative pressures. The central government should influence local authorities through law, and the local authorities should have recourse to law to protect their rights if the central government resorts to extralegal pressures. In current conditions, we do not support the idea of the central government concluding agreements with local authorities. In our opinion, these relations should be regulated not by agreements, but by law. Disputes between central and local authorities should be resolved by administrative courts, which unfortunately have not yet been formed. It is vital promptly to establish both a system of financial monitoring and supervision and a mechanism for settling disputes between the central and local authorities.

5. *Strengthen democratic control at each level of government.* Central control, however, cannot be the major means of controlling local authorities. At each level of government, both chief executives (governors or mayors) and popular assemblies should be democratically elected.

Many of these provisions differ from norms set in the Constitution, but they are necessary for the state to function effectively. The Constitution thus may have to be amended.

2.4. The Need for Comprehensive Judicial Reform

The lack of a reliable and fair judiciary system in Ukraine makes the achievement of legal clarity impossible in social and economic relationships. During its years of independence Ukraine has made significant progress in ensuring access to justice. The jurisdiction of the courts extends to all legal relationships in the state. Despite considerable progress, however, the process of judicial reform in Ukraine must be described as slow and inconsistent. The courts do not enjoy the trust that they should in a democratic society.

There are many reasons for this deficiency:

Lack of a guiding vision for judicial reform. The judicial and legal reform of 1992 lost its significance as a programmatic document with the adoption of the Ukrainian Constitution in 1996. The Constitution outlined the future system of justice in a very general manner and sketched the basic principles for its organization and activities, but it failed to set out the specific steps necessary to create the new judicial system.

Inadequate structure of courts of general jurisdiction. The current system of courts of general jurisdiction is not organized in line with constitutional requirements, especially with regard to specialization and territoriality. The structure of the courts and their division of jurisdiction has become irrational. Often a single case is considered in various courts of the same level and the right to appeal against judgments in certain categories of cases is unfairly restricted. The retention of military courts and a lack of safeguards to ensure the independence and impartiality of judges make fair judgments unlikely in cases involving military servicemen. Administrative courts ensuring protection of human rights and the rights of organizations vis-à-vis the public administration have not been created.

Insufficient funding. The allocations provided annually in the state budget fall far short of the judiciary's actual needs. Moreover, the state budget has long failed to provide even what financing has been budgeted for the courts, and the President and the cabinet have reduced expenditures for financing the courts. The state fee that is charged for filing a court case goes to the central budget rather than to financing of the courts.

Low level of professionalism and responsibility of many judges. Judicial appointments often go to individuals with professional and moral merits insufficient for the high status of a judge. Because of the low remuneration of judges, they have low prestige among professional lawyers. At the same time, the great opportunities to receive illegal benefits while holding such a position attract individuals whose motivations have nothing in common with the just and unbiased resolution of cases. No relevant training for judges to improve their skills has been established. The disciplinary system is ineffective; it allows culpable judges to escape responsibility while providing an easy avenue for the removal of judges who assert their independence.

Dependence of courts on state authorities. The procedure for recruiting judges is non-transparent and open to abuse. Positions of judges often become a subject of bargaining. Compensation of judges is regulated by the President and the government, and is also non-transparent because certain acts related to these issues are not published. Judges are not fully relieved of administrative and economic duties related to the functioning of courts. Court presidents assign cases to judges, form judge chambers for consideration of cases, and influence issues related to careers and social provisions for judges (vacations, bonuses, and the like). In violation of the Constitution, court presidents and their deputies are designated by the President with the active involvement of the presidential administration. Court presidents can thus in certain cases unduly influence the judges.

Corruption. The common view is that judges are highly corrupt, especially those specializing in economic cases, and that court judgments can be bought.

Excessive workloads. Judges are often unable to consider cases in a timely fashion, owing to a deluge of trivial offences referred to the courts, inefficient judicial procedures, and the absence of simplified mechanisms for dispute resolution. Judges often illegally conceal or deny appeals and delay consideration of a case or the preparation of a court decision. No mechanisms exist to appeal against the inactivity of judges or for reparation of resulting damages. The absence of an effective system of legal redress, particularly for people with low incomes, also hinders access to justice.

Non-transparency of court activities. The information necessary to go to court is often inaccessible. Often judges themselves provide consultations to citizens during their reception hours. Judges often express their views on the prospects for the resolution of a case. As a rule, individuals who have not been involved in a case have no access to the texts of court decisions. Decisions of lower-level courts are published unofficially and selectively. Judges often hear cases not in a courtroom but in their work offices due to a scarcity of facilities, so the public is denied access to court proceedings.

Ineffectiveness of the system of execution of court orders. The courts have no authority to control and monitor the execution of their decisions. A large share of the appeals against Ukraine in the European Court of Human Rights consist of complaints about the non-fulfillment of decisions by national courts. Most of the problems arise with regard to the execution of orders against the state.

Recommendations

The judicial system in Ukraine is in dire need of reform. The most urgent measures are listed below. The first four recommendations should be carried out within the first 100 days of the new administration, while the others should be executed by the end of 2005.

1. *Bring the judicial system into conformity with the Constitution.* Strategic directions for further judicial reform need to be set in accordance with constitutional requirements.
 - a) Adopt a concept for the development of the system of justice in 2005-2015.
 - b) Refrain from establishing Appeal and Cassation Courts. Establish Superior Civil and Superior Criminal Courts, and identify their composition. Designate general courts as specialized ones for the consideration of civil, criminal, and other cases, as appropriately required by the law.
 - c) Eliminate military courts. Encourage the transfer of military judges to other courts and make provisions for their privileged retirement.
 - d) Bring the authority of the President with regard to the judicial branch into conformity with the Ukrainian Constitution. This refers particularly to the transfer of the right to designate court presidents to the self-government bodies for judges. The President needs in this way to demonstrate respect for the independence of judges.
 - e) Restrict the administrative authority of court presidents. The machinery of courts should be subordinated to the state judicial administration. The provision of justice should be completely disassociated from the provision of support to judicial proceedings. The state judicial administration should be made responsible for the organizational support of superior specialized courts. The assemblies of judges of the appropriate courts should receive the power to determine the procedure for the distribution of legal cases and the procedure for formation of chambers of judges.

- f) Introduce a transparent and competitive selection of judges, including for the highest courts in Ukraine. Assign judges to work as members of qualification boards on a permanent basis. Reestablish elections of representatives of institutions of higher education of law to the qualification boards of judges.
 - g) Establish a judicial militia within the system of the state judicial administration to ensure the safety of judges and other court employees, as well as the safety of participants in criminal judicial proceedings.
2. *Develop administrative courts and establish administrative courts of appeal.* Appoint the President of the Superior Administrative Court of Ukraine. Establish five administrative courts of appeal and provide for their staff (following the requirement of the Law on the Judicial System of Ukraine, issued in 2002 regarding the establishment of the system of administrative courts within three years). The state judicial administration should provide them and the Superior Administrative Court of Ukraine with facilities, appropriate equipment, and other necessary resources.
 3. *Improve the status of judges.* Align the status of judges of general and economic courts. Deprive the military courts of their special status. Establish by law a mechanism for the remuneration of judges, because judges' earnings should not depend on executive discretion. Judges should enjoy additional safeguards against unjustified attempts to bring them to account. At the same time, disciplinary liability of judges needs to be made more effective. A revised Law on the Status of Judges should be adopted.
 4. *Complete the new codification of procedural law.* A complete set of new procedural legislation needs to be adopted and implemented.
 - a) Adopt the Administrative Procedural Code, the new Criminal Procedural Code, and the Economic Procedural Code and implement these new procedural codes.
 - b) Identify the types of related legal redress, reasons, and mechanism for access to legal redress free of charge or on beneficial terms, and responsibility for the currently low quality of legal redress by promulgating the Law on Legal Redress.
 - c) Set a fee for going to court, a procedure for payment of this fee, and a procedure for spending the revenues generated from such fees in the Law on Court Fees.
 - d) Bring the authority of the office of prosecutor into conformity with the Ukrainian Constitution. Terminate the functions of general supervision and pre-judicial investigation by the office of prosecutor. Transfer the function of the office of prosecutor of pre-judicial investigation to a specifically established body within the system of executive power.
 5. *Complete the establishment of a system of administrative courts.* Establish at least 20 administrative circuit courts (their number may increase later on). After they have been staffed, the system of administrative courts should operate in accordance with the Administrative Procedural Code.
 6. *Amend the Constitution with regard to the composition of the Supreme Council of Justice.* Constitutional amendments should ensure that judges, including retired judges, constitute at least one half of the staff of the Supreme Council of Justice. This will conform with European standards for the body involved in resolving issues concerning the recruitment and removal of judges and also disciplinary proceedings against judges.
 7. *Demand higher requirements for the professional level of judges.* Establish more stringent requirements for the professional training of judges. Examine their competence through testing. Establish short-term training for judges appointed to this post for the first time and hold regular training courses to improve their qualifications.

8. *Improve the transparency of judicial activities.* Develop a practical way to publish court decisions through the Internet and other means. The state judicial administration should develop and maintain a roster of court decisions in accordance with the law. Open access to a database of court decisions should be provided via the Internet.
9. *Improve the system of execution of court decisions.* Make the execution of court decisions more efficient by allowing both state and non-governmental (private) providers to implement execution, in both civil and economic cases. Adopt legislation that would provide a procedure for implementing decisions of the European Court of Human Rights, as well as a procedure for the execution of decisions against Ukraine by the government.
10. *Ensure full funding of the needs of courts.* Courts and all their needs should be fully financed by the central state budget, and all fees that courts earn should go straight to the state treasury. Central state financing should also pay for premises and other costs of the courts.

Chapter 3. A More Effective and Humane Social Policy

The weaknesses of the Ukrainian state are particularly apparent in its inability to translate the rapid economic growth reported since 2000 into sustained reductions in poverty or improvements in social policy. Over the past decade, social policy has, by and large, taken a back seat to macroeconomic stabilization and private sector development. Excessive benefits for the nomenklatura and other privileged groups continue to be pervasive. In education and health care, the gaps between the government's declared reform agenda and the measures which are needed realize it are extensive. In some areas, positive initiatives have been taken, notably the pension laws of July 2003. In those cases, the challenge is to put these initiatives fully into effect, and to take the further steps needed to ensure that these reforms are viable and sustainable.

Three of the most striking symptoms of the social malaise that persists despite rapid growth are demographic:

- Ukraine has a surprisingly low fertility rate (1.2 children per woman—one of the lowest rates in the world);
- Life expectancy is low (62 years for men—one of the lowest averages in the region); and
- There is a persistent exodus of workers seeking gainful employment abroad.

The combined effect of these factors is that the country's population is shrinking. During the period 1997-2003, it decreased from 50.2 million to 47.5 million. Over the same period, the average age of the population rose from 36.5 to 39 years.

Every month, around 3,500 people leave Ukraine to work elsewhere. Cumulatively, a substantial part of the population—probably as many as 3 million people—is working abroad. In principle, many of these are temporary emigrants, but they may not come back if conditions do not improve. At the same time, around 3,000 people immigrate every month. Presumably, they come from countries where conditions are worse than they are in Ukraine.

Clearly, social policy should be a priority in the new administration's reform agenda. This does not mean, however, that the country needs to spend more on its social objectives. Existing programs suffer from bureaucratic centralization and pervasive corruption. What is needed is more flexibility and efficiency.

Contrary to common preconceptions, social expenditures are large for a country of Ukraine's GDP and at its relative level of economic development. According to World Bank statistics, social expenditures amounted to no less than 25.5 percent of GDP in 2003—a high level even for a very developed country. Education expenditures have gradually risen to 5.7 percent of GDP, a level on a par with the much richer countries of the Organization for Economic Cooperation and Development (OECD, 5.2 percent on the average). Health care expenditures at 3.7 percent of GDP are normal for a country at this level of development. Comparisons with other countries suggest that Ukraine could reasonably spend 7 percent of GDP on pensions, 2 percent of GDP on family allowances, 1 percent of GDP on labor market support, and 1 percent of GDP on targeted social support. Altogether that would amount to 11 percent of GDP in social transfers, while the actual current amount is 16 percent of GDP. Thus, it would appear reasonable to reduce social transfers by 5 percent of GDP and bring total social expenditures to just over 20 percent of GDP. Since Ukrainian social transfers are heavily geared toward the wealthy rather than the poor, this could be accomplished with only moderate hardship for the poorest categories. Furthermore, Ukraine's current extraordinary growth rates should facilitate

such a correction, because a moderate real increase in one kind of expenditure would not preclude a simultaneous significant decline in its share of GDP.

In several areas, quantitative reallocations are called for. First, within the education system, money should be re-directed from pampered higher education to neglected primary and secondary education. Second, health care funds should be reallocated from hospitals to primary care as a matter of efficiency. Third, nomenklatura benefits should be eliminated wherever they persist.

At least five kinds of structural reforms are called for to increase efficiency and ensure that, within each sector, resources are directed to those in greatest need. First, decision-making should be delegated from the central state to the regional and local governments. In parallel, taxation should be decentralized (as discussed in the Chapter 4), in order to provide regional and local governments with more independent financing. Second, not only the different levels of government but also the individual institutions—hospitals, polyclinics, institutes, and schools—should be given institutional financial responsibility. Many of these bodies should be reorganized as autonomous entities under independent boards. Third, the private payments that are rampant throughout the social service system should either be legalized and brought into the open, or outlawed, and service providers compensated with higher salaries. Fourth, state financing needs to change its form. It should be provided in return for services delivered and not only for costs. Medical services should increasingly be financed through insurance, and education through fixed state payments per student of each type. Fifth, after having decentralized its responsibilities for the delivery of public services, the state should focus on inspecting and testing the quality of the education and health care delivered.

The old social service system encouraged an excessive accumulation of real estate and staff, and budgets were consumed by their maintenance. If the social service sector reduces its holdings of real estate and diminishes its staff, remaining employees can be paid higher salaries, and the remaining real estate can be better maintained. More money would then be available for equipment and medicine, and the quality of education and health care would improve.

This chapter is divided into four sections, each dealing with major social issues. Sections 3.1 and 3.2 consider the problems of the health care and education sectors, urging substantial systemic reform in both cases in order to enhance efficiency and quality. Section 3.3 deals with social benefits for the poor, and suggests how they can be better targeted. Section 3.4 discusses the potential and shortcomings of Ukraine's recently adopted pension reform.

3.1. Health Care Reform

The government has traditionally played a central role in Ukraine's health care system, and popular expectations of "free" comprehensive public health care remain strong. Alas, Ukraine's health care system is unable to provide universal access to quality health care, and informal fees are endemic. The unfavorable demographic trends that took hold late in the Soviet period have continued since independence, exacerbated by the lingering consequences of the Chernobyl disaster and the adverse socio-economic effects of the transition.

Addressing these challenges requires the government urgently to undertake health care reform. The ultimate objective of health care reform in Ukraine should be the establishment of a well-managed, integrated health care system that provides patient-focused, timely, efficient, and equitable health care. Even small but systematic changes can help to achieve this goal.

Health and Transformation

Under Soviet socialism, universal free health care meant an integrated network of primary care institutions, hospitals, pharmacies, and sanatoriums that worked under the centralized governance of the Ministry of Health at the federal and republican levels. The planning and supply of health care services was driven by two quantitative indicators, the number of hospital beds and physicians, rather than by actual health needs and outcomes. All medical personnel were state employees, and virtually all official health services were funded from the state budget. Although private medical practice did not exist officially until 1987, quasi market systems existed in the form of unofficial side payments for doctors and other officials who *de facto* controlled access to better medical services. Urban residents generally received better quality health care than did rural dwellers, and members of the Soviet nomenklatura often enjoyed privileged access to high-quality medical services.

Political upheaval in the late 1980s and early 1990s led to changes in the Soviet and thus Ukrainian health care system. Private health care providers and health care insurance emerged. The health care system was somewhat decentralized, and attempts to introduce job- and community-based mandatory medical insurance were initiated (and are still being debated in the Parliament). These reforms have generally been introduced slowly and inconsistently, and they lagged well behind analogous transition processes in neighboring countries, even in Russia. The limited funding of public health care, the lack of integrated management and finance, legal uncertainties, and the overall socio-economic crisis all aggravated the situation. Health developments were miserable in the 1990s. According to the World Health Organization (WHO), mortality from cardiovascular diseases rose by 30 percent from 1990 to 1999, and disparities in access to and quality of health care increased.

The Ukrainian Constitution, in article 49, guarantees free medical care, at least *de jure*, but in reality this right is increasingly honored in the breach. Substantial reductions in real GDP during the early 1990s led to commensurate reductions in real health care spending. The government was forced to decide which health services should formally remain publicly financed, and which services should be explicitly co-financed by patients. The first step in developing the legal framework for such changes was the presidential decree On the Concepts of Health Care Development in Ukraine (7 December 2000), which called for the development of a territorial model of care provision. Two types of health care (basic/state-guaranteed care and additional care) are provided at three levels: primary care, specialized care, and high-tech care for rare and most threatening diseases. Funding mechanisms may differ substantially with the level of care.

While Ukraine's poorly funded public institutions cannot support provision of health care at Soviet levels, private institutions are generally too weak to fill the gaps. Meanwhile, the costs of medical care have skyrocketed around the world. The privatization of health care in Ukraine began before alternative health care funding mechanisms, such as medical insurance institutions, were put in place. The health care system has therefore been unable to attract private resources from insurance funds that receive payroll tax revenues, because the appropriate legislation is not in place, and it continues to rely on inadequate public resources.

Inadequate funding and poorly enforced legislation mean that health care professionals are often among public employees most likely to receive unofficial payments. While these payments help to support underpaid health personnel, they limit access to health care for the poor—who are also likely to be elderly, chronically ill, or disabled, and thus in the greatest need of care.

Another aspect of this erratic financing is the disproportionate emphasis on funding specialized secondary care (e.g., hospitals) at the expense of primary care (e.g., polyclinics).

Despite the importance of primary care in cost-saving prevention and early detection of many diseases, this branch of Ukraine's health care system is much more under-funded than specialized care (e.g., inpatient care accounted for 68 percent of total medical expenditures in 1998).

Health care in Ukraine has always been marked by urban-rural disparities. Regional policies have traditionally favored the development of urban areas and have, together with the unattractiveness of many rural areas for health personnel, generated large differences in access to, and quality of, care between big cities, smaller towns, and, most strikingly, the countryside. The situation deteriorated further during the past decade. Health care disparities are also apparent across regions. Since local budgets account for nearly three-quarters of total public medical funding, local health care expenditures are heavily influenced by the number of large profitable employers (hence payroll tax providers) in a given region.

Despite the challenges facing private health care providers, they now account for around one-third of total health care spending, and have entered many fields in outpatient and inpatient care. Large regional variations in access to private medical care nonetheless persist in Ukraine, particularly in rural areas, due to regional differences in ability to pay for medical services. Uncertain payment arrangements and the poor financial condition of many employers create additional barriers to the development of private health care providers and insurers.

The situation calls for a fundamental change in the structure of health care in Ukraine. Fee-for-service-rendered should become the dominant mode for the financing of health services. The eventual objective should be that doctors, hospitals, and clinics—public as well as private—are no longer financed by central, administrative procedures, but rather by the payments patients make for the care they receive. A new system based on this principle will, by imposing budgetary discipline on providers, vastly enhance efficiency. It will also reduce opportunities for corruption. The change must go hand in hand with the introduction of mandatory health insurance, supplemented by voluntary private insurance, individually or collectively procured.

The adoption of new health insurance principles in Ukraine has been very slow. Draft legislation to establish mandatory state medical insurance has been stalled in the Parliament. This legislation would create a single national insurance fund with financing from different sources. Mandatory health insurance would be job-based for employed persons (with a 50:50 split of insurance payments between employer and employee). It would be financed from local budgets for the disabled, students, and other individuals outside the labor force, and from the corresponding social funds for the unemployed and retired people. Private insurance companies would not be included in the system of mandatory state medical insurance.

Recommendations

We recommend that the new administration introduce the following reforms on a priority basis:

1. *Move to a pay-for-service basis for the financing of public as well as private health care institutions.* Because this involves a fundamental change in the structure of health care provision, the change should be preceded by a national debate on the pros and cons of such a system.
2. *Introduce mandatory medical insurance and encourage the development of additional, voluntary private insurance.* The draft legislation, currently languishing in the Parliament, should be reviewed, broadened to offer a greater role to private insurance providers, and passed.

3. *Restructure health care financing to the benefit of primary care.* Substituting inpatient care for outpatient services is a proven cost-effective policy. Better funding for primary care and a stronger focus on secondary prevention will reduce the need for costly specialized care and hospitalization.
4. *Develop and implement uniform quality measures for public and private health care providers.* International institutions should be asked to help finance the introduction of the necessary information systems and quality standards.
5. *Extend public campaigns on preventing HIV/AIDS, tuberculosis and other infectious diseases.* Adequate screening and treatment of communicable diseases in prisons and hospitals is needed to prevent tuberculosis and HIV/AIDS epidemics from spinning out of control.
6. *Strengthen control over the production, import, and distribution of pharmaceutical products.* Legal liability for the distribution of health-endangering pharmaceutical products should be introduced and enforced. Public servants should also face personal accountability for illegal activities associated with the accreditation, licensing, and certification of pharmaceutical products. The sale of pharmaceutical products by health personnel should be prohibited and the prohibition enforced.
7. *Initiate health-promoting public programs.* The public health authorities should promote healthier lifestyles among Ukrainians, and, notably, ban smoking in public places.

3.2. Education Reform

Education is Ukraine's bridge to the future. Ukraine has officially accepted the UN's Human Rights Convention, the Convention on the Rights of the Child, and the Millennium Development Goals as the overarching development framework for the education sphere. The country's commitment to educational reform has been made manifest in article 53 of Constitution, in the Law on Education No. 1060-XII (23 May 1991), the Law on General Secondary Education (13 May 1999), the National Doctrine of Education Development in Ukraine (2001), and Parliamentary Decree No. 2551-III on the State, Directions of Reform, and Financing of Education in Ukraine (2001). In addition, a number of general curriculum reforms have been adopted, including the introduction of state standards for elementary, basic, and complete secondary education (2003), and the concept of specialized education (2003).

Nonetheless, many challenges remain. In assessing the need for reform of Ukraine's educational system, it is important to distinguish between primary and secondary schools, on the one hand, and universities and other institutions of higher learning, on the other.

Problems in Primary and Secondary Schooling

The key issues are waste, inappropriate allocation of resources, complex demographic tendencies, quality, the modernization of curricula, and teacher pay.

Reforming education finance. The biggest flaw in Ukrainian education is extraordinary waste. Money is being spent on real estate rather than on education and on too large a staff rather than on teachers of high quality. Financing is far too centralized, and local institutions do not have even the legal right to receive private financing. State financing should be based on how many students of what kind receive education rather than on how many institutions of learning are being maintained.

Excessive managerial centralization. Another fundamental problem of the education system is that too much power rests with the Ministry of Education and too little with the institutions of learning. Local authorities should take over key responsibilities for primary and secondary education.

Low teacher pay. Low levels of teacher pay encourage the widespread practice of informal, private payments. When a child's scholastic results depend on the size of the bribe that his or her parents have paid, the integrity of schooling is jeopardized, and teachers and students are both encouraged to abandon their principles. Salaries should be raised sufficiently so that such side payments can be credibly prohibited.

Insufficient quality control. The Ministry of Education should administer national tests to monitor the achievement of both individual students and their schools—something that is now done not at all or only insufficiently. National testing can improve quality control. In a country as linguistically and culturally diverse as Ukraine, it can also help strengthen a civic sense of national unity. Such testing is particularly important when managerial and financial decentralization are being promoted.

Curricular modernization. In spite of significant changes in course content, teaching plans, and teaching materials, the educational curriculum still falls short of the demands of the labor market and other aspects of a market democracy. Syllabi and teaching materials are overloaded with factual information, and do not promote the mastering of vital competencies. The choice of syllabi is limited, the quality of textbooks is poor, educational innovations are introduced ineffectively, and teaching methods often require significant improvement. Vocational training continues to be plagued by gaps between labor market demands and available training programs. The number of vocational schools in Ukraine has dropped considerably in the last ten years, and their capital stock has deteriorated sharply.

Demographic tendencies. Ukraine's population is both shrinking and aging. As a result, fewer pupils enter the education system each year, and schools in rural and other depressed areas are reporting enrollment declines. The educational infrastructure needs to be rationalized and realigned to reflect Ukraine's changing demographic patterns. Numbers and locations of schools and teachers need to be adapted to these trends in particular.

Ensuring educational access. Overstaffing, insufficient material and technological support, and inadequate teacher training are major worries. Children in rural areas, disabled children, and children from other vulnerable groups face particularly difficult circumstances. Although a school busing program has been introduced to address geographic disparities, the maintenance of buses and ensuring that they are used for the intended purposes are problematic.

Problems in Higher Education

Over the last decade Ukraine's institutions of higher learning have received a lot of attention. New colleges have been created. Fees have been introduced in state-run higher educational institutions, as well as non-state higher educational institutions. International organizations dealing with education, including the United Nations, the Council of Europe, the World Bank, the British Council, and the Soros Foundation, are playing important roles. New projects in higher education implemented by these agencies are introducing and supporting democratic principles in education.

This being said, centralization remains stifling. Public universities have no control over their finances, and are not even allowed to receive private grants. Exchange between Ukrainian colleges and universities and international colleges and universities remains limited.

Recommendations

Primary and Secondary Schools

1. *Devolve responsibility for the management of primary and secondary schools to local governments.* Engage parents more in the education system.
2. *Redirect education finance from higher education to primary and secondary education, so that the state guarantee of free state education of all children can be realized.*
3. *Allocate funds each year on a pay-per-pupil basis, rather than, as is the case currently, with a view to maintaining existing staff and buildings.*
4. *Improve teacher salaries and raise qualifications.* Outlaw bribes and other informal side payments.
5. *Redefine the role of the Ministry of Education to focus on quality.* Develop curricula that meet international standards and strengthen the national identity of the students. Task the ministry with conducting regular national tests to monitor both student achievement and school quality.

Higher Education

1. *Accept and accommodate both private and state financing.* Concentrate state financing on scholarships for especially gifted or especially poor students.
2. *Make both public and private universities autonomous.* Make independent boards responsible for financial management.
3. *Develop international education exchanges, with a particular emphasis on entry into the European Union's Erasmus program of student exchange.* Recognize international teaching degrees, and encourage the development of international education institutions within the country.

3.3. Better Targeting of Social Benefits

The economic crises of the 1990s have left very limited resources to fight the poverty that has been aggravated by Ukraine's inconsistent transition to a market economy. These resources will suffice for poverty alleviation only if they are well targeted for people in need.

The pre-1992 Soviet social safety net was based largely on universal in-kind transfers, such as free housing, child care, subsidized food, education, and medical services, and it was almost universal. It also featured wage supplements tied to family income levels. The near 100 percent employment and the supplementary character of the safety net meant that the safety net was *de facto* administered by state enterprises.

The transition forced the government to take responsibility for social expenditures that had previously been financed by enterprises. These were initially converted into relatively generous social privileges, Chernobyl benefits, housing and utility allowances, and family benefits. Some two dozen social privileges—mostly in kind, and few of which were means tested—remained in effect through the 1990s for different social groups. The government in turn assumed the obligation of reimbursing service providers (e.g., telecommunications and transportation companies) for services provided under these conditions. Unfortunately, the government failed chronically to finance all these obligations, incurring in the process growing debts to service providers and beneficiaries. In order to shield families from the impact of rapidly growing energy and housing prices, the government in 1995 introduced the Housing and Municipal Services Allowance Program. Allowances under this program were financed by local budgets, and regions with weak revenue bases rapidly accumulated arrears.

All of these programs were more focused on preserving the status quo of Soviet era privileges than on poverty alleviation. It is officially acknowledged that the social safety net in Ukraine has instead contributed to poverty. The presidential decree On the Strategy to Eradicate Poverty (#637/2001, 15 August 2001) mentions that the share of social privileges in total household income of the poorest and the richest 10 percent of households equaled 5.5 percent and 8.1 percent, respectively in 2000.

Modern approaches to poverty alleviation are new to Ukraine. The need systematically to monitor and analyze poverty trends was officially articulated only in 2001, in the Strategy to Eradicate Poverty. The first tools to estimate the extent of poverty only became available in 1999, with introduction of a new household budget survey. This study showed that during 1999-2001 the share of Ukrainians living in poverty remained largely unchanged, with 27 percent of the population living below the official poverty line and some 13 percent living in extreme poverty.

In 2000 the Parliament adopted the Law on Targeted Social Assistance to Low Income Families. This law provided families living below the subsistence level with compensating benefits of up to 75 percent of the minimal subsistence level. The beneficiaries were restricted by an asset test that excluded those who possessed a second apartment or a new car, or who had made substantial durable goods purchases during the previous 12 months.

This was the first law that focused directly on poverty alleviation and attempted to target benefits to those most in need. Other changes to social policy legislation were subsequently introduced, in order to reduce the number of benefits and program costs, and to change eligibility criteria. For example, the 2000 State Budget Law suspended a number of social privileges, and reduced government liabilities to finance the privileges from UAH 30 billion (US\$ 7 billion) to UAH 17 billion (US\$ 4 billion). However, program costs remain high and targeting remains inefficient. Further reforms are needed.

Problems with Social Benefits

All Ukrainian social transfer programs suffer from significant amounts of leakage (program expenditures that go to people outside the target group). According to the World Bank and the presidential administration, 88 percent of those who received housing subsidies in 2001 were not entitled to them, as social protection and housing offices were overwhelmed by benefit claims from potentially ineligible recipients. Yet 71 percent of the families that should have been eligible for housing subsidies did not receive them, and some 90 percent of families that were entitled to support for low-income families were not among its recipients.

Leakage leads to problems in financing the system and therefore to inadequate coverage, whereby payments received by beneficiaries are not sufficient to bring their incomes above the subsistence level. At the same time, according to World Bank calculations confirmed by the Ministry of Labor, the state budget already has the resources needed to bring all poor households above the poverty line. For example, in the first three quarters of 1999, the amount of money needed to eradicate poverty was estimated at UAH 4.2 billion, while the government spent over UAH 4.5 billion during this period on poverty alleviation programs that did not achieve their goals.

The main weakness of the current social protection system is therefore the inefficient use of available resources, due to inadequate benefit targeting and excessive leakage. This in turn reflects several smaller problems. First, the government possesses insufficient capacities in monitoring poverty and analyzing, designing, and evaluating social assistance programs. The Committee for Statistics and the Ministry of Labor, together with international organizations, have established some poverty monitoring tools (e.g., the household budget survey). The

Ministry of Finance and the Ministry of Labor monitor social program expenditures and arrears. However, existing surveys do not monitor the long-term impact of changes in social benefits on their recipients. The ministries do not have the capacity to conduct background research on leakage and optimal targeting mechanisms. The non-government sector does have the capacity, but it lacks the funding and access to data needed for such research.

Second, in order to target assistance to the poor, the government has to be able to assess the income of program participants. Although Ukraine's current benefits system for low-income families measures assets to determine eligibility, the size of the benefits is based only on reported income. The size of the shadow economy suggests that many families with reported income below the poverty line earn significant unofficial income, bringing total income above this amount. However, total income does not need to be monitored. Instead, improving the use of indirect income assessment techniques, sharing information about systemic abuses, and introducing appropriate punishments for offenders are the key challenges. The social assistance offices are currently introducing new information technology tools to store and share records about all recipients of social benefits, in order to identify systemic abusers. Legislation approved in 2000 established the position of social inspectors, who monitor the veracity of the information provided by benefit recipients. However, the numbers of these inspectors, and their training and capacities, are not adequate to solve the problem.

Third, many social privileges are still provided in kind and according to categorical criteria. Although these privileges are supposed to provide social support for the poor, wealthier groups generally receive a larger share of them than do poorer ones. For example, in order to benefit from free telephone service, a household must have a phone in the first place. Moreover, the in-kind provision of most privileges makes it hard (often impossible) to monitor their usage or estimate their value. This harms the government (which often pays more than the actual amount of privileges consumed), service providers (which in some cases provide free services for which they are not compensated), and the recipients (some of whom are unable to use the privileges they are entitled to receive). According to World Bank studies, Ukraine allocates sufficient fiscal resources for social protection to lift all needy families above the poverty line. But achieving this goal will only be possible if benefit systems are simple and transparent, and if leakage from the system is minimized.

Fourth, the social benefits system is too complex. Ukraine has about 20 different social privileges and more than ten other types of social assistance. This plethora of possible benefits both makes it hard to monitor individual eligibility for each benefit (thereby exacerbating the leakage problem) and confuses potential recipients about their eligibility (exacerbating the adequate coverage problem). The government is currently consolidating application procedures for many social benefits into a single form, and making it possible for potential beneficiaries to apply for them all at a single location. Still, further simplification of the system seems necessary, in order to make social protection more targeted and efficient.

Recommendations

The most urgent measures needed to improve Ukraine's social protection system are listed here.

1. *Firmly align Ukraine's social protection system with the requirements of poverty alleviation.* It has to be declared that social protection is intended to alleviate poverty, and that persons living above the poverty line must be excluded from the system.

2. *Reduce the numbers of benefits and monetize them.*⁴ Converting in-kind benefits into cash payments will increase transparency and accountability in social welfare policy. In the long term, social protection should be based on two key pillars: welfare payments for low-income families and child support assistance. (These would be supplemented by unemployment insurance and pensions, while the medical and education systems should ensure access to proper health care and education for low-income families.)
3. *Means test beneficiaries.* Since better targeting of social benefits requires the indirect estimation of incomes, better methodologies should be employed. Better targeting will require the retraining of existing social inspectors and changes in legislation.
4. *Strengthen responsibility for systemic abuse.* Punishment for providing incorrect information and unlawfully receiving benefits is currently limited to exclusion from future benefits. Such misdeeds should be punishable by large fines for defrauding the government.
5. *Provide additional child benefits that provide an incentive to increase the birth rate.* Universal child benefits are not income targeted, and this recommendation is an exception (based on Ukraine's dire demographic situation) to our general emphasis on means testing.

3.4. Addressing Ukraine's Pension Crisis

Despite five years of impressive real GDP growth, many of Ukraine's citizens continue to live in conditions of hardship. The oldest and poorest pensioners are particularly hard hit. Of Ukraine's 13.8 million pensioners, 91 percent receive monthly payments below the estimated monthly subsistence level for a healthy individual (UAH 268, or US\$ 45). The average pension at the beginning of 2004 was UAH 185.⁵ The statutory minimum pension was UAH 92 (US\$ 17) per month. One million pensioners received benefits at or below that amount.

Paradoxically, these low benefits are generated by a social security system whose tax rates are among the highest in the region. Wage tax payments into the National Pension Fund amount to 38 percent of gross wages for many workers. It matters little that 32 percent is paid by the employer and 5 percent by the worker. Both payments add to the cost of labor and, along with payments to other wage funds, impede the growth of enterprises and push economic activity into the informal sector. To make matters worse, these high taxes are not sufficient to cover pension expenditures. Every year, roughly 10 percent of the expenditures of the Pension Fund (1 percent of GDP) have to be covered by transfers from elsewhere.

Ukraine's Imploding Pension System

High taxes and low benefits are symptomatic of a demoralized pension system. Part of the problem is demographic. The end of the baby boom in the 1960s and 1970s, and the dramatic declines in birth rates recorded since independence, are unbalancing the ratio of the working population to the number of potential pensioners. Today, there are roughly 2.5 individuals of working age for every person above the normal retirement age. Experts project that by the middle of the century, there will only be 1.2 persons of working age for every normal retiree. Unless Ukraine's pension system is dramatically reformed, demography will cause either wage taxes to double or replacement rates to be cut in half.

But demography is only part of the problem: West European countries have even less favorable replacement ratios than Ukraine. The root causes of the demoralization of Ukraine's

⁴ Monetized assistance means not only assistance received in money, but also in the form of vouchers or other documents having monetary value, which can be used fully or in part to pay for goods and services foreseen by a specific privilege.

⁵ Not including increases introduced in the autumn of 2004.

pension system are a plethora of special benefits, and the migration of the official labor force into the informal sector during the last decade. In the early 1990s governments sought to enhance their popularity by distributing early retirement and other special pension benefits. The higher tax rates needed to pay for these benefits accelerated what was already a growing exodus from the official Ukrainian labor force. When Ukraine achieved independence, it had about 20 million salaried workers. Today, that number has dropped to 15 million. Many workers have emigrated; many jobs became undeclared—or half-declared (UAH 200 on the books, and UAH 200 under the table). Although the barter economy has receded significantly since the crisis of 1998-2000, recent estimates suggest that one-third of total GDP is still produced in the informal sector. When privileged groups receive generous benefits that are all out of proportion with their contributions, while the rank and file pay high taxes and receive meager benefits, common sense pushes many workers to opt out of the formal economy.

The Road to Comprehensive Pension Reform

Pension system implosion has been common in the post-communist transition in Europe. The countries that responded successfully to this crisis (Hungary, Poland, Kazakhstan, Bulgaria) have implemented comprehensive pension reform programs that feature two separate but complementary undertakings. The first is the rationalization of the solidarity-based public pension system, via the winding down of pension privileges, extending uniform minimum pensions close to the subsistence level, and recalculating benefits above the minimum in accordance with a formula that reflects lifetime contributions. These reforms have eliminated distortions, released resources to cover reasonable minimum pensions, and restored public confidence in the fairness of the system.

The “second pillar” of comprehensive pension reforms has, in every case, been the introduction of a system of mandatory accumulation, in which workers contribute to a fund whose investments can generate an annuity-like stream of retirement income at the end of their active life. The “second pillar” provides a better long-term return for all workers than the solidarity system, which is inevitably limited by the aging of the population. Higher returns break the vicious circle in which low returns lead to higher taxes and more evasion. The desire to reap the higher return provides a key incentive for workers to remain in the official sector. And by providing workers with the opportunity to own stocks and bonds, the accumulation system gives them a stake in the growth of business.

This “second pillar” of reform can be accompanied by provisions for additional, voluntary retirement savings—the “third pillar” of the reformed pension system. Although important for the few who can take advantage of it, the third pillar is only of modest macroeconomic significance. Experience from other transition economies suggests that the take-up of voluntary savings mechanisms is unlikely to be sufficient to correct the systemic imbalances that characterize a pension crisis like that of Ukraine.

The Significance of the Laws of 9 July 2003

In mid-2003, Ukraine took significant steps to restore the national pension system durably to a sound footing. Two laws passed by the Parliament on 9 July 2003 (the Law on Mandatory State Pension Insurance and the Law on Non-State Pension Provision) are milestones towards comprehensive pension reform.

The first part of the Law on Mandatory State Pension Insurance, which went into effect on 1 January 2004, rationalizes the public solidarity system. It introduces as a central organizing principle the notion that the public system is contributory: what a worker gets out of it is proportional to what he pays in. Every pensioner’s retirement begins with a fraction of the previous year’s national average wage. The fraction increases with the total number of months

that the worker has contributed during his working life, and with the wage that the worker or his employer declared as the base of the social security tax paid on his behalf that month. Gone is the possibility of contributing only a negligible minimum for years, and still receiving a full pension. Gone also are the manipulations that were possible when pensions were tied to wages earned in the last active months.

The second part of the Law on Mandatory State Pension Insurance lays the groundwork for the introduction of a national mandatory retirement savings fund. Sections X and XI of the Law (and other related articles) outline the governance structure and operating procedures of an Accumulation Fund to which up to 7 percent of a worker's gross wages (20 percent of his total mandatory contribution) are to be diverted. If the Fund is invested efficiently in the interests of future retirees, this system will supplement the average working person's pension with the fruits of capital accumulation. The Law on Non-State Pension Provision sets forth rules for establishing voluntary, private pension funds and structures for supervising them. Several have already been licensed and are expected to go into operation at the beginning of 2005.

Important Problems Remain

Major pitfalls remain. One of the most glaring involves the regimes governing special pension benefits (for miners, alleged Chernobyl victims, and other privileged groups). These are to be transferred to occupational and corporate plans in one year's time. This displaces the problem without solving it. The affected sectors will be no more able to afford these expenditures than the national budget. If miners and other workers are required to make additional contributions to funded occupational plans, those contributions will not be available to pay for the current benefits of retirees in the same category. Until pension privileges are reformed, they will continue directly or indirectly to burden the central budget, and to be an obstacle to urgently needed tax reduction.

Another problem is that the 2003 law leaves the normal retirement age (55 for women and 60 for men) unchanged. Projected demographic trends require gradual increases in the retirement age, and in the number of years of contribution (currently 25) required for a full pension.

The Accumulation Fund created in the second part of the Law on Mandatory Pension Insurance is, as presently designed, dangerously vulnerable to political interference and corruption. This is a monopoly, national fund, administered by a semi-public authority. Its 14 members are appointed either by the President or by the Parliament, and can be removed at will by the authority that appointed them. They serve without pay. Both considerations threaten their independence.

Though it is authorized to hire private asset managers to maximize value, this Fund may also direct investments into projects and sectors that are deemed "in the national interest." Similar monopoly national funds have been tried in several African countries, and in East Asia. They have generally been found lacking. The best-known model is that of Singapore, whose Provident Fund has been criticized for investing in politically favored social projects, and for producing a rate of return below that of equivalent market investments. In Hungary, Poland, and elsewhere in Eastern Europe, an independent regulatory agency was created, which licensed private, national, and international financial companies to compete for the management of pension savings. Workers choose the companies to which they entrust their savings, and can move their accounts from one company to another at reasonable intervals.

What is at issue is the very nature of the relationship of the Fund to its beneficiaries. The Law on Mandatory State Pension Insurance emphasizes that the Fund is the "private property" of the contributors. But calling something "private property" does not make it private property. If

contributors own their accounts, they should be able to transfer them to a different administrator. The law allows contributors to transfer their accounts to a private pension fund licensed under the Non-State Pension Provision system—but only after the Accumulation Fund has been operating for 11 years.

Kazakhstan's pension reform offers an interesting example for Ukraine. When Kazakhstan's mixed accumulation system was launched in 1998, workers were entitled to choose between a semi-public national fund and licensed private funds. Initially, 80 percent of the contributions went to the semi-public fund. Four years later, the private funds, which had prospered and grown in membership, accounted for two-thirds of the total assets in the system.

Private funds may also be abused—as the losses of individuals who entrusted their savings to unregulated pyramid schemes throughout the region can attest. Ukraine is no exception. Strengthening the regulatory authorities that supervise financial markets in general should be a high priority objective for the new administration.

Recommendations

1. *Reduce special pension benefits for privileged categories.*
2. *Raise retirement ages and close loopholes for early retirement.* To ensure that these increases are gradual, they should begin now.
3. *Authorize competition from private pension fund managers as soon as the Accumulation Fund is established.* This would allow workers to protect their benefits by voting with their feet, and provide an important safeguard against abuse.
4. *Increase the independence of the Executive Directorate of the Accumulation Fund.* Its 14 members should be immune to being removed during their terms (short of criminal conviction). They should receive professional salaries.
5. *Increase the independence of the State Commission on Regulating the Financial Services Market, the principal regulatory authority for "non-state pension funds."* Appointments to this vitally important body should be made transparently, and be subject to public review by elected officials who are not party to the appointments. Leaders of political parties should be prohibited from serving on the Commission.

Chapter 4. Tax and Financial Reforms

This chapter is devoted to two major conditions for the development of the economy: the tax system and financial markets. Section 4.1 discusses the need for further tax reform. The tax system is one of the most effective levers by which the government rules the economy. It is of key importance to every enterprise and physical person, and the government can effectively change it through legislation much faster than it can most other institutions.

Section 4.2 deals with Ukraine's financial markets. Although the legislation regulating them is rudimentary, the country's financial markets are developing very rapidly. As rapid economic growth takes hold, it becomes increasingly urgent that the financing of investment not create too severe a bottleneck. Unfortunately, financial crises are common when financial markets develop fast, and they can cause serious setbacks to economic development.

4.1. The Need for Further Tax Reform

The tax system determines how large a share of the total economy goes through the public sector and to what parts of the public sector the money goes. Taxes can be levied on different objects—enterprises, wage earners, consumers, or property owners. Taxes can vary in number, scope, and rates. The mode of taxation is significant for the relationship between state and citizen.

The Current Tax System

Ukraine's tax system has developed piecemeal, in many small steps. Changes over the last eight years have generally been positive. The number of taxes has been reduced; tax rates have been trimmed; the number of exemptions has been cut, broadening the tax base; tax collection has improved greatly. Even so, much remains to be done. The current tax laws have been adopted at different times with different philosophies over the last twelve years, and Ukraine does not yet have a proper unified tax code. This has left the tax system in disarray. However, a political consensus now seems to have emerged in favor of putting the system in order, and the collection of revenues is no longer a major worry after several years of near balance in the state budget. In short, the time is ripe for fundamental tax reform.

The Law on the Taxation System of 18 February 1997 is the framework law that sets the principles for the Ukrainian taxation system, covering the structure of taxes and fees to budgets and specific state funds, as well as taxpayers' rights, duties, and responsibilities. At the moment, the law enumerates 27 central state taxes and fees and 14 local ones.

Ukraine has four dominant taxes. In 2003, taken together, they accounted for 87 percent of all tax revenues of the consolidated budget.

- The Law on Value-Added Tax of 3 April 1997 sets a single value-added tax (VAT) rate of 20 percent and lists the rules for VAT. In 2003 VAT accounted for 23 percent of all tax revenues of the consolidated budget.
- The present corporate profit tax was introduced by the Law on the Taxation of the Profit of Enterprises of 22 May 1997. Significant changes were introduced with an amendment of 24 December 2002. This reduced the corporate profit tax rate from 30 percent to 25 percent, effective 1 January 2004; increased the norms for the depreciation of fixed assets; changed the monthly tax payment schedule to a quarterly scheme; and made reporting somewhat simpler for enterprises. In 2003 the profit tax accounted for 24 percent of total tax payments to the consolidated budget.

- Personal taxation was greatly changed by the Law on the Taxation of Incomes of Physical Persons of 22 May 2003. Instead of the former tax scale of five rates (10, 15, 20, 30, and 40 percent), a single tax rate of 13 percent was introduced for physical persons' incomes for the years 2004-2006. The tax rate is set to rise to 15 percent effective 1 January 2007. In 2003 revenues from this tax accounted for about 25 percent of total tax payments to the consolidated budget.
- Excise duty was introduced by a government decree of 26 December 1992. The list of commodities subject to the excise duty was initially very long, but it has now been limited to spirits, tobacco, oil products, and means of transport, in accordance with international standards. Most of the excise duties relate to physical quantities rather than value (calculated in hryvnia or euro), though there are also mixed rates, considering both physical quantity and value. The excise duty accounted for 10 percent of total tax payments to the consolidated budget in 2003.

Apart from what is called taxes, very substantial payments have to be made by employers from payrolls for social security purposes. Officially, these are considered social insurance fees, but they are really payroll taxes amounting to no less than 38 percent of the total wage fund. Of the payroll, 32 percent is supposed to be paid to the Pension Fund, 2.9 percent to the Social Security Fund, 1.9 percent to the Employment Fund and 0.7-1.5 percent to the Work Accident Insurance Fund. This places a very heavy tax burden on labor and provides a strong incentive to workers and employers alike to hide actual salary payments from the tax authorities, in spite of the sharp reduction in the income tax rate for physical persons.

The State Tax Administration was established by law in 1990, but the office was really only created six years later, through a presidential decree. Since then, despite the major socio-political changes in the country, the tax authority has not undergone any serious reform.

Ukraine has been working on a new tax code for many years. A draft tax code was approved in its second reading on 29 November 2001, but it has yet to be adopted. This draft law is intended to provide a comprehensive regulation of tax relations; to define the principles of the tax structure; to list taxes, duties, and other obligatory payments to the budgets of all levels; to identify the methods for their calculation, as well as tax rates, taxpayers' legal status, procedures for tax administration, and financial sanctions for tax violations.

Problems with the Ukrainian Tax System

Although much has been done to develop and improve the tax system since independence, the tax system is complex, unjust, and ineffective, so that substantial reforms are called for. There are too many taxes, the tax rates are too high, exemptions are excessive, and the tax authorities possess arbitrary powers. We shall focus on a few key shortcomings.

Exclusive fiscal focus. At present, Ukraine's tax legislation focuses entirely on meeting fiscal needs—a goal met quite successfully in recent years. Unfortunately, this approach ignores the costs of taxation to enterprises and the economy as the whole. All other possible functions of taxation, such as stimulating production, innovation, investment, entrepreneurial activity, or legality, are barely taken into consideration. The quality of the tax legislation is also questionable, because it has been adopted as a patchwork, without consistency.

Excessive tax burden. The current tax system in Ukraine generally resembles those of developed European nations, with regard to the structure of the tax system and tax rates. The aggregate fiscal burden on the Ukrainian economy (including all payments to the budget and to extrabudgetary funds) was 39 percent in 2003. But the more developed countries have higher per capita income. Wagner's Law has long shown that richer countries tend to have a higher tax burden. Countries with high incomes (over US\$ 20,000 per capita) tend to have a high tax level

relative to GDP (35-50 percent). In Ukraine, however, per capita income is rather low, just over US\$ 1,000, and countries at such an income level tend to have a much lower tax level (10-30 percent), according to IMF research. Therefore, Ukraine's tax burden is disproportionately large and must be cut. The goal should be to reduce it to 25-30 percent of GDP in the medium term. Obviously, expenditures will have to decline correspondingly.

Uneven tax burden. Not all enterprises have to pay taxes in full. A large number of taxpayers are awarded economically unfounded tax exemptions, accumulate tax debts, or otherwise avoid paying taxes. For such enterprises the tax burden is not very onerous. The result is favoritism and an unfair taxation system. Diligent taxpayers who obey the tax rules become uncompetitive, and are forced either to leave the market or to start evading taxes.

Legal instability and inconsistency. The Ukrainian tax system has been subject to continuous legal changes since independence. As a result, enterprises are unable to plan their activities sensibly even for short periods, not to mention long-term investment planning. This uncertainty seriously hampers economic development. Constant volatility and the influence of special-interest lobbies mean that the tax system suffers from gross legal inconsistency.

Excessive complication of the tax system. The taxation system contains numerous inefficient taxes and fees generating little budget revenue but requiring substantial administrative expenses. Such nuisance taxes would best be abolished. The methods for tax calculation are set in legislative acts and specified in instructions from the State Tax Administration of Ukraine. These documents provide algorithms for the calculation of particular taxes. Overly complicated and clumsy algorithms for tax calculations provide a fertile ground both for errors and abuse on the part of taxpayers and taxation authorities.

VAT refunds for exporters. VAT has long provided scope for gross administrative malpractice. One problem is the long delays that enterprises face between paying VAT and receiving refunds from the budget. An even worse problem is that the government often refuses to reimburse VAT for exporters. This gross neglect undermines the trustworthiness of both the law and the government. At present, a principle of "selective" repayment is used, which creates an extremely conducive environment for abuse and corruption. As a result of the difficulties in obtaining VAT refunds, honest export producers in effect have to accept an illegal surcharge of no less than 20 percent on their exports. It is difficult to imagine any single measure that would do more harm to the competitiveness of the Ukrainian economy.

Discriminatory tax exemptions. The Ukrainian tax system is not neutral. While enterprises in general are burdened with excessive taxes, the government attempts to support selected enterprises through tax exemptions. Although the official rationale for this practice is to defend the national interest, in fact it serves only to undermine economic order, and a stable, transparent, neutral, and moderate tax system is to be preferred.

First, exemptions are granted to favored enterprises and organizations, distorting competition in the domestic market. Tax exemptions for selected companies reduce the tax base, and thus mean a higher tax burden for other companies. Exemptions also distort the incentives for managers of exempt companies, encouraging them to maintain cozy relations with the government rather than improving the efficiency of their companies.

Second, tax exemptions often yield unintended results. Tax exemptions provide an incentive for shadow economic activity and corruption, as exemptions are extended not to those economic entities for which they were created, but rather to those who manage to obtain the exemptions through illegal means. That is, tax exemptions easily turn into tax evasion.

Third, administrative complexity is increased with the proliferation of exemptions. Tax administrators must monitor enterprises that obtain exemptions (or special incentives) to ensure that standards are maintained and qualifications satisfied. Administrative resources are thus devoted to activities that are unproductive for revenue generation. In addition, every incentive or exemption creates a special case for the tax administration, increasing administrative costs even for honest taxpayers. Administration is also increased because avoidance incentives are heightened for those without exemptions. Those with no special privileges are expected to pay a disproportional amount of tax and they respond by attempting to reduce their taxation through avoidance, evasion, and corruption.

At present, about one-tenth of Ukraine's territory is covered by "special economic zones." These zones have failed in their chief aim, to attract foreign investment, and the privileges they offer have instead worked to generate corrupt practices. In addition, such zones have caused leakage from other parts of the economy owing to transfer pricing and other schemes. For Ukraine, this experiment has failed. Special economic zones should be abolished.

Widespread tax evasion. The heavy tax burden limits the economic possibilities of enterprises and individuals. Taxpayers have problems understanding highly volatile and complicated tax legislation, so even law-abiding taxpayers tend to make their tax payments late. Tax arrears are large. But large-scale tax evasion is also encouraged by legislative gaps, a failure to punish violations, and poor tax surveillance. Entrepreneurs weigh high taxes and the high costs of tax conformity against the potential sanctions for evasion, and find that tax evasion in Ukraine is very profitable. There is little chance of discovery, moreover, and even if evasion is discovered, in conditions of widespread corruption the tax police can often be bought off. Most entrepreneurs thus prefer to minimize taxes or avoid them altogether.

Recommendations

All these problems underscore the need for far-reaching reform of the taxation system. The tax system is one of the pillars of the economic system, and few parts of the economic system can be as effectively changed by legislation.

The only function the current tax system fulfils reasonably well is the fiscal function, and this function is even over fulfilled. Given Ukraine's per capita GDP, the large underground economy, and the wasteful use of state resources, the aggregate fiscal burden needs to be significantly reduced, while spreading the burden more uniformly over the taxpaying population. Still, a careful approach should be used to reduce taxes, so that tax cuts do not risk a deterioration of the currently sound budget balance. Tax cuts should be complemented by an expansion of the tax base through the abolition of excessive and unreasonable tax exemptions and measures to prevent their growth in the future. The tax system should be economically neutral; it should not distort production or consumption or provide unreasonable advantages to a particular sector at the expense of other sectors. Privileges, to the extent allowed, should be precise and specific. There should be a system of registration and control of the granting of tax exemptions and an assessment of their efficiency.

To sum up, the agenda for tax reform should include the following:

1. *Reduce the tax burden significantly.* The level of about 25-30 percent of official GDP is a good medium-term goal for Ukraine's aggregate fiscal burden. The taxes for honest taxpayers should be reduced both on average and at the margin.
 - a) *Lower corporate profit tax.* Although 25 percent might appear low, several postcommunist countries have opted for 19 percent (Poland, Slovakia, Lithuania, and Latvia), while Estonia has taken a step further and abolished the profit tax altogether. Ukraine should gradually cut the profit tax to become truly competitive. An attempt

should be made to equate the profit tax rate with the personal income tax rate. This will reduce incentives for tax arbitrage and avoidance while stimulating entrepreneurship. Such a change will simplify the system, making it easier for complete integration of income taxes, for instance.

- b) *Simplify and liberalize depreciation of firms' assets.* This could promote investment by firms.
- c) *Reduce the VAT rate.* VAT is the source of the biggest distortions. The rate is too high, prompting too many exemptions. The rate should be reduced and exemptions abolished. If some major VAT exemptions were scrapped, the rate could be reduced to 16 percent immediately, without any loss of revenue.
- d) *Lower payroll tax.* The payroll tax of 38 percent puts a huge burden on the economy. It is especially harmful because it keeps much labor underground and inhibits legal hiring. In the medium term, it should be reduced to 20 percent, as is the case in Kazakhstan—a reduction that would have to go hand in hand with social spending reform, notably for pensions. In the future, Ukraine could move to a combined single rate of the personal income tax and the unified social tax.
- e) *Preserve a low and flat personal income tax.* The flat personal income tax of 13 percent is one of the tax system's best innovations. It should be made permanent.

2. *Level the tax burden and restructure public expenditures.* This will broaden the tax base and preserve budget balance while creating a better business environment:

- a) *Review public expenditures immediately after the presidential elections.* Eliminate socially harmful spending, such as nomenklatura privileges and subsidies for favored firms. In the medium term, the restructuring of public spending is closely related to the regulation of state aid and development of fiscal decentralization.
- b) *Abolish all tax exemptions...* Special economic zones and most branch-specific and individual tax exemptions should be abolished. This will broaden the tax base and promote a level playing field for enterprises.
- c) *...except for the fixed land tax in agriculture and the presumptive tax for small entrepreneurs.* These are sectors where hard evidence is difficult to find and abuses by lawless tax inspectors are widely possible. The success of the low and fixed presumptive tax should be safeguarded until the small enterprise sector has reached at least a 40 percent share of GDP. In the agricultural sector, preserving in the short run the low and stable agricultural tax should be accompanied by the elimination of exemptions for companies that are classified as predominantly agricultural but conduct other economic activities. In the medium term, the fixed land tax should be replaced by a land tax based on the real value of agricultural land. This will stimulate more efficient use of agricultural land and encourage the redistribution of land to those who can manage it professionally.

3. *Make tax legislation simpler, more consistent, and transparent.*

- a) *Adopt the new tax code.* This should supersede current tax legislation and bring order, consistency, simplicity, and transparency into the tax system. The code should become the primary statutory act regulating all tax relations in society and applicable to all taxes, fees, and other obligatory payments to the state and local budgets, with the exception of duties, fees, and payments regulated by the Customs Code of Ukraine. Other legislative acts that contradict the code should be void of legislative power. Given the years it has waited for approval, the draft of the tax code currently before the Parliament is obsolete and requires serious improvement. The basic requirement is that the code should clearly define tax obligations, so that they can be unequivocally determined by court.

- b) *Reduce the number of taxes from 41 to 15-20.* This will simplify the tax system and do away with costly and ineffective nuisance taxes. All kinds of fees that are in fact hidden taxes should be abolished in the process of tax reform.
4. *Improve administration of taxes.*
- a) *Allocate taxes as far as possible to one administrative level.* VAT, the unified social tax, foreign trade taxes, and excise taxes should be central state taxes. Property and real estate taxes, small enterprise taxes, and agricultural taxes should be local taxes, while personal income taxes could be divided between the local and regional authorities and corporate profit taxes between the regional and central authorities. All shared taxes should be administered by the central government. Local taxes should be administered locally.
- b) *Concentrate tax collection in one agency, namely the State Tax Administration.* This will help to avoid competition in tax collection. The one exception is the Customs Service, which collects foreign trade taxes and handles VAT on the border. The four social funds that now collect their payroll taxes independently of the State Tax Administration should pass these tasks to the State Tax Administration. At the same time, the four social payroll taxes should be combined into a unified social tax.
- c) *Simplify tax payments.* Some tax payments are simply too bureaucratic. VAT currently has to be paid once a month. No taxes should be collected more frequently than on a quarterly basis.
5. *Improve tax discipline.* The relationship between tax authorities and taxpayers is currently one that pits the persecutors against the persecuted. This must be replaced by a normal voluntary service relationship.
- a) *Ensure exporters receive VAT refunds.* There is evidence that a centrally placed group illegally sells the right to receive VAT refunds for a hefty commission. The new President should prohibit such malpractice, and enforce the prohibition. Procedures providing for a rapid VAT refund for regular exporters combined with periodic audits should replace the current arbitrary regime.
- b) *Decriminalize most tax violations, and reduce the powers of tax authorities in order to minimize their ability to extort bribes from taxpayers.* The tax authorities should be forced to take non-complying taxpayers to court. The possibility of arrest for tax violations that are not of a criminal nature should be eliminated.
- c) *Prohibit conducting tax inspections on site without due suspicion and court order.* Tax inspections should not normally be conducted on a firm's premises except when excise taxes and VAT are in question and when prior notice has been given. Tax inspectors should not have police powers; tax authorities should not be able to halt the work of an enterprise subject to inspection. VAT inspections should be allowed to the extent that an inspector may enter the premises during normal business hours to check if VAT licenses are clearly displayed and if the enterprise is duly registered. Excises unfortunately depend on physical control, so an excise staff is needed. It should be rotated in order to reduce corruption. Enterprises should be obliged to deliver their accounts and tax payment to the tax authorities.
- d) *Abolish the tax police, as has been done in Russia.*
- e) *Increase the salary and reduce the number of tax inspectors.* The number of on-site inspections should be severely reduced, and the number of tax inspectors cut by half. Salaries for remaining staff should be raised accordingly, together with professional training and the imposition of strict safeguards against corruption. The tax administration should be fully computerized, and manuals should be updated.

- f) *Consider reducing tax penalties.* They are high and not capped. For non-criminal violations, they should not exceed the level of the original tax claim.

All proposed measures are closely interconnected. Eliminating harmful public expenditures paves the way to the reduction of key tax rates. The number of taxes can be decreased without costs. Taxpayers' legal rights can also be enhanced without cost to the treasury. Lower tax rates imposed without exemptions will ease and level tax burdens, boosting the tax base and contributing to economic growth. A sound tax reform is a win-win proposition.

4.2. Development of Financial Markets

Financial markets have developed in Ukraine over the years of market reforms, and at great speed during the last few years. But they remain rudimentary. Their strongest part is the commercial banks. The securities market of stocks and bonds might rank as a poor second, while insurance companies, mortgages, and leasing at least exist.

One relevant measure of the financial market is the financing of fixed capital investment. According to World Bank statistics for the first half of 2003, firms' own funds accounted for 63 percent of funding for fixed capital investment, bonds for 11 percent, state budgets for 10 percent, bank credit for 8.5 percent, individual savings for housing for 4 percent, and foreign investors for 4 percent. It is natural that own funds dominate in a nascent financial market, but it is striking that the share is not larger (it was 75 percent in 1997), and that bank credits and bonds each account for about one-tenth of the financing of fixed investment. The fastest growing source of financing is bank credit, followed by corporate bonds.

Economic growth generally depends on a sturdy financial system. Ukraine's rudimentary financial sector has not yet inhibited economic growth, because in the early stages of postcommunist transition it has been more important to impose hard budget constraints on enterprises so that they utilize ample physical capital more efficiently. For the future, however, new capital is badly needed for all kinds of investment, especially as Ukraine is currently experiencing rapid economic growth and robust investment. Unfortunately, even in comparison with other post-Soviet economies, the Ukrainian financial sector is feeble, and is likely soon to become a major obstacle to economic development. The current challenge is to find the best way to remove this obstacle, without prompting dangerous financial bubbles and crashes. The problems are primarily on the supply side, in legislation, regulation, institutions, skills, and capital, whereas demand is ample.

The State of Financial Markets

Commercial banks are the strongest element of the financial sector in Ukraine. The Ukrainian banking system has experienced substantial consolidation, with a still large number of 157 commercial banks remaining after a series of bankruptcies and regulatory closures. Moreover, of the remaining banks only two are owned by the state, accounting for just one-tenth of the country's banking capital and assets. The Ukrainian banking system thus looks quite promising, being private, competitive, and not too fragmented.

Banks have grown very rapidly in recent years. In 2001-2003, their credit volume increased almost threefold. Incredibly, commercial credits surged from a volume corresponding to only 6.7 percent of GDP in 1996 to no less than 26 percent in 2003. Thus, in terms of its relative volume of commercial credits, Ukraine is approaching the more advanced Central European transition countries, despite having started from a very low level.

Despite its rapid growth, however, the banking sector has not kept up with the development of the real sector. In addition, bank loans have grown much faster than the banks'

own capital, which “only” doubled in 2001-2003. As a result, the capital-asset ratio of the banking system is close to the permissible minimum. The volume of other services of commercial banks (apart from payments and foreign exchange) remains small, and over the last three years the volume of mortgage loans has grown much more slowly than the real estate market. Particular problems in the credit market are a lack of access for most small and medium-size borrowers, minimal credit services of a more sophisticated kind, and the near absence of long-term credits and a mortgage market. The explosive development of the banking sector and the falling capital-asset ratio raise concerns about banking crises during any downturn.

The services of non-banking financial institutions have developed much more slowly than those of commercial banks. Among them, the **insurance** market has advanced the most. In 2003 alone, insurance premiums more than doubled, although from a tiny base. However, genuine insurance services amount to only 25-30 percent of the total suggested by official data. Most of what passes for insurance is in fact a form of tax avoidance, particularly by large financial-industrial groups that incorporate their own insurance companies.

The Ukrainian insurance market remains minuscule. In 2001, insurance premiums per capita amounted to US\$ 11.5, compared with US\$ 1,482 in Germany and US\$ 140 in Poland. In relation to GDP, insurance premiums in Ukraine amounted to 3.5 percent, compared with 8-12 percent in developed countries. As a consequence, most enterprises, houses, individuals, households, and cars are not covered by insurance, greatly aggravating the level of risk. The insurance sector suffers from an extremely rudimentary legal base, rendering much of the business nearly impossible. Insurance companies need reliable financial instruments to invest their reserves in the national economy, but these are nearly absent.

Among non-banking lending agencies, **credit unions** have developed relatively successfully. They have rapidly augmented their capital and broken even, while steadily reducing interest rates. The volume of leasing operations is tiny and has even decreased in the last two years. In 2003, they accounted for only 0.95 percent of gross investments. The absence of legislative regulation of non-government pension provision has impeded the development of non-state pension funds, whose volume of assets remains very low (UAH 16 billion in 2003).

Leasing exists but is tiny. A major problem is that leasing companies face discrimination in taxation and suffer from a particular squeeze on capital, which prevents efficient competitive companies from entering this market. Another problem is that state leasing companies operating on a non-market basis enjoy a monopoly in some sectors, notably agriculture.

The **stock market** in Ukraine emerged as a result of large-scale privatization involving the distribution of vouchers to the entire population. Exchanging vouchers for shares, millions of Ukrainians became shareholders, and the total number of registered joint-stock companies exceeded 35,000. Trade in stocks has been very limited, however, and the supply of stocks has declined as large investors have accumulated stakes in attractive companies.

In 2003-2004 the stock market in Ukraine experienced great dynamism. By the end of 2003 market capitalization had reached US\$ 4.3 billion, an amount equal to 9.7 percent of GDP—just one-third to one-half the ratio in Central Europe, but still substantial. Although liquidity remains very limited, stock prices have risen sharply in the last two years.

In parallel, a variety of bonds have developed. Because of low equity prices, it is more beneficial for enterprises in need of capital to issue bonds rather than to sell their equity. Apart from ordinary government and corporate bonds, municipal bonds, investment certificates of share investment funds, and recently VAT bonds have also been issued. Because of legal uncertainties surrounding these instruments, yields remain very high.

The number of investment funds, mainly venture funds, has also grown. The market infrastructure has developed with the rapidly growing number of stock exchanges and the creation of a National Depository System. Despite the growing number of trading organizers, the share of securities trading on the organized market has actually fallen recently, which indicates that the securities market is not efficiently organized. Publicly available information and rating agencies have developed very slowly due to lack of access to the necessary information, which is monopolized by state regulatory bodies.

One problem in the securities market is that minority shareholders have minimal protection. Dilution of shares is common and not even illegal. Another big issue is that of minimal supply owing to the lack of a legal foundation for many types of securities, ranging from mortgages to even the most elementary derivatives, such as futures. In addition, the exchange and depository systems function poorly, and are unreliable and non-transparent. A curious phenomenon is that state agencies accumulate a huge volume of information from market participants, for example, on mergers and acquisitions, but keep this information secret.

Most of the housing market in Ukraine is now privatized and housing prices in large Ukrainian cities are fast approaching West European levels. Ukraine needs a **mortgage** market to facilitate financing both of new housing and trade in existing housing. Traditional mortgage finance remains very limited in Ukraine, although mortgage crediting has taken off in recent years, rising in volume by a factor of 3.6 between 2002 and 2004. In the last two years, the government has taken steps to develop a legal framework for a mortgage system that will give access to long-term credit for more households. A new Housing Code has been drafted. The Parliament in July 2003 enacted a new Law on Mortgages, which came into force on 1 January 2004, along with substantial accompanying legislation and regulations. Many problems remain, however. Ukrainian banks have not introduced mortgage lending on a large scale because of a shortage of long-term deposits, the high costs of borrowed funds, the comparatively low profitability of mortgage lending, difficulties in examining a borrower's solvency (particularly given the prevalence of unregistered sources of income), a lack of public trust in banks, and difficulties in the foreclosure of bad debts.

Key Problems of Financial Markets

There are many reasons for the poor condition of the Ukrainian financial sector. First, the legal base is extremely poor, with some regulations completely lacking, and others contradictory. Second, legal regulations are not enforced, owing to the lack of a strong financial regulator. Third, institutions and skills are lacking. Fourth, information on credit histories and credit ratings is almost unavailable. Fifth, capital is scarce as well. The problems can be summarized as an unfavorable investment climate, with poor protection of investors' and creditors' rights. As a result, the country has a low investment rating, which stops foreign capital at the border, while domestic capital flees offshore. This capital outflow undermines Ukrainian financial markets, which suffer from a restricted capital supply.

Inadequate legal foundation. The worst legal problem is that Ukraine in 2003 adopted two broad economic frameworks, a Civil Code and an Economic Code, both with effect from 2004. The two frameworks contradict each other on virtually every point. As a result, litigation is becoming virtually arbitrary. Judges are free to refer to either code, depending on which claimant pays the most. Of the two, the Civil Code, although rudimentary, represents at least a starting point for normal legislation to regulate a market economy.

The Economic Code, by contrast, is a Soviet throwback, and its adoption as late as 2003 is mystifying. The code adopts the Soviet notion of "enterprise" as an economic unit rather than "firm" as a legal notion. It extensively regulates the process of concluding agreements between juridical persons and establishes overly restrictive procedures, and it allows the government to

establish mandatory terms for agreements between enterprises. Agreements between private parties should not be subject to state interference. In sum, the Economic Code has recreated a role for the state more characteristic of a socialist economy. This legislation is entirely harmful and has no reason to exist.

The legal foundation for the stock market and the corporate sector of Ukraine were laid as early as 1991 by the Law on Securities and the Stock Exchange and the Law on Economic Societies, when real market relations were still nascent and lagged significantly behind the new legislative base. Today the opposite is true. The rapidly growing market has outgrown its legislative framework, and legal shortcomings are constraint to growth. Many issues concerning the stock market and the corporate sector are in a legal limbo, including, among others, the confirmation and transfer of title to securities; the rights of securities owners; the execution of deals for securities; the clearing of securities trades; shareholders' influence over company management; and indemnification of material damage to shareholders. The legal grey area generates numerous corporate conflicts and undermines the protection of the rights of owners of securities and other investors. The *Verkhovna Rada* has not adopted such fundamental laws as the Laws on Joint-Stock Companies, on Derivatives, on Term Instruments, or on the State Property Fund, or the revised version of the Law on Securities and the Stock Exchange.

The lack of a law on joint-stock companies merits special concern. The only relevant law is the Law on Economic Societies, adopted in 1991, and it does not say much. It does not ensure the proper protection of shareholders or creditors, and it does not regulate numerous issues related to management. Shareholders' rights need to be protected. All shareholders need to be reassured of their right to adequate information about the finances of a company. Their right to participate in the management of a joint-stock company needs to be protected by strengthening the role of the supervisory board and ensuring the participation of representatives of various shareholder groups in its work through cumulative voting when electing supervisory board members. Minority shareholders must be guaranteed their right to a share of the company's profits. If a company is being bought, procedures need to be established to protect the rights of minority shareholders by guaranteeing the repurchase of their shares by the new dominant shareholders. To achieve this, Ukraine needs to adopt legislation incorporating the corporate management principles of OECD and EU directives, such as cumulative voting at shareholders' general meetings; regular and complete disclosure by issuers of current information capable of influencing the market price of shares; a ban on the use of insider information in deals with company shares; and control on part of the society of larger deals and deals where private interests of governmental officials and large shareholders exist. All this can be accomplished with a Law on Joint-Stock Companies.

The little law there is on insurance is contradictory. There are major contradictions between the Civil Code of Ukraine and the Laws on Insurance and on Financial Services and State Regulation of the Financial Services Market.

The legal framework for housing mortgages, despite recent improvements, remains unsatisfactory, according to the World Bank experts. The Law on Mortgage Lending and Operations with Consolidated Mortgage Debt, as well as the Law on Special Mechanisms for Financing of Housing Construction, both need to be revised (or abrogated) to bring them into compliance with the recently enacted Law on Mortgages, and with international best practice. A Law on Mortgage Securities should also be passed to establish clear provisions for the issuance of mortgage securities and protection of investors' rights. Although the new legislation makes provisions for eviction, this will not work without the availability of temporary housing for evicted households, which cannot afford commercial housing or belong to socially vulnerable groups. This requires targeted government support and the revision of state policies on social housing in Ukraine.

While the Civil Code is a good start, it needs to be expanded with specialized legislation concerning factoring, leasing, guarantees, and pledges. The legal base for creating specialized banks, first of all investment banks, is inadequate. Similarly, the legal base for the issuance and trading of mortgages and the trust management of property is lacking, as well as the legal base for issuing and trading even the most elementary derivatives, such as futures.

Tax legislation has inadequate standards for the taxation of factoring and leasing operations, which means that factoring and leasing are discriminated against and become unprofitable.

As one would expect, entrepreneurs are reacting rationally to the poor state of enterprise legislation. First, given that the rights of minority shareholders are so limited even in law, Ukraine is seeing a swift concentration of ownership, as is clear from enterprise surveys conducted by the Institute of Economic Research. Second, given the limited possibilities to have contractual agreements imposed through court, enterprises are defending themselves through vertical integration, relying more on the hierarchy of their own structure and less on markets, effectively minimizing the number of transactions each enterprise undertakes. The natural outcome is the predominance of large financial-industrial groups.

Inadequate international integration. Ukraine has failed to ratify numerous international conventions that are vital for international financial integration, notably the International Institute for the Unification of Private Law (UNIDROIT) Convention on international factoring, the UNIDROIT Convention on international financial leasing, and the Convention on International Guarantees in Relations with Mobile Equipment. Rules for taxation of leasing do not comply with international standards provided for by the Istanbul Convention on temporary export and the Kyoto Convention on simplification and harmonization of customs procedures. National insurance legislation clashes with the requirements of international legislation (including that of the EU), as well as with the principles and standards of the International Association for Insurance Supervision. The ratification of these and other major financial conventions would help introduce international financial regulations into Ukraine.

Unsatisfactory registration of property rights. The key problem with property rights is that trade in agricultural land is still not permitted. This makes it difficult to use land as collateral for loans. The registration of land property rights is incomplete. As of 1 August 2004, more than one-third of Ukraine's agricultural landowners were still waiting to obtain their titles. The delay in issuing land titles has led to the dominance of land leasing and discouraged long-term investment in agricultural production. Mortgage lending remains rare, comprising only 6 percent of banks assets, with 75 percent of such loans concentrated in Kiev. The adoption of the Law on the Land Market (Land Exchange) and the cancellation of the land transfer moratorium are preconditions for launching trade in land parcels.

Ukraine suffers from a lack of a unified title registry. Several different registries exist for real estate, and they contain contradictory information. A recent presidential decree calls for the establishment of a single unified register for land and other real estate property rights. This is a positive development, but it has yet to be implemented.

There is no single depository institution or any common flow of documents between participants in the National Depository System, which complicates the registration of securities ownership. Market participants (especially issuers and large stockholders) use the registry system as an instrument to block the transfer of share ownership rights, deny the registration of minority shareholders, and thus thwart competitors at the shareholders' general meeting. Another factor reducing the efficiency of securities circulation is the lack of settlement and clearing services in the depository system. In addition, registrars and depositories use different registration technologies and payment principles.

A bizarre practice has evolved in notarization. A wide variety of documents have to be notarized for no good reason, encumbering people with unnecessary bureaucracy. Moreover, notarization is unreasonably costly, often incurring costs of 1 percent of the value of the transaction described in the document being notarized.

Ukraine has reasonable legislation on restructuring, insolvency, and bankruptcy. A new bankruptcy law came into force in 2000 and has been improved through subsequent amendments. Two major problems remain, however. The first concern is that a special Law on the Introduction of a Moratorium for Compulsory Sale of Assets, dated 19 November 2001, prohibits the recovery of debts through bankruptcy from companies in which the state owns at least 25 percent. The second issue is that debt collection remains rudimentary.

Institutional and regulatory shortcomings. Ukraine lacks a single organized securities market. This shortcoming stands in the way of fair price formation, transparency, and liquidity of operations on the financial market, and it promotes the spread of arbitrage transactions. The information and requirements of stock exchanges, trade and information systems need to be unified to facilitate trade in securities.

Ukraine has a central state regulator of the stock market, the State Commission for Securities and the Stock Exchange, but its powers are inadequate to supervise the stock market and the corporate sector of economy. This prevents the commission from settling controversial issues and corporate conflicts at an early stage, forcing market participants to go to court to protect their rights. The commission is also not independent from other government authorities or large financial-industrial groups, so that its ability to protect the rights of securities owners is limited. These shortcomings have their roots in both legislative deficiencies and unsatisfactory informal practices.

The limited judicial protection enjoyed by owners or buyers of securities allows other participants in the stock market to violate the interests of other investors with impunity. They can settle issues that lack legislative clarity in their favor, gaining unreasonable profit while harming market participants. Stock dilutions are commonplace even in large and widely recognized companies. For instance, in 2004 Mykolayiv Alumina Plant decided to consolidate several hundred thousand shares to just 80, and to reorganize the public joint-stock company into a limited partnership. As a result, approximately 200,000 small shareholders were forced to give up their property. In order to limit the circulation of its shares, the controlling shareholders of OJSC Kievoblenergo decided to transform the company into a closed joint-stock company, infringing the rights of small shareholders.

The violation of securities ownership rights is further aggravated by the lamentable quality of Ukrainian courts. Corporate conflicts are often settled in courts of general jurisdiction, which are poorly versed in the practices of economic conflict settlement and existing corporate law. Gaps in the legislation, "telephone law" (whereby officials receive illegal instructions "from above" by telephone), corrupt officers in various branches of power, and bribery in judiciary bodies all deprive shareholders of any real judicial protection.

Scarcity of capital. At present, it is cheaper to raise funds as credits than as equity capital. One reason why corporate governance must improve is that it will be impossible to attract equity capital from minority shareholders if they are not reassured of reasonable rights.

It is quite difficult to attract capital from abroad as well. One major impediment is a number of currency regulations involving licensing that no longer seem to be relevant. Similarly, various regulations impede the inflow of foreign capital to banks, insurance companies, and leasing operations. While most transition economies currently allow branches of foreign banks to operate in their country, Ukraine does not. Foreign banks in Ukraine are now represented only

by six subsidiaries. This reduces competition in the banking sector, discourages the inflow of foreign capital, and creates problems for WTO accession.

Poor supply of financial instruments and institutions. Pension funds are only rudimentary. As a part of the pension reform, a system of cumulative pension funds should be launched as soon as possible, both voluntary and mandatory private funds. They should provide a powerful and steadily growing source of long-term investment in the securities markets and the financial system as a whole. The Ukrainian stock market is in urgent need of reliable and marketable financial instruments for the sake of financial intermediation from both domestic and foreign sources to enterprise investment. This requires the introduction of internationally accepted corporate management principles, defending minority shareholders from arbitrary behavior by officials, managers, large owners, and other market participants. The state could improve supply by letting the State Property Fund sell off remaining state stakes in privatized enterprises. The corporate bond market needs additional legislative restrictions with respect to the maximum possible volumes of their issuance in relation to the issuer's own capital, as well as an obligatory audit of the issuer and a bond rating. Internal state and municipal bonds need additional guarantees. The mortgage market should be developed at accelerated rate.

Weak human capital and information systems. The first problem is that the system of professional training of financial market specialists is insufficiently harmonized with the higher education system. The second problem is that the certification system of financial market specialists at the National Bank of Ukraine, the State Commission for Securities, and the State Commission for Financial Services is poor. Yet human capital does not appear to be a critical bottleneck. It could be improved relatively easily through a better certification procedure. Creditors have no information on the credit history of potential borrowers when providing loans, and rating agencies are underdeveloped. State regulation bodies accumulate vast amounts of information, yet use it only for control and supervision purposes without disclosing it to the participants. There is no accessible system for obtaining official reporting information provided by financial market participants, which is necessary for assessing operational decisions and for developing a system of analytical and rating agencies.

Recommendations

1. *Create an adequate and consistent legal basis for the development of the financial sector.*
 - a) Abolish the Economic Code while ensuring further improvement of the Civil Code.
 - b) Adopt a new Law on Joint-Stock Companies in line with European standards as soon as possible, as well as specific new laws on other legal entities;
 - c) Accelerate the adoption of draft Laws on State Registration of Real Estate Property Rights and Their Restrictions, on a Land Cadastre of Ukraine, on Derivatives, on Organization and Formation of Credit History Circulation, and on Trust Property Management.
 - d) Draft and adopt new Laws on Financial Leasing, on Insurance, on Financial Services and State Regulation of the Financial Services Market, on the National Depository System and Electronic Circulation of Securities in Ukraine, and on Securities and the Stock Exchange.
 - e) Revise the Law on Mortgage Lending and Operations with Consolidated Mortgage Debt, as well as the Law on Special Mechanisms for Financing of Housing Construction, to bring them into compliance with the recently enacted Law on Mortgage, and with international best practice. Enact the draft Law on Mortgage Securities.

- f) Eliminate the differences between tax legislation and specialized financial services legislation to create favorable conditions for the development of leasing, factoring, and non-resident re-insurers.
2. *Improve registration of property rights.*
 - a) Complete within two years the issuance of land titles and make the land market operational. A proper land market will start functioning only after (1) titles are issued, (2) a unified title registry is in place, and (3) restrictions on agricultural land ownership and transactions are lifted. This is critical for the development of financial markets as well as for removing the barriers blocking progress in agricultural reform.
 - b) Create a single depositary, with standardized rules for the flow of documents and the interaction among subjects of the National Depositary System.
 3. *Strengthen the protection of property rights.*
 - a) Given the lack of competence of ordinary courts, consider establishing special jurisdiction for economic courts with respect to corporate conflicts and property disputes related to securities. In particular, this is needed for property disputes between different shareholders as well as between shareholders and joint-stock companies.
 - b) Prohibit the Ministry of Interior from dealing with the financial sector unless there is a well-founded suspicion of criminal activity. The Security Service of Ukraine (SBU) should be altogether prohibited from dealing with the financial sector.
 - c) Liquidate the moratorium on bankruptcy of companies with state ownership and make collection of debt that has fallen due more effective.
 - d) Limit the need for notarization of documents and cap fees at a low level.
 4. *Ratify the relevant international conventions to promote international financial integration (including the UNIDROIT Conventions on international factoring and on international financial leasing, the Convention on International Guarantees in Relations with Mobile Equipment, the Istanbul Convention on temporary export, and the Kyoto Convention on simplification and harmonization of customs procedures).*
 5. *Develop an integral national system of financial market institutions and adequate state regulation of financial markets.*
 - a) Establish strong and competent state regulatory bodies for all financial markets. Amend the Law on State Regulation of the Stock Exchange to strengthen the independence and efficacy of the State Commission on Securities and the Stock Market.
 - b) Abolish all state monopolies in the leasing market and guarantee equal operating conditions for state and private companies.
 - c) Create conditions for the development of both voluntary and mandatory private pension funds.
 - d) Create a regulatory and legal basis for the development of specialized banks.
 6. *Encourage the inflow of capital to the financial sector.*
 - a) Liberalize the rules for foreign investment in banks and insurance companies.
 - b) Liberalize currency regulation and abolish licensing of currency inflows.
 - c) Allow entry of branches of foreign banks into the Ukrainian financial market. Opening the banking sector to foreign branches will foster competition and efficiency, increase the volume of capital imports and foreign direct investment, and have a positive

impact on trade and WTO negotiations. At the same time, it should be properly regulated in order to minimize the potential risks related to weakened stability, deposit safety, as well as the entry of non-reliable banks.

7. *Modify information systems for financial markets.*

- a) Collect and make publicly available relevant and permissible financial information through a universal and accessible state system of information based on the reports of actors on the financial market. At the same time, abolish unjustified government requests for information. A case in point is the current collection of all kinds of data with regard to any merger or acquisition by the Anti-Monopoly Committee;
- b) Stimulate the creation of non-government information and rating agencies in the financial markets.

Chapter 5. Privatization and Regulatory Reform

As in many other transition economies, state weaknesses and imperfections in Ukraine are key barriers to the development of market mechanisms and prospects for sustainable development. Regulatory reforms to separate and clarify the state's role as owner, regulator, and policy maker must be a high priority. These reforms need to promote market competition and entrepreneurship while strengthening the state's ability to protect property rights and mitigate socioeconomic uncertainty. At the same time, they are needed to empower Ukrainian citizens and civil society, and protect them from invasive and frequently counterproductive government practices.

This chapter examines these issues in some detail. Section 5.1 provides an overview of the privatization challenges now facing the government, and points to the overwhelming importance of continuing with both mass and case-by-case privatization. Since Ukraine's private sector is now well developed, emphasis should be placed on the country's more complicated privatization challenges, which generally require close coordination with other policy areas. The competitive restructuring of Ukraine's infrastructure monopolies, better corporate governance, and the introduction of market mechanisms into the military-industrial and other large integrated production complexes, are among the challenges now on Ukraine's privatization agenda.

Like many other transition economies, Ukraine in the recent past has introduced ambitious fiscal and deregulation reforms intended to reduce the burden of taxes, inspections, and licensing on the commercial sector (and especially on small companies). But despite important progress in this area, Section 5.2 shows that much still remains to be done. A lack of state capacity—particularly in the regions—once again appears as a key constraint on reform.

The links between privatization, market competition, competition policy, and regulatory reform are taken up in Section 5.3. The analysis here shows that economic progress requires the further modernization of Ukraine's regulatory infrastructure, particularly the Antimonopoly Commission and the commissions regulating Ukraine's infrastructure sectors. Regulatory reform to promote market competition and private sector development here requires both a clarification of the state's role as owner, regulator, and strategic policy maker, and further assistance to strengthening these agencies.

5.1. Completing Privatization

The Current State of Privatization

Mass privatization in Ukraine has fulfilled its main political function by ensuring the development and predominance of the non-state sector of the economy. In 2002 the non-state sector (privatized and new enterprises) accounted for a large share of major economic activities.

Share of Ukraine's non-state sector in economic activities (percent of total)

Profit before taxes	74.7%
Annual average number of employees (including small enterprises)	55.2%
Investments in capital stock	63.9%

Deployment of fixed assets	62.4%
Industrial production (including small enterprises)	81.4%
Production of construction enterprises	79.0%
Domestic wholesale trade	93.3%
Export of goods	84.6%

Source: 2002 Statistical Yearbook of Ukraine, Kiev, 2003.

If the real size of the “black” economy is taken into account, the share of the non-state sector would be much higher. But from the point of view of Ukraine’s privatization objectives, it is the size of the non-state sector in the legal economy that is most important.

Five years of vigorous growth since mass privatization have shown that privatization enhances economic efficiency and promotes socio-economic development. However, the transformation of the state production sector remains far from complete. About 15,000 enterprises, 350 controlling interests of the largest production joint-stock companies and holdings, and 1,500 blocks of minority shareholdings remain in state hands. The state continues to control the most capital-intensive enterprises: two-thirds of the capital assets of the real sector remain in state ownership. Thus far, privatization has barely touched the following sectors:

- Military-industrial complex: defense, space, aviation, and shipbuilding.
- Energy complex: extraction and processing (gas, oil, coal, uranium, peat) and electric power generation and distribution.
- Transport complex: railway transport (infrastructure and maintenance); motor transport (infrastructure and maintenance); pipeline transport (infrastructure, maintenance, shipping); air transport (infrastructure, maintenance, shipping); construction of transport infrastructure.
- Research and development.
- Post and communication: telecommunications (infrastructure, maintenance, and services).
- Public utilities: heat generation and distribution; water collection, treatment, and distribution; gas distribution for household use; sewage system; waste disposal and cleanup.

Key Problems with Privatization

Should privatization be continued, since its main political objectives have been achieved? Has the economy acquired the rough characteristics of a living market organism? Such questions are often posed by critics of privatization, whose views are widely shared in Ukraine. Ordinary citizens, experts, and politicians see Ukrainian privatization as ill-timed, ineffective, and unjust.

According to the “ill-timed” argument, the necessary institutions—particularly an independent and effective legal system—should have been created before privatization began. Order in the state sector should have been restored, and the “black spontaneous privatization” that began in the Soviet Union with the reforms of Communist Party leader Mikhail Gorbachev should have been rolled back. Likewise, macroeconomic stabilization should have been completed before privatization began. The same goes for the introduction of the market

institutions and infrastructure (such as corporate law and the stock market) needed to protect property rights. The state production sector should have been demonopolized and restructured before privatization.

According to the “ineffective” argument, privatization did not bring the expected results because it did not create real owners. State property was instead dispersed during voucher privatization, creating a perverse “insider plus oligarch” model that was both completely “black” and corrupt.

According to the “unjust” argument, state property was privatized secretly, in an environment of corruption and unfair competition, with large owners benefiting from artificially low prices, while millions of rank and file stockholders received only fictitious property rights.

Opponents of privatization believe that the negative consequences of this “fire sale” can be redressed by immediate suspension of the process pending the implementation of the other reforms listed above—and by revising the results of privatizations already conducted, by renationalizing assets in order to privatize them fairly and justly in the future.

These arguments have their merits, but any suspension or revision of privatization outcomes would be extremely dangerous for Ukraine’s future. Creating an effective state and efficient market institutions is not just about passing new laws. A long social maturation process, an evolution of values, stereotypes, and informal rules, is required. Any suspension of legal privatization results so far would promote a much more dangerous “black” privatization, which would probably be impossible to contain within the framework of a market economy. This suspension would promote the further degradation of the state sector, which badly needs the efficient management and private investment that comes with an open competitive economy.

Re-nationalization and subsequent privatization (so called re-privatization), in order to correct “bad” privatizations, are still more dangerous. The issue is not the routine work done by the State Property Fund, but rather politically motivated actions aimed at revising ownership, or demonstratively punishing misdeeds. Such plans would likely meet with public approval, since a majority takes a negative view of the privatization of large enterprises (51.8 percent in 2003, according to a survey by the Institute of Sociology of the National Academy of Sciences).

But the price for this approval would be too high. Reprivatization would amount to a massive violation of private property rights, and would trigger an extremely negative reaction from potential investors, both domestic and foreign. This would not just reduce investments and stimulate capital outflow. Investment risk would rise and market valuations of national wealth would fall accordingly. Likewise, mass nationalization and secondary privatization would likely degenerate into a corrupt transfer of property from one clan to another.

Privatization must therefore continue without political interruption and attempts at re-privatization. But the methods of privatization need not remain the same. Even after the completion of mass privatization, large amounts of assets belonging to the powerful industrial complex and associated infrastructure that used to serve the military and industrial needs of the Soviet empire remain under state ownership. Future privatization policies must reflect the special status of these strategic facilities and avoid the mistakes of earlier mass privatization.

The complexities of selling strategic production complexes (such as energy, transport, the extractive industries, and aviation) were underestimated during the transition to case-by-case privatization in 1999. The “inertia” of mass privatization led policy makers to regard an individual enterprise as a facility in itself, without taking into account that enterprise’s links to the overall economic complex and without developing strategies to reform ownership relations within these complexes. A complete inventory of state assets was not conducted, and the state

was unprepared for the post-privatization regulation of monopolistic enterprises. Policies addressing the special status of politically sensitive enterprises were only rarely articulated explicitly, leaving the government to implement its policy implicitly (e.g., through artificial tenders for a privileged buyer, by means of “telephone law”—instructions to officials relayed “from above” by telephone, or by selectively impeding particular privatization deals).

The central and local authorities that manage state property have resisted the completion of mass privatization because it narrows their influence. The accelerated sale of ordinary enterprises and minority shareholdings set by the privatization program for 2000-2002, which is still in force, has therefore not received necessary technical and other support. The achievement of the main political objectives of mass privatization has also reduced pressure on the bureaucracy to reform. But mass privatization is not complete, and case-by-case privatization has turned into “custom-made” privatization. Popular distrust of privatization plays into the hands of the bureaucracy and its aspirations to prolong the process and thereby generate a constant source of work and income.

These unresolved problems hamper the formation of full-fledged market relations, criminalize the privatization process, and create a poor impression of the Ukrainian economy among investors.

Recommendations

The problems that arose during the course of privatization require rapid and complex responses. The following measures are particularly urgent.

1. *Complete mass privatization.* A credible commitment to completing mass privatization must be made, in order to strengthen market forces and to send appropriate signals to investors.
2. *Shift the focus of privatization policy.* This should move away from *ad hoc* privatization of individual assets toward strategic long-range planning for privatizing entire production complexes. This long run approach must reflect the complexes’ socio-economic characteristics, as well as the relevant state regulatory capacity. It must be accompanied by reform of the management of those assets that remain under state ownership.
3. *Pursue asset sales.* The completion of mass privatization should not mean that the state will not sell other assets. Mass privatization should give way to a greater emphasis on case-by-case sales. These should be based on special laws for major sales, and civil contracts for others.
4. *Develop long-term planning.* The desirability of completing mass privatization is not a justification for the hasty disposal of all remaining state assets. On the contrary, the rational completion of mass privatization must be a major element of the transition from short-term management (focusing on short-term problems) to longer-term strategic planning. A longer time horizon is needed to define explicit privatization strategies for major production complexes. It will also help to synchronize the privatization of individual enterprises (especially monopolists) with their marketization, particularly in infrastructure sectors (such as energy, telecommunications, and extracting industries). A longer time horizon will facilitate the coordination of privatization with the modernization of corporate governance in those companies that remain under state ownership. And it will help prepare the organizational and legal framework needed for the continuation of privatization after mass privatization is finished.

In sum, privatization in the future should be based on a clear conceptual and procedural separation of assets selected for mass and case-by-case privatization. Mass privatization should be accelerated via the removal of bureaucratic restrictions, administrative simplification, and the

introduction of more flexible sale procedures. Case-by-case privatization procedures should reflect the individual characteristics of the assets being privatized while maintaining the integrity of production complexes to which they belong. They should also ensure that their privatization is conducted in accordance with a reform of the state regulatory system.

However desirable, such technocratic improvements do not address the principal social challenge: building popular support for privatization. This requires clear explanations of privatization in the context of Ukraine's economic transition. Privatization procedures must be made more understandable for society, and correspond to generally accepted notions of rationality and fair competition. All privatization goals (including political ones) and methods for achieving them must be explicit in privatization procedures rather than implemented in "black" decisions. Privatization procedures should combat the unauthorized appropriation of state assets and the spontaneous decomposition of integrated production complexes. Perhaps most importantly, institutional transparency of all privatization procedures, including their monitoring and evaluation, must be guaranteed and benefit from broad social participation.

5.2. Regulatory Policy and Entrepreneurship

During 1992-1994 an aggressive approach was taken to business regulation. This approach reflected the belief that social problems can be addressed through large numbers of regulatory instruments, and it contributed to the growth of administrative barriers to market competition. The massive entry of low-quality goods onto the market, and the rapid development of the service sector, prompted the application of strict administrative measures (in particular, strict certification and licensing procedures) in many markets. In the process, business registration and licensing procedures evolved into formal requirements that effectively meant that the right to conduct business had to be purchased from the state. These administrative barriers were not only highly ineffective *per se*: they also resulted in complicated, non-transparent regulations that created favorable conditions for administrative corruption.

The first step toward regulatory reform based on market-friendly principles was the presidential decree on deregulation of February 1998 (On Eliminating Restrictions Impeding the Development of Entrepreneurial Activities). This decree vested the State Committee for Entrepreneurship with the power to overturn administrative decisions impeding the development of entrepreneurship. It sought to increase the transparency of regulatory procedures and create common principles for regulatory policy. It also set the stage for the promulgation of the Law on the Principles of Regulatory Policy in Economic Activities enacted on 15 January 2004, which created a legal basis for a common approach to analyzing regulatory influence and monitoring the effectiveness, revision, and systematization of regulatory documents. This law also created the prerequisites for simplifying regulatory documents and making them publicly accessible, with particular emphasis on draft legislation.

These steps have since been accompanied by numerous initiatives in many other areas, including tax and accounting reform, the development and rationalization of support for small businesses, administrative reform and civil service training, and promoting dialogue between entrepreneurs and policy makers. At the same time, many regulatory problems remain unresolved, both in terms of legislation and the implementation of laws that have already been adopted.

Key Regulatory Issues

Key regulatory issues for the development of entrepreneurship include:

- Administrative barriers that prevent the implementation of the relatively progressive legislation that is now in force;
- Weaknesses in systems of permits, registration, and licensing;
- Unsettled tax and accounting issues; and
- Remaining legal imperfections.

Regulatory policies do not live up to legally prescribed principles and procedures. This is most often due to inadequate professionalism and training on the part of regulatory personnel (particularly in the regions), insufficient transparency of regulatory procedures used, and limited public monitoring and evaluation of regulatory effectiveness.

The system of company permits remains excessively bureaucratic and onerous. Procedures for granting permits and approvals for business activities are today the most complicated and disordered element in the administrative management system. Excessively long waits for permits and approvals, and burdensome lists of documents to be submitted, are commonplace. Individual clerks still enjoy excessive discretion, which facilitates corruption and instability in the regulatory environment. Many permits and approvals are unnecessary, and many permits lack legal ground.

The Law on State Registration of Subjects of Economic Activities (enacted on 1 July 2004) created the legal basis for introducing a European system of electronic registration and the formation of an integrated commercial registry. This registry can provide companies with reliable information on actual and potential business partners, thereby minimizing commercial risk. But due to inadequate technical assistance and a lack of information about the registry, this system is not working.

The Law on Licensing of Certain Types of Economic Activities adopted in 2000 created a new legal framework governing licensing. However, this law does not apply to foreign economic activities, broadcasting, the energy sector, the use of nuclear power and intellectual property, and the production and sale of ethyl, brandy, and fruit alcohol, alcoholic beverages, and tobacco products. These exceptions create conditions for political manipulation and violate fair competition principles. Moreover, the system of permits, licenses, and other approvals in Ukraine remains regulated by more than 150 laws, some 500 government decrees, and more than 150 regulatory documents of branch ministries and acts of local authorities. A rationalization of the legal framework in this area is still critically necessary.

In 1998, the presidential decree On a Simplified System of Taxation, Accounting, and Reporting of Subjects of Small Business simplified and clarified regulations in this area, introducing simplified, fixed presumptive taxes and exemption from bookkeeping on a wide scale for micro-enterprises. This gave semi-legal companies the opportunity to legalize their activities and invest in their own development. It greatly boosted the development of small firms. The most important benefit was that most state inspection agencies were deprived of any excuse to visit these entrepreneurs to harass and extort them. Unfortunately, some negative tendencies have also appeared, connected with the misuse of tax preferences by small businesses that were not supposed to benefit from the simplified system. The fraudulent use of tax minimization schemes has become widespread. In addition, the principles of the simplified system of taxation, accounting, and reporting were weakened by the exclusion from the single tax of social and pension taxes. Legal conflicts between the presidential decree On a Simplified System of Taxation, Accounting, and Reporting of Subjects of Small Business and laws adopted

pertaining to national social and pension insurance remain unresolved. The deregulation agenda still faces challenges in the areas of social protection for small-scale entrepreneurs, increasing the efficiency and transparency of the management of social fund assets, and combining the various social payments that remain outside the simplified tax system into a unified social payment.

Some 26 ministries, departments, and other government institutions are entitled to conduct various inspections on the premises of legal persons, and 18 of these may directly impose administrative sanctions. More than 100 agencies and services are entitled to inspect the commercial activities of legal persons, and 61 of these have the right to freeze bank accounts, annul shares, and impound documents. A variety of enterprise surveys, organized primarily by the Institute of Economic Research, the World Bank, and the OECD, indicate that the average Ukrainian company is subject to about 20 different inspections by various regulatory agencies every year. Although the situation today is much better than it was in the late 1990s, this is still far too much.

Recommendations

1. *Ensure efficient implementation of the Law on the Principles of Regulatory Policy in Economic Activities.* The impact of proposed regulations should be assessed before they are introduced. This requires more transparency in regulators' activities and the active involvement of non-government and public organizations in assessing draft regulatory documents. The broad engagement of civil society institutions in the assessment and monitoring of the regulatory framework will strengthen confidence in the government, and help create a new regulatory culture (particularly at the local level) based on a sound balance of the power of the state, the freedom of the individual, and the rule of law.
2. *Make regulatory agencies accountable for the results of their regulatory activities.* Requiring judicial bodies to suspend or overturn regulations that are at odds with Ukraine's basic legal framework would help create such a system of responsibility. So would more assertive public monitoring of, and interaction with, regulatory agencies. The possibility to sue regulatory agencies for damages should be introduced.
3. *Improve methodological and organizational support for those engaged in reforming regulations that are at odds with Ukraine's legal framework.* A cost-benefit calculation for each new law should be made compulsory. Also essential are monitoring of regulatory practices, independent public investigations into potential legal violations by regulatory agencies, and transparency in the activities of corporate lobbies.
4. *Improve the legislative basis for granting permits, licensing, and state control of economic activities.*
 - a) *Rationalize the system of permits.* This will be achieved through the adoption and early implementation of the draft Law on the Authorization System in Economic Activities. Only those permits and approvals that fulfill effective regulatory functions and have a real social value should be retained. The implementation of the "one-stop shop" principle, which will allow entrepreneurs to obtain all necessary permits in a single, consolidated fashion and in a timely manner, needs to be completed.
 - b) *Extend coverage of licensing law.* The Law on Licensing of Certain Types of Economic Activities should be extended to the sectors that still remain outside its scope. The organizational structure and information technology systems of the integrated licensing registry should be modernized.
 - c) *Protect businesses from arbitrary inspection.* The Law on Principles of State Control (Supervision) of Economic Activities in Ukraine (tabled by parliamentarian K. T. Vashchuk on 24 February 2003) should be adopted. This law calls for a single

inspection process, introduces responsibility for legal violations in this process, and names the agencies that are entitled to collect fines. Any monitoring of enterprises' compliance with legal rules should aim to help companies avoid potential violations, rather than executing sanctions. Most of the state agencies that currently conduct inspections should be deprived of this right. Only the agencies that are responsible for the safety of food, medicines, and buildings have justified reasons to visit an enterprise. Other agencies could invite entrepreneurs to their offices or, in cases of suspected criminality, seek a court order allowing the police to be dispatched.

5. *Improve skills of regulatory officials.* Improving the qualifications of regulatory officials (particularly in the regions) is an important complement to better legislation. Training of personnel in regulatory procedures, administrative management, and monitoring and evaluation is needed. The expansion of training and advisory institutions, interacting with regulatory bodies to provide consulting, advisory, and information services, is important.
6. *Simplify the system of taxation, accounting, and reporting.* The Law on a Simplified System of Taxation, Accounting, and Reporting of Subjects of Small Business should be enacted as soon as possible. Simplification and a reduction of hurdles between different taxation schemes will help to establish clear rules and limit the possibilities for tax avoidance. Subsequent steps include the introduction of a unified social payment and the creation of a unified treasury that will help to manage social funds more efficiently and transparently.
7. *Make the commercial registry work.* Support is needed to ensure that the commercial registry functions well. This includes methodological and technical assistance for the collection and processing of commercial data, professional training of state registrars, and improvement in the organizational structure of registration authorities. More reliable commercial information would be a boon for both commercial entities and the authorities. It would also help Ukrainian companies to enter international business registries more promptly.
8. *Restrict official information requests to companies.* Requests for information by various authorities must be strictly regulated by law in order to prevent an undue bureaucratic burden or the release of firms' commercial secrets.

5.3. Competition Policy and Regulation of Network Industries

Competition is crucial for a functioning market economy and sustainable economic growth. Ukraine (like many other former socialist countries) started market-oriented reforms without an institutional framework for competition policy, with dominating state-owned monopolistic companies, a very small private sector, and overwhelming state regulation of production, prices, and resource allocation. During the last 12 years the Ukrainian government has made some progress in developing a competitive market environment. It started to build the institutional framework for competition policy by establishing an Anti-Monopoly Committee, and independent sectoral regulatory bodies. It passed competition legislation with rules for preventing unfair competition and abuse of market power, for lowering market entry and exit barriers, and for leveling the playing field for market participants. The government also pushed forward privatization and the liberalization of foreign trade, and tried to harden budget constraints on firms, which is necessary for building a competitive environment.

Despite some achievements, further reforms are needed to improve competition, and the enforcement of competition legislation is rather weak. Extensive direct and implicit state subsidies and regulatory capture by powerful business groups result in unequal treatment of market participants and distort the allocation of resources. Inefficient regulation and delays in bankrupting insolvent firms prevent enterprise restructuring and preserve outdated industrial

structures. Rhetorical appeals to “social concerns” are used to justify excessive state regulation of trade flows, protecting jobs in unstructured industries, and keeping prices for basic products (like food, energy, and utilities) below cost-recovery levels.

In a number of surveys, the World Bank has presented a clear picture of the state of competition in Ukraine. The conclusion is that, by and large, the Ukrainian market is quite competitive. In 2003, about 85 percent of all enterprises stated that they had at least four competitors. The situation is not improving, however. The threat to competition comes essentially from a combination of three forces: the big financial-industrial groups; their strong links with government institutions, not least the Parliament; and the network industries, which largely remain state-owned, though often under the influence of one of financial-industrial groups.

Sustainable economic growth cannot be achieved without strengthening competitive forces, which in turn requires eliminating barriers to market competition. In this section we focus on three main obstacles to competition: institutional arrangements, hardness of budget constraints and exit barriers, and barriers to competition in network industries.⁶

Institutional Barriers to Competition

Institutional barriers to market competition in Ukraine are linked to the weakness of competition-promoting institutions (the Anti-Monopoly Committee and sectoral regulatory bodies) and the absence of a consistent regulatory framework for the provision of state aid.

Anti-Monopoly Committee. Since its establishment in 1994, the Anti-Monopoly Committee (AMC) has a checkered record. On the one hand, it has been vigilant in monitoring abuse of market power and preventing unfair competition. On the other hand, the AMC has suffered from five great weaknesses. First, it has tended to focus on rather small enterprises that could not be considered monopolies by any stretch of imagination. The big fish, however, have either been outside of the competence of the AMC or just been left alone.

Second, rather than working for a free market, the AMC long imposed price controls on perfectly competitive markets, such as liquor. In many cases, its regulation of prices (for instance of restaurant food) was nothing but absurd. Third, the AMC has persistently demanded vast amounts of documentation that it manifestly does not need. Notably, the AMC currently requires a huge volume of documents on any merger or acquisition, however small the enterprises concerned. Much of the commercial information collected looks more like economic espionage than plausible regulatory activity. Fourth, the AMC has been one of many inspectorates that have indulged in extortion of businessmen, even if it has not been very prominent.

Fifth, the AMC is not independent of the executive authorities: the government can veto committee rulings. (A similar provision is envisaged in the newly drafted Law on State Aid.) This significantly reduces the AMC’s influence and undermines its ability to safeguard competition. As a result, AMC investigations into anti-competitive behavior by large companies (where political pressure of interest groups is especially intense) are rare, and fines imposed are insignificant compared to company revenues. For example, in 2001-2002, the AMC imposed fines for antitrust violations on Ukrtelecom that totaled only UAH 208,000 (about US\$ 39,000), or

⁶ Competition policy is multidimensional and cannot be fully analyzed within the limited scope of this section. Competition-related policies are also discussed elsewhere (see Section 2.4 on security of property rights, Section 4.1 on tax privileges, Section 5.1 on privatization policies, and Section 5.2 on regulatory policy and entrepreneurship).

just 0.02 percent of the company's net profits. In other countries, penalties for similar violations are much larger in terms of both monetary value and share of profits.⁷

Implementation of AMC decisions, especially on the local level, is often problematic. As noted in the recent World Bank Country Economic Memorandum on Ukraine (2004), the AMC does not have enough power to induce local state administrations to comply with its decisions. While enforcement implies long and costly court procedures, local state administrations cannot be punished for non-compliance with AMC decisions.

Sectoral regulatory bodies. Efficient and independent regulation is crucially important for network industries. International best practice suggests that regulators should be separated from ministries and operational management in the regulated sector. They should enjoy financial independence and have appropriate administrative structures. The head of a regulatory authority should be appointed by the President or head of government, subject to approval by the Parliament. Regulators should have fixed terms of office and report to a body that does not make policy decisions in the sector. It should also have autonomy in recruiting personnel.

Judged by these standards, the situation in Ukrainian network industries is far from ideal. First of all, some sectors still lack independent regulatory bodies. While they have been established in the power sector (NERC–National Electricity Regulatory Commission) and telecommunications (NCRC–National Communication Regulatory Commission), such important sectors as public utilities (water supply, sewerage, and heating) and transportation still lack independent regulators. As a result, regulation in these sectors is combined with operational management, is non-transparent, and is subject to strong political pressures.

For public utilities, regulation is carried out by local state administrations, which set fees at “socially affordable” levels. Rail transportation is simultaneously managed and regulated by the State Railway Transportation Administration (UkrZaliznytsya). In an illustration of the lack of transparency and the politicization of price-setting, railroad fees for export of scrap metal have increased several times, but fees for internal transportation have been kept almost unchanged owing to an agreement between UkrZaliznytsya, metal producers, and the government.

The best model for organizing the regulatory authorities is presently under discussion. Though there are some arguments in favor of a single united regulatory authority (the AMC), which would combine anti-trust activities with regulation of network industries, this approach seems inappropriate for Ukraine in the short and medium term. A dual system of regulatory authorities (combining independent sectoral regulators in network industries and the Anti-Monopoly Committee) is a better solution, since it concentrates regulatory functions that require sector-specific expertise (e.g., setting tariffs) in relatively small and flexible sectoral regulatory agencies, preventing unnecessary enlargement of the AMC's structures. The AMC remains the main guardian of competition and investigates potential conflicts between regulatory agencies and market actors in the implementation of competition legislation. This reduces the burden on the courts, which have neither the expertise nor the administrative capacity to deal with competition cases. Given regulators' lack of political independence, the dual system is also useful since it raises the costs of adopting anticompetitive decisions. In addition, potential investors might perceive a merger of the AMC with other regulatory agencies as a sign of significant changes in the regulatory environment—something that would deter investment activity.

Like the AMC, sectoral regulatory authorities lack independence. In telecommunications, although the NCRC has the right to grant permits for frequency use, recently approved legislation (the Law on Radio Frequency Resources of 24 June 2004) gives the decisive role in

⁷ *Development of Domestic Markets in Ukraine: Welfare Through Competition*, Kiev, 2003, p. 57

frequency management to the central executive authority. In the power sector, political interference in NERC decisions is reflected in tariff setting and the non-transparent cross-subsidization of different classes of users. Another recently created powerful structure in the electricity sector, the Energy Company of Ukraine (which controls almost all state assets in the power sector), may further weaken the position of the NERC. Their administrative structures leave the sectoral regulatory authorities open to political pressures. Both the NERC and NCRC are subordinated solely to the President (the Parliament does not play any role); and members of the commissions can be dismissed by presidential decree.

Competition legislation. Ukraine's competition legislation is generally in line with international norms. Its main shortcoming is its excessively general terminology concerning state aid and preferential treatment for certain groups of enterprises. The magnitude of state aid (amounting to one-fourth of GDP) and its non-transparent structure (more than 70 percent is provided implicitly, e.g., as tax privileges) increase its distortionary impact on competition. Better regulation of state aid must therefore rank high on the reform agenda. At present Ukraine has only sector-specific laws on state aid. It needs general legislation setting out transparent procedures for providing state aid and creating institutions for its monitoring and evaluation.

Enforcement of legislation is another big problem. This is due to institutional weakness, frequent overlap of regulatory power and business interests, as well as insufficient funding for regulatory authorities, making it difficult to attract and retain highly qualified specialists.

Budget Constraints, Exit Barriers, and Direct State Intervention

Hard budget constraints and effective bankruptcy procedures are important elements of a competitive environment, since they provide incentives to increase both *ex ante* efficiency (the credible threat of losing property promotes better performance) and *ex post* efficiency (bankruptcy mechanisms reallocate resources to more efficient owners). Although Ukraine's bankruptcy legislation is well developed, its implementation has so far been limited mainly to small and medium-size enterprises. By contrast, larger firms have artificially prolonged their existence thanks to selective tax privileges, cross-taxation and subsidization, and state support for insolvent firms. These factors have prevented the hardening of budget constraints and the exit of unviable firms from the market (especially where the state still owns a large share of assets).

The coal and steel industries have been particularly favored. The policy of state support to Ukrainian coal mining involved the setting of "indicative" prices for coal and using state subsidies to compensate for losses generated by coal production. It established the wrong incentives for coal mines, preventing a market-led consolidation by keeping alive mines that were not economically viable, while weakening efficient mines because they received proportionately smaller subsidies. The rationale cited most frequently to postpone bankruptcy is the high social cost of layoffs. In practice, soft budget constraints distort competition since bailing out insolvent enterprises puts better performing firms at a disadvantage and limits their ability to hire new workers. At the same time, maintaining non-viable enterprises postpones inevitable structural changes and prevents the restructuring of potentially solvent firms without being able to secure threatened jobs in the medium term.

The financial health of firms is often damaged by regulatory failures and state capture by powerful business groups. One of the reasons why coal prices are currently depressed below cost-recovery levels (which in turn makes some potentially profitable coal mines non-viable) is lobbying by business groups from the coal and metallurgy complex. They reap significant state subsidies and concentrate losses in the mining sector through transfer pricing.

Soft budget constraints are often complemented by direct state intervention in price setting, which distorts competition and hurts the market. This has become typical in the agricultural sector, which during 1990-1999 fell behind other sectors in terms of price liberalization and state withdrawal from input and output markets. Government agencies continuously intervened in production activities, issuing “state orders” regulating production, and procuring outputs at fixed prices. Such regressive trends have recently accelerated in some areas. Poor grain yields in 2003-2004 served as an official argument for government intervention in agricultural markets, mainly in the form of administered pricing and restrictions on the free movement and sale of commodities. Not surprisingly, these measures failed to produce positive effects. Bread prices fell, but this happened mostly at the expense of farms and bakeries. Wholesalers accumulated large stocks of unsold grain, and the credibility of agricultural policy was undermined.

Barriers to Competition in Network Industries

Network industries (e.g., power generation and distribution, public utilities, and telecommunications) rely on large-scale infrastructure networks that are costly to install or divide. This creates “natural” barriers for competition, so that these industries are often called natural monopolies. However, even here competitive forces have a role to play, although competition on the market is often replaced by competition for the market. In network industries, regulatory problems and soft budget constraints are especially acute and constitute the main barriers to promoting competition.

The absence or weakness of independent regulators generates deficient tariff policies. Tariffs are set below cost-recovery levels, particularly in public utilities and the power sector. This causes technical and financial deterioration in the sectors and poor service quality. The situation is especially dramatic in the water supply sector, where problems with obsolete equipment co-exist with poor water quality and difficulties with water supply. In the power sector, the situation is complicated by distortions on the market for primary fuels and by inter-fuel cross-subsidization. Tariff setting does not create incentives to raise efficiency and quality or to reduce costs. In the power industry, electricity tariffs are set by capping the profit margin, i.e., through cost-plus pricing. Detailed cost-based formulas provide incentives for manipulation by reporting or creating higher costs. Tariffs are generally not linked to the quality of service (for drinking water), thus providing no incentive for quality improvement. The lack of metering equipment and the use of direct controls over users (especially in the public utilities sector) weaken incentives to increase operational efficiency, since delivery losses are covered by consumers.

Tariffs below cost recovery are exacerbated by substantial cross-subsidization between users and low payment discipline. In the utilities sector, enterprises cross-subsidize households. In the power sector, two plants (the Zaporizhsky Alumina Plant and the Zaporizhsky Titano-Magnesium Plant) and households are subsidized by other industrial and commercial energy users, which pay higher tariffs for electricity. Although cross-subsidization is perceived by policy makers as socially justified, it distorts competition and generates inefficiencies. It fails to provide targeted support to low-income households, moreover, since all households benefit from low tariffs.

Despite cross-subsidization, payments discipline remains an unresolved problem in the public utilities and energy sectors. In early 2004 the outstanding debts of households for public utilities amounted to UAH 7.5 billion (US\$ 1.4 billion). Non-payments coexist with extensive privileges for about 20-30 percent of households and are often not fully covered by local budgets. Payments discipline is further weakened as major non-payers are rarely disconnected from the network. In the power sector, Energorynok continues to accumulate debts vis-à-vis power generating companies, which in turn are unable to meet financial obligations to their suppliers.

Competition in network industries is also constrained by the recent deceleration of the privatization process, low involvement of private partners, and growing tendencies toward monopolization. In the transportation sector, for example, the privatization of several ancillary enterprises managed by the State Railway Transportation Administration was cancelled, and these companies were instead put on the list of enterprises not subject of privatization. This has been accompanied by growth in the non-core activities of the State Railway Transportation Administration. In telecommunications, the privatisation of Ukrtelecom has not been conducted. Moreover, the conversion of Utel into a Ukrtelecom subsidiary with the intention to buy out a 43 percent stake in the Internet provider Infocom from German Controlware suggest further vertical integration in this sector, which increases the danger of monopolization. In the power sector, the creation of a state holding company (Energy Company of Ukraine) reversed recent tendencies of (slow) privatization and the separation of a natural monopoly from potentially competitive market activities. This could endanger competition among the power generating companies and increase opportunities for inefficient cross-subsidization within the holding.

Recommendations

1. *Broaden the responsibilities of the Anti-Monopoly Committee.* Strong, independent regulatory authorities provide a sound institutional basis for promoting competition.
 - a) *Monitor state aid.* The AMC should monitor the provision of state aid, including sector-specific aid (which is currently beyond its remit), in order to minimize its adverse effects on competition. New legislation should prevent the central authorities from providing state aid without AMC approval. Only the courts should have the power to overturn AMC decisions.
 - b) *Monitor government bodies.* AMC responsibilities should include monitoring government bodies (both central and local) for possible violations of competition legislation, as well as reporting violations to the public, the government, the Parliament, and the judiciary. Special attention should be paid to the implementation of AMC decisions on a local level, and to bringing local administrations to heel for anti-competitive activities. The AMC should be able to impose immediate fines and other sanctions on state bodies that ignore its decisions.
2. *Increase AMC efficiency.* The AMC should concentrate on large enterprises that represent real monopoly threats. Its right to demand documentation should be limited to what is really necessary for conducting its functions. Methodologies should be developed to assess the impact of state aid, and guidelines set to differentiate between pro-competitive and anti-competitive vertical integration schemes, which are widely used by financial-industrial groups.
3. *Strengthen independent regulators in network industries.*
 - a) *Establish independent regulatory authorities in public utilities and transportation.* This does not preclude the transfer of authority from sectoral agencies to the AMC, in the long term. The preconditions for this transfer would be guaranteed political independence for the AMC; established and efficiently implemented regulatory rules in network industries; and a court system with the expertise to handle competition cases. In these conditions, concentration of all responsibility for competition policy in the AMC alone would contribute to the integrity of competition policy.
 - b) *Insulate sectoral regulators from political interference.* Legal provisions that allow central authorities to influence regulatory decisions should be abolished. Court appeals should be the only way to challenge regulators' decisions. Regulatory agencies should be accountable both to the President and the Parliament. The independence of regulators would be strengthened through the use of appointment and dismissal procedures similar to those in force at the National Bank of Ukraine. The regulators'

financial independence should also be bolstered by combining direct budget financing with revenues from a special fund created by transfers of a fixed percent of revenues from market operators. New funds would help attract highly skilled specialists.

4. *Create a proper regulatory framework for state aid.* The reshaping and final adoption of the Law on State Aid (which was drafted by the AMC in 2003) would increase transparency and minimize the adverse effects of state aid on competition. This law should be based on international standards, namely non-interference, adequate institutions, accountability, transparency, and limited scope and duration. The law should put all state aid schemes (except social benefits) under the AMC's jurisdiction, restrict the provision of operating aid, and promote gradual reductions in the total amount of state aid, particularly in harmful forms such as *ad hoc* and sectoral aid. The law should have a strong anti-corruption focus, requiring transparent and well-defined procedures that leave no room for dubious interpretations.
5. *Promote competition in network industries.*
 - a) *Set efficient tariff policies.* Tariffs should be raised to economically justified cost-recovery levels for all classes of users. Cross-subsidization of users should be dramatically reduced, if not abolished altogether. The profit-cap regulatory schemes now in place should gradually be replaced by price-cap regulation that stimulates cost minimization and increases the attractiveness of enterprises for private investors.
 - b) *Strengthen payments discipline.* Both enterprises and households have to be disconnected for serious non-payment. Low-income households that are unable to pay cost-recovery rates for services should benefit from well targeted support policies. The current practice of providing services to poor households through below-cost pricing should be replaced by direct monetary transfers that are financed by central and local governments.
 - c) *Support efficient tariff setting.* In public utilities and the power sector, the installation of modern meters for measuring service consumption can push companies to reduce delivery losses. Divestiture of company assets is a commendable cost-reduction strategy in sectors where significant diseconomies of scale are present (e.g., in hot water distribution systems where costs rise with the length of distribution pipelines). In sectors where direct competition between producers is problematic, yardstick competition—using comparisons with similar but non-regulated firms—should be introduced.
 - d) *Complete privatization.* In the power sector, this implies continuing privatization of the remaining power generating and distribution companies—an aim which has recently been called into question. The government should work to avert the dangers posed by the creation of the Energy Company of Ukraine and present a clear vision of how (and whether) privatization in the sector is expected. Privatization of profitable and potentially profitable coal mines is important for promoting competition in the market for primary fuels for power generation. In telecommunications, the government should finalize the privatization of Ukrtelecom as transparently as possible. Following Utel's integration in Ukrtelecom, this task has been further complicated by the necessity to prevent abuse of market power. In public utilities, where in the short run privatization is not feasible, the state should stimulate private participation by promoting private-public partnerships and providing legal and institutional support for private initiatives. In transportation, reforms should focus on separating the State Railway Transport Administration (whose operations are often politically rather commercially motivated) from the Ministry of Transportation, followed by its corporatization and divestment of non-core activities.

6. *Harden budget constraints and promote the exit of insolvent firms.* Enforcement of bankruptcy legislation should be matched by the imposition of hard budget constraints both at the firm level (via reductions in enterprise tax arrears) and at the state level (via timely VAT reimbursements for exporters). This requires a strong judicial system that protects property rights and efficiently enforces contracts. State aid to insolvent firms and tax privileges for select enterprises should be gradually reduced and replaced by a system of targeted social support for dismissed workers.
7. *Prohibit administrative interference in commercial activities.* This is a basic principle of market economies. Hasty policy changes, such as a return to administrative pricing (whatever the justification offered) or restrictions on the free movement of goods, must be avoided.

Chapter 6. Ukraine's International Economic Integration: Possibilities and Challenges

Ukraine's main economic objective is to maintain high economic growth. World experience shows that rapid economic growth is almost always export-led. Integration into the world economy has proven a powerful instrument to promote economic growth, which is a precondition for raising living standards in the country. Promisingly, in the last few years Ukraine has shown impressive rates of economic growth, fueled by surging exports of goods and services.

As the country's exports expand, Ukraine is becoming ever more dependent on access to foreign markets for its producers. Such access will be of key importance for the country's further economic development and stability. Therefore, Ukraine has no choice but to pursue an outward-looking strategy aimed at further integrating the country into the world economy. Such a strategy also supports market transformation and the establishment of a modern market economy.

Trade policy has assumed such importance that it should be the country's top priority in international economic policy. Proper formulation of trade policies and their implementation requires adequate institutions, personnel, and financial support. In fact, Ukraine is very vulnerable in its foreign trade. Its exports are dominated by a limited number of products, notably steel. Demand for these products is highly cyclical and therefore they are often subject to severe protectionist measures. Ukraine needs to exploit the current boom for its export commodities to secure access to markets for its exports in harder times.

Ukraine is currently facing the challenge of large-scale industrial restructuring and modernization. This challenge, coupled with increasing international competition, will spur demands for protection by certain business lobbies, and the government must respond to these pressures in a proper way. Like so many other countries, Ukraine has attempted to elaborate a variety of support schemes for specific sectors, which have included protection against foreign competitors. Theoretically, temporary protection might be justified for so-called infant industries, when a sector offers prospects for significant growth and is perceived as essential for the nation's economic and social development. Yet other countries' attempts to protect infant industries or to identify future winners have usually failed and incurred heavy costs for the state budget. Governments have generally proven incapable of identifying future winners, and interest groups have exercised strong influence on policymaking, resulting in the misallocation of budget funds, and the granting of tax exemptions and other privileges.

Foreign investment is an important component of international economic integration. It comes in several phases. To begin with, exporters to Ukraine invest in local production to cut costs and improve market access. Such foreign direct investment brings not only capital, but also management, technology, and access to international networks. Early foreign direct investment also goes into services, notably retail trade and telecommunications. In a second phase, exporters to the European Union (EU) and possibly Russia move to Ukraine to cut production costs. This process appears to have started seriously in the last two years. In a third phase, Ukrainian exporters buy factories in their export markets to reduce or eliminate trade barriers. That has already started with Ukrainian purchases of Russian chocolate factories and East European steelworks with access to the EU. Foreign direct investment is of many kinds, and it is directed both inward and outward. Not all of it is useful from the country's perspective, but quite a lot is. Ukraine's policy must strive to facilitate foreign direct investment, though not to maximize it.

Ukraine's foreign trade agenda naturally falls into three parts: accession to the World Trade Organization (WTO), trade relations with the European Union, and trade with Russia and other former Soviet countries.

6.1. WTO Accession Has Top Priority

Ninety-five percent of world trade is carried out among the 148 members of the WTO. The most important trading nations outside the WTO are Russia, Ukraine, Kazakhstan, Iran, and Algeria, all of which are now scrambling to enter. In comparison with other international organizations, such as the UN, the IMF, or the World Bank, the WTO is rather limited in its activities, resources, and staff. Essentially, it fulfills three functions. First, it is the world forum where countries meet to negotiate multilateral trade issues. Second, it is a depository of international trade conventions, which contain WTO rules and standards used throughout the world. Third, the WTO is an arbitration court for countries with trade conflicts, and it levies substantial penalties that are taken seriously. It is the only world trade court, and non-members are effectively excluded from the rule of international trade law.

Ukraine applied for membership of the WTO in November 1993, but the country has yet to become a member. One reason is that the WTO operates very slowly, but Ukraine also treated WTO membership mainly as a technical issue, rather than the priority political issue it is. Therefore, other WTO members did not take Ukraine's accession attempts very seriously. Ukraine elevated early WTO entry to a political priority only in 2002. A wake-up call for Ukraine was Russia's drive to energize its own entry negotiations in 2000. Meanwhile, no country actually opposes Ukraine's entry to the WTO in principle, offering the country a substantial opportunity.

Ukraine needs urgently to accede to the WTO. So long as a country is not a member, it remains an outcast in international trade. Ukraine has no recourse if another country prohibits imports from Ukraine. Nor can it conclude a meaningful free trade agreement before it joins the WTO, because all the rules for free trade agreements are endowed in the WTO. Over time it will become more difficult to join the WTO, moreover, as an increasing number of countries has entered the body. WTO members can make demands of new applicants, because all WTO decisions are made by consensus, giving each country an effective veto. Ukraine is now facing demands from recent WTO entrants Moldova and Lithuania, and these must be taken seriously because either country can block Ukraine's entry to the WTO. By contrast, Russian or Kazakh concerns cannot influence Ukraine's accession, so long as these countries are not members.

WTO accession is also of great importance for foreign direct investment in Ukraine. Foreign investors will be more easily convinced, and reassured, about the stability of Ukrainian economic regulations once Ukraine is a member. WTO membership will also force Ukraine to eliminate various sectoral restrictions on foreign investment, especially in insurance and commercial banking. Ukraine will also have to adopt international standards for the protection of intellectual property rights, and various currency regulations will have to be abolished.

WTO accession is a necessary precondition for integration into the international trade system. Ukraine must therefore redouble its efforts to complete WTO accession negotiations as soon as possible. No alternate cooperation scheme, such as the recent agreement on a Common Economic Space with Russia, Belarus, and Kazakhstan, should slow Ukraine's WTO accession negotiations, because none of these agreements can be successfully implemented without access to the WTO arbitration system.

Ukraine needs to see WTO accession as its overriding trade policy priority. Transparent and rule-based national trade policies are also essential for encouraging closer involvement of Ukraine in global industrial development. Therefore, WTO accession should be viewed as an

instrument that not only integrates Ukraine into the multilateral trade system, but also accelerates and provides greater consistency to domestic market-oriented reforms. WTO membership will improve Ukraine's standing in trade relations with all major trading partners, including the EU and Russia.

WTO membership imposes discipline on national policymaking and poses greater demands on economic regulation, which is not simply a collection of laws and rules but a process with its own momentum. To be effective, the regulatory process needs to be based on a comprehensive and coherent long-term framework with clearly defined priorities and strategies. Outside commitments, such as submission to US demands on intellectual property rights legislation, will compel Ukraine to adopt more sophisticated legislation. Other demands, such as access to the Ukrainian financial markets, are completely in line with Ukraine's own demands.

One of the main obligations WTO members have—and often a burdensome one—is the obligation to notify the WTO of changes in legislation and regulations affecting trade policies and practices. This obligation is meant to provide additional transparency to the system. Each country has to submit all legislation and regulations affecting trade policy, including all modifications, to the WTO. All the information is automatically transmitted to the other members of the WTO. The Ukrainian government is unprepared to fulfill this obligation and has taken no steps to develop the relevant institutional capacity. Therefore, Ukraine needs to develop an effective system for notifying the WTO of the country's legislation and trade policies.

Ukraine's current tariff schedule is quite modest, but the tariff structure is rather complicated. Weaknesses include extensive granting of import duty exemptions and lax enforcement. The operation of such a complicated system incurs high administrative costs, and encourages smuggling and corruption. Exporters face an additional non-tariff barrier in the form of value-added tax (VAT) refunds, which are almost always withheld by the government. VAT thus functions in effect as a 20 percent penalty tax on exports—an impermissible aberration.

Non-tariff barriers obstructing imports into Ukraine are becoming increasingly common. In comparison with OECD countries, Ukraine has only modest formal non-tariff measures, but it does have numerous informal ones, which tend to be more distortionary and damaging than official ones. Such unofficial barriers to trade, as well as customs controls and the way the tax system operates in Ukraine, hinder business development. Policy-makers should recognize that often even small institutional improvements could bring substantial economic benefits.

WTO accession negotiations are sensitive and confidential, so it is difficult to pinpoint the positions of the countries involved. But there are grounds to believe that Ukraine's partners are more concerned with the issues outside the trade agenda. The Ukrainian government must be fully aware that declarations and intentions, even when coupled with generous market access concessions and commitments, need to be backed by visible progress in the implementation of legal and institutional reforms. These reform efforts must be concentrated on the system of standards, intellectual property rights protection, and agricultural support.

WTO membership requires policymaking procedures that prevent the adoption of legislative and regulatory acts contradicting WTO standards. A special coordination mechanism within the government should be created. After Ukraine accedes to the WTO, the country will face the daunting task of carrying out its commitments to liberalize access to its domestic market and implement WTO-consistent principles of national economic policymaking. We recommend that the Intra-Agency Commission on Ukraine's WTO Accession be made a gatekeeper charged with blocking policy decisions in violation of WTO provisions. Alternatively, such control powers could be given to the Commission on International Trade.

The existing State Program of Industrial Development (adopted in 2003) must be reconsidered. A document of this sort must set clear guidelines and specify industrial policy principles and relevant policy instruments compatible with WTO requirements. The same is true of the Program of Export Stimulation adopted by the government on 26 October 2001.

To prepare the various government agencies, as well as the business community, for the changes that will follow Ukraine's WTO accession, many measures should undertaken now. The WTO Agreement on Subsidies and Countervailing Measures requires the government to reconsider its current policy of granting privileges to certain industries. Similarly, Ukraine must accelerate its preparation and adoption of a Law on State Aid, which should incorporate the European standards for the effective regulation of state aid, namely non-interference, adequate institutions, accountability, transparency, and limited scope and duration of state aid. When Ukraine becomes a member of the WTO, the government needs to publish a set of documents carefully explaining Ukraine's commitments and their implications for the policy-making and business community.

The costs of WTO membership are not negligible. The modernization and harmonization of various institutions involved in foreign trade and investment policies, as well as the protection of intellectual property rights, require fairly large investment. The Government must have a clear picture of the costs of meeting WTO commitments when drafting the state budget.

All these things are perfectly possible. On the whole, Ukraine's entry to the WTO looks pretty straightforward. Political will is the main issue. Bilateral talks on market access are well advanced. All outstanding problems could be solved within half a year. Legislation is well advanced, and the main issues at stake concern the focus of policymaking and the implementation of commitments made. Ukraine's entry into the WTO in 2005 is a realistic possibility, provided the government focuses on this goal.

Recommendations

1. *Accede to the WTO in 2005.* The timing of accession is more important than the specific conditions, because Ukraine's negotiating position will worsen rather than improve as time goes by. To gain WTO entry, Ukraine needs to adopt legislation on intellectual property rights that will satisfy the United States. Concessions on agricultural subsidies are also necessary.
2. *Create a policy coordinating mechanism.* The Intra-Agency Commission on Ukraine's WTO Accession could be made a gatekeeper to stop policy decisions that violate WTO provisions. Alternatively, such control powers could be given to the Commission on International Trade.
3. *Adapt legislation to WTO requirements.* Industrial policy must be revised to set clear guidelines and specifying industrial policy principles and relevant policy instruments compatible with WTO requirements. The same is true of the export promotion program. The policy of granting privileges to certain industries needs to be revised in line with WTO rules.
4. *Adopt a law on state aid.* This should incorporate European standards for the regulation of state aid, namely non-interference, adequate institutions, accountability, transparency, and limited scope and duration of state aid.
5. *Publicize Ukraine's commitments.* When Ukraine becomes member of the WTO, the government needs to publish a set of documents carefully explaining the commitments the country has undertaken and their implications for the policy-making and business community.

6. *Streamline tariffs.* It is in Ukraine's interests to adopt simple, uniform tariff structures in order to make tariff administration more efficient, transparent, and less costly. WTO accession presents a good opportunity to initiate these changes.
7. *Dismantle non-tariff barriers.* Ukraine needs to make a realistic assessment of official and non-official non-tariff barriers and strive to reduce or eliminate them. Although these issues are addressed in the WTO accession negotiations, nothing prevents Ukraine from taking relevant measures, such as shortening the list of goods requiring mandatory certification or inspection, immediately and incorporating them into a wider reform agenda.
8. *Enforce intellectual property rights.* To do this, Ukraine needs to develop proper administrative capacity. Initially, Ukraine should improve law enforcement procedures in this field to render the current intellectual property rights legislation more effective.
9. *Reduce agricultural subsidies.* Ukraine needs to take a more realistic stand on agricultural subsidies and outline a medium-term strategy to replace aid that is incompatible with WTO rules with permissible protective measures. Direct intervention in agricultural markets should cease.

6.2. Seeking a Free Trade Agreement with the EU

Since 1996, Ukraine has repeatedly stated that it wants to become a member of the EU. Unfortunately, the EU has shown little enthusiasm for Ukraine's quest, and the Ukrainian government has made negligible progress towards its goal. Yet Article 49 of the EU Treaty stipulates that any European state may apply to become a member. Although numerous European politicians and even a few EU Commissioners have publicly ruled out Ukrainian membership, the question remains open. Ukrainian public opinion favors the country's European Choice, though its implications are seldom spelled out. The Ukrainian authorities should recognize that EU membership will become a realistic possibility only in the long term, and anticipate this in the formulation of Ukraine's trade strategy. Still, Ukraine's strategic goal is to become a EU member, and that aim must be a key factor in determining current trade policies.

Institutional cooperation between the EU and Ukraine has been rudimentary. The EU offered Partnership and Cooperation Agreements (PCAs) to the CIS countries, but these are little more than a codification of WTO principles for non-WTO members. They do not offer any trade concessions beyond what the EU accords to its WTO partners, while the EU has concluded free trade agreements with dozens of other countries. Ukraine has been treated as one CIS country among many. The Ukrainian PCA was concluded in 1994, but it did not come into force until 1997. It is valid for ten years and can be prolonged. Although it is comprehensive, covering political dialogue, trade in goods and services, and economic, environmental, scientific, cultural, and legal matters, it contains little of substance. The only subsequent EU trade policy gesture towards Ukraine was the conclusion of a textile agreement that eliminated import quotas.

In March 2003 the European Commission issued a communication to the European Council and the European Parliament on *Wider Europe–Neighborhood. A New Framework for Relations with our Eastern and Southern Neighbors*. This was disappointing to pro-European Ukrainians, because the implication was that Ukraine would stay a neighbor rather than enjoy the eventual prospect of membership. The neighborhood concept leaves open the question of eventual membership, however. Although only Ukraine and Moldova are European and have persistently asked for EU membership, they are treated as members of a pack, together not only with Russia and Belarus but also North African and Middle Eastern countries. Russia and Belarus have rejected the neighbor concept, whereas the three Caucasus countries have embraced it.

The EU intention is to negotiate an individual action plan for each neighbor, and these individual action plans can vary substantially. Ukraine should make the most of this opportunity.

Ukraine's domestic market works reasonably well, but regional distortions in its foreign trade are all too apparent. In 2002, just 19 percent of Ukraine's exports went to the 15 old EU member states. According to the gravity model, which assesses how much countries should trade with one another given their size and the distance between them, this share should have been three times greater, or about 60 percent. The share of Ukrainian exports going to Russia and other post-Soviet countries contracted steadily in the 1990s, reaching a low of only 17 percent in 2002. Export growth has come from distant, new developing country markets in Asia and the Far East, notably China, and the Middle East, which are more open. It is more important that exports grow than where they go, but this is not a normal development. It reflects trade distortion, and Ukraine would benefit if it were able to export more to nearby big markets. Although Ukraine is an open economy, agriculture is considered to be 93 percent self-sufficient, suggesting substantial sectoral distortions as well.

The experience of Ukraine and CIS countries is in stark contrast to that of the eight new EU member states from Eastern Europe. Barely half of the eight countries' exports went to the EU in 1989, but by 2000 this share had risen to 67 percent. By contrast, 33 percent of Soviet exports went to the EU in 1989, but by 2000 the share of total CIS exports to the EU had fallen slightly to 31 percent, according to IMF statistics. Ukraine was especially disadvantaged despite its closeness to the EU.

The main explanation is that so-called sensitive products (goods that are particularly exposed to protectionist measures by other countries) dominate Ukraine's exports. EU protection focuses on these sensitive goods, especially agricultural products, textiles, steel, and chemicals. These four categories accounted for 65 percent of Ukraine's total exports in 2002, according to World Bank statistics. In 2002 steel generated 40 percent of Ukraine's total exports, agriculture accounted for 13 percent, and chemicals made up 8 percent. Anti-dumping measures, which usually amount to sheer protectionism, are applied particularly frequently against steel and chemicals, the two categories that comprise nearly half of Ukraine's total exports. According to the WTO, Ukraine ranked tenth in the world as a target of antidumping measures between January 1995 and June 2002, with no less than 37 antidumping measures concluded by various countries.

The obvious solution to Ukraine's trade problems with the EU is an ordinary bilateral free trade agreement, which is mentioned as one of the possibilities in the EU neighborhood concept. Unlike Ukraine, all the Southern Mediterranean countries have free trade agreements with the EU, and these are now meant to expand to include the services sector as well as more of the goods sector. The only other real neighbors without free trade agreements are Moldova, Belarus, and Russia. In its PCA with Ukraine the EU commits itself to start negotiations on a free trade agreement. Although WTO membership is a precondition, a free trade agreement could still be concluded much faster than a European Economic Area (EEA) agreement. Pursuing this strategy would put the onus on the EU, moreover. It would facilitate further integration efforts between the EU and Ukraine, as Ukrainian access to the EU market appears the weakest link.

Ukrainians have declared their European Choice for a long time in a loud voice, but this has had few practical consequences. The time has come to make this choice operative and actively engage the EU in negotiations, demanding something concrete in return for each concession. The best plan would be to draft a "roadmap," according to which each action by Ukraine should be reciprocated contractually by the EU with something that Ukraine desires. The best vehicle appears to be an individual action plan to be negotiated under the EU neighborhood concept. This is a path to the gradual development of a mutually beneficial and ever more fertile relationship.

The prospect of EU membership played an important role in galvanizing economic reform in accession countries. Ukraine needs to formulate a trade policy strategy that anticipates a fairly protracted interim period leading to EU accession. New ways of enhancing Ukraine-EU cooperation need to be found.

Recommendations

1. *Negotiate a neighborhood plan.* Ukraine should negotiate a neighborhood action plan with the EU, specifying what each side should do, and what the other side should be given in return. Ukraine should be prepared for substantial concessions, but the EU must commit itself to reciprocate, especially with better trade access and a better visa regime.
2. *Obtain market economy status.* Ukraine needs to strengthen its efforts to obtain market economy status from the EU and the United States. The status of a market economy is important for antidumping investigations. Non-market economies have few chances of winning antidumping cases, and as a consequence risk facing prohibitively high tariffs.
3. *Negotiate free trade with the EU.* Ukraine should endeavor to conclude a free trade agreement with the EU as soon as possible, after having joined the WTO. In the process, Ukraine should negotiate an individual action plan that gradually renders relations between Ukraine and the EU closer, so that each step forward by Ukraine is reciprocated with a previously-agreed concession of the EU in trade or simplified visa rules for individuals.
4. *Gain EU access for steel exports.* An early Ukrainian demand should be free access for its steel products to EU markets, but in practical terms Ukraine needs to negotiate a new steel agreement allowing steadily increasing export volumes to the EU.
5. *Embrace some EU legal norms.* This applies with particular urgency to company legislation, if Ukraine is really determined to open negotiations on a free trade agreement. Ukraine stands benefit from much of EU company legislation, and it might be necessary also to adopt EU rules on standardization and certification. However, Ukraine should not embrace full regulatory convergence, particularly over the short term, because the EU is heavily overregulated, and such overregulation could dampen Ukraine's economic dynamism.

6.3. Promoting Free Trade within the CIS Region

The Commonwealth of Independent States (CIS) concluded an Agreement on the Creation of a Free Trade Zone in 1994. This was meant to provide a foundation for trade between the CIS countries, although ratification was slow. Arguably, it is the only important CIS agreement that has any real impact. The free trade agreement was amended and improved in 1999.

Unfortunately, trade among the CIS countries is not very free. Whenever a company or industry in one CIS country successfully exports to another CIS country, the importing country tends to clamp down, without any justification, with a sudden quota or prohibitive import tariff. The CIS lacks any efficient conflict-solving mechanism, so the countries concerned have to settle their trade disputes in bilateral negotiations. Lacking a framework for conflict resolution, they often fail to settle their differences. This is a highly inefficient trading system, and trade disputes tend to multiply. The problem is not the free trade zone itself, but the lack of a conflict-solving mechanism. The world's smoothly functioning regional free trade areas—for example, the European Free Trade Association (EFTA) or the North American Free Trade Agreement (NAFTA)—are all based on WTO rules and standards. The WTO has a mechanism for conflict resolution, and its arbitration court and penalty mechanism are universally recognized. The CIS countries need to join the WTO and base their mutual trade on WTO principles, like everyone else.

Unfortunately, the CIS countries have a bad habit of setting up a new organization with a different mix of countries rather than solve the problems of organizations that already exist. The latest example is the Common Economic Space (CES), which was launched in Moscow on 23 February 2003 with a declaration by the Presidents of Russia, Ukraine, Kazakhstan, and Belarus. By September 2003 they concluded an agreement, and this has been ratified by all four parliaments. The CES is meant to be a customs union as well as a currency union and to coordinate the four countries' entry into the WTO. Neither a customs union nor a currency union makes any sense for these countries at present, nor is either likely to work. Any attempt at coordinating WTO membership is likely to delay entry for all countries concerned. Moreover, this harebrained scheme is a drain on time, energy, and policymaking capacity.

Rather than attempting more complex economic integration than they can manage, the CIS countries should focus on the essence of their economic relations and make their free trade agreements work, which requires that they become members of the WTO and base trade on WTO rules and standards. Irrelevant and harmful ideas such as customs and currency unions are best forgotten. Russia must accept that its state regulation of natural gas prices is not compatible with free trade—something the EU is pursuing in Russia's negotiations for WTO membership.

Recommendations

1. *Use WTO entry to realize CIS free trade.* This would require that Ukraine and its CIS partners become members of the WTO and base their free trade on WTO rules and standards.
2. *Focus on the basics in the CIS.* Ukraine should resist the CIS tendency to propose new and ever more complex schemes of cooperation rather than solve the basic problems hampering trade. The country should steer clear of any customs or currency union.

Appendix: Abridged Recommendations

Our Key Recommendations

1. Undertake an administrative reform.
2. Undertake judicial reform.
3. Start a territorial-administrative reform, initially consolidating the lowest administrative levels, while decentralizing powers and financing from the central government to regional and local governments.
4. Introduce mandatory public medical insurance and a multi-level insurance-based approach to health care finance with competition among care providers.
5. Enact a liberal tax code, reducing the number of taxes, lowering tax rates, eliminating exemptions, decentralizing the tax system, and eliminating competing revenue services.
6. Reduce Ukraine's excessive public expenditures substantially over the coming five years. Cut non-essential and harmful spending, such as enterprise subsidies that impede structural reform. End social transfers to the wealthy; social spending should target poverty reduction.
7. Improve corporate legislation, by adopting a modern Law on Joint-Stock Companies and legislation for other forms of companies.
8. To resolve the conflict between two contradictory legislative frameworks, abolish the Economic Code while further developing the Civil Code.
9. Create functioning property markets. Most importantly, abolish the moratorium on the sale of agricultural land and establish a functioning unified property registry.
10. Create a level playing field by abolishing regulatory discrimination and enterprise subsidies. Prohibit discretionary state intervention in pricing, trade, and enterprise, except where regulated by law.
11. To integrate fully in the world economy, join the World Trade Organization (WTO) in 2005.
12. Make the European Choice a reality by adopting European legal standards. Reach agreement with the European Union on an initial action plan that will pave the way to a free trade agreement and make future membership of the EU a real possibility.

Chapter 2. State and Citizen: Improvement of the State

2.1. The Relationship between State and Citizen

1. Complete the process of administrative reform and improve the quality of the state administration.
2. Start a territorial-administrative reform.
3. Enact judicial reform to hold state bodies accountable.
4. Enhance civil society participation in the governance process.

2.2. Vital Administrative Reform

1. Make the government political.
2. Focus on strategy and policy.

3. Make a vice premier responsible for administrative reform.
4. Restructure the cabinet of ministers.
5. Reform the secretariat of the cabinet of ministers. Make the secretariat the prime minister's chancellery, analyzing government policy decisions developed by the ministries, in addition to the chancellery that formally prepares meetings of government committees and the cabinet.
6. Make ministers responsible.
7. Change the work of the ministries, so that they are functional rather than branch-oriented.
8. Finance the government in full.
9. Distinguish political appointees from civil servants.
10. Introduce transparency.
11. Review the functions of ministries, as well as offices and institutions subordinated to them.
12. Abolish redundant inspection and revenue agencies.
13. Reform the civil service according to the following principles.
 - Formation of a politically neutral civil service.
 - Political neutrality for entry into the civil service.
 - Guaranteed rights and duties of civil servants, including safety of employment regardless of political conviction and promotion based on merit rather than political views or favoritism.
 - Competitive exams based on merits for entry into the civil service.
 - A clear definition of corruption combined with a prohibition against it.
 - Strict ethics rules to prevent conflicts of interest, prohibiting the combination of business activities and government office.
14. Reduce the power of civil servants.
15. Raise salaries of civil servants.
16. Transform privileges in kind into money.

2.3. Relations Between Central And Local Authorities

1. Separate clearly the functions and powers of the three levels of government.
2. Consolidate the number of local communities.
3. Decentralize government powers.
4. Decentralize financing and make it sufficient for the tasks required.
5. Strengthen democratic control at each level of government.

2.4. Comprehensive Judicial Reform Is Needed

1. Bring the judicial system into conformity with the Ukrainian Constitution.
 - Adopt a concept for the development of the system of justice in 2005-2015.

- Refrain from establishing Appeal and Cassation Courts. Establish Superior Civil and Superior Criminal Courts. Designate general courts as specialized ones for the consideration of civil, criminal, and other cases, as appropriately required by the law.
 - Eliminate military courts.
 - Bring the authority of the President with regard to the judicial branch of power into conformity with the Constitution.
 - Restrict the administrative authority of court presidents.
 - Introduce a transparent and competitive selection of judges.
 - Establish a judicial militia within the system of the state judicial administration to ensure safety of judges and other court employees, as well as participants in judicial proceedings.
2. Develop administrative courts and establish administrative courts of appeal.
 3. Improve the status of judges. Adopt a revised Law on the Status of Judges.
 4. Complete the new codification of procedural law. A complete set of new procedural codes needs to be adopted and implemented.
 - Adopt the Administrative Procedural Code, the new Criminal Procedural Code, and the Economic Procedural Code and implement them.
 - Identify the types of related legal redress (including redress free of charge) and address the current low quality of legal redress by promulgating the Law on Legal Redress.
 - Set a fee for going to court, a procedure for payment of this fee, and a procedure for spending the revenues generated from such fees in the Law on Court Fees.
 - Bring the authority of the office of prosecutor into conformity with the Ukrainian Constitution.
 5. Complete the establishment of a system of administrative courts.
 6. Amend the Constitution with regard to the composition of the Supreme Council of Justice.
 7. Raise requirements for the professional level of judges
 8. Improve the transparency of judicial activities.
 9. Improve the system of execution of court decisions.
 10. Ensure full funding of the needs of courts.

Chapter 3. A More Effective and Humane Social Policy

3.1. Health Care Reform

1. Move to a pay-for-service basis for the financing of public as well as private health care institutions.
2. Introduce mandatory medical insurance and encourage the development of additional, voluntary private insurance.
3. Restructure health care financing to the benefit of primary care.
4. Develop and implement uniform quality measures for public and private health care providers.

5. Extend public information campaigns on preventing HIV/AIDS, tuberculosis and other infectious diseases.
6. Strengthen control over the production, import, and distribution of pharmaceutical products.
7. Initiate programs to promote healthier lifestyles.

3.2. Education Reform

Primary and secondary schools

1. Devolve responsibility for the management of primary and secondary schools to local governments. Engage parents more in the education system.
2. Redirect education finance from higher education to primary and secondary education, so that the state guarantee of free state education can be realized for all children.
3. Allocate funds each year on a pay-per-pupil basis, rather than—as currently—with a view to maintaining existing staff and buildings.
4. Increase teacher salaries and raise qualifications while outlawing bribes and other informal side payments.
5. Redefine the role of the Ministry of Education to focus on quality, develop curricula that meet international standards and strengthen students' national identity. Apply standardized testing.

Higher education

1. Accept and accommodate both private and state financing for higher education. Concentrate state financing on scholarships for especially gifted or especially poor students.
2. Make both public and private universities autonomous, with independent boards responsible for financial management.
3. Develop international education exchanges, in particular through entry into the EU Erasmus program of student exchange. Recognize international teaching degrees, and encourage the development of international education institutions within the country.

3.3. Better Targeting of Social Benefits

1. Firmly align Ukraine's social protection system with the requirements of poverty alleviation.
2. Reduce the number of benefits and monetize them.
3. Apply means testing to beneficiaries. Since better targeting of social benefits requires the indirect estimation of incomes, develop better methodologies to conduct such estimates.
4. Strengthen responsibility for systemic abuse.
5. Provide additional child benefits that incorporate incentives to increase the birth rate.

3.4. Addressing Ukraine's Pension Crisis

1. Reduce special pension benefits for privileged categories.
2. Raise retirement ages and close loopholes for early retirement.
3. Authorize competition from private pension fund managers as soon as the Accumulation Fund is established.

4. Increase the independence of the Executive Directorate of the Accumulation Fund. Make its members immune from removal during their terms (short of criminal conviction).
5. Increase the independence of the State Commission on Regulating the Financial Services Market, the principal regulatory authority for non-state pension funds.

Chapter 4. Tax and Financial Reforms

4.1. The Need for Further Tax Reform

1. Reduce the tax burden, taking 25-30 percent of official GDP as a medium-term goal.
 - Lower corporate profit tax.
 - Simplify and liberalize depreciation of firms' assets.
 - Reduce the VAT rate.
 - Lower payroll taxes.
 - Preserve the low and flat personal income tax.
2. Level the tax burden and restructure public expenditures.
 - Review public expenditures swiftly immediately after the presidential elections.
 - Abolish almost all tax exemptions, including special economic zones and most branch-specific and individual tax exemptions.
 - Make a short-run exception for the fixed land tax in agriculture and the presumptive tax for small entrepreneurs.
3. Make tax legislation simpler and more consistent and transparent.
 - Adopt a new tax code that supersedes current tax legislation and brings order and consistency into the tax system. Make the system simpler and more transparent.
 - Cut the current number of taxes from 41 to 15-20.
4. Improve administration of taxes.
 - Allocate taxes as far as possible to one administrative level.
 - Concentrate tax collection in one agency, namely the State Tax Administration, with a sole exception for the Customs Service. Transfer collection responsibility for the four social funds to the State Tax Administration.
 - Simplify tax payments. Collect no more frequently than on a quarterly basis.
5. Improve tax discipline and establish a voluntary service relationship between tax authorities and taxpayers.
 - Ensure exporters receive VAT refunds.
 - Decriminalize most tax violations, and reduce the powers of tax authorities to limit their ability to extort bribes from taxpayers. Force the tax authorities to take non-complying taxpayers to court. Eliminate the possibility of arrest for non-criminal tax violations.
 - Prohibit conducting tax inspections on site without due suspicion and a court order.
 - Abolish the tax police.
 - Increase the salary and reduce the number of tax inspectors.

- Consider reducing tax penalties.

4.2. Development of Financial Markets

1. Create an adequate and consistent legal basis for the development of the financial sector.
 - Abolish the Economic Code while ensuring further improvement of the Civil Code.
 - Adopt a new Law on Joint-Stock Companies that conforms with European standards, as well as specific new laws on other legal entities.
 - Accelerate the adoption of draft Laws on State Registration of Real Estate Property Rights and their Restrictions, on a Land Cadastre of Ukraine, on Derivatives, on Organization and Formation of Credit History Circulation, and on Trust Property Management.
 - Draft and adopt new Laws on Financial Leasing, on Insurance, on Financial Services and State Regulation of the Financial Services Market, on the National Depository System and Electronic Circulation of Securities in Ukraine, and on Securities and the Stock Exchange.
 - Revise the Law on Mortgage Lending and Operations with Consolidated Mortgage Debt, as well as the Law on Special Mechanisms for Financing of Housing Construction, to bring them into compliance with the recently enacted Law on Mortgage, and with international best practice. Enact the draft Law on Mortgage Securities.
 - Eliminate the differences between tax legislation and specialized financial services legislation to create favorable conditions for the development of leasing, factoring, and non-resident re-insurers.
2. Improve registration of property rights:
 - Complete within two years the issuance of land titles and make the land market operational.
 - Create a single depository, with standardized rules for the flow of documents and the interaction among subjects of the National Depository System.
3. Strengthen the protection of property rights:
 - Consider the establishment of special jurisdiction for economic courts with respect to corporate conflicts and property disputes related to securities.
 - Prohibit the Ministry of Interior from dealing with the financial sector unless it has a well-founded suspicion of criminal activity. Ban the Security Service of Ukraine (SBU) completely from dealing with the financial sector.
 - End the moratorium on bankruptcy of companies with state ownership and make collection of debt that has fallen due more effective.
 - Limit the need for notarization of documents and cap fees at a low level.
4. Ratify the relevant international conventions to promote international financial integration.
5. Develop an integral national system of financial market institutions and adequate state regulation of financial markets.
 - Establish strong and competent state regulatory bodies for all financial markets. Amend the Law on State Regulation of the Stock Exchange to strengthen the

independence and efficacy of the State Commission on Securities and the Stock Exchange.

- Abolish all state monopolies in the leasing market and guarantee equal operating conditions for state and private companies.
 - Create conditions for the development of both voluntary and mandatory private pension funds.
 - Create a regulatory and legal basis for the development of specialized banks.
6. Encourage the inflow of capital to the financial sector.
- Liberalize the rules for foreign investment in banks and insurance companies.
 - Liberalize currency regulations and abolish licensing of currency inflows.
 - Allow entry of branches of foreign banks into the Ukrainian financial market.
7. Modify information systems for financial markets.
- Collect and make publicly available financial information through a universal and accessible state system of information based on the reports of financial market actors.
 - Stimulate the creation of non-government information and rating agencies in the financial markets.

Chapter 5. Privatization and Regulatory Reform

5.1. Completing Privatization

1. Complete mass privatization.
2. Shift the focus of privatization policy from *ad hoc* privatization of individual assets toward strategic long-range planning for privatizing entire production complexes.
3. Pursue asset sales, through a greater emphasis on case-by-base transactions.
4. Develop long-term planning. Define privatization strategies for major production complexes. Coordinate privatization with the modernization of corporate governance in those companies that remain under state ownership.

5.2. Regulatory Policy and Entrepreneurship

1. Ensure efficient implementation of the Law on the Principles of Regulatory Policy in Economic Activities.
2. Make regulatory agencies accountable for the results of their regulatory activities.
3. Improve methodological and organizational support for those engaged in reforming regulations that are at odds with Ukraine's legal framework.
4. Improve the legislative basis for granting permits, licensing, and state control of economic activities.
 - Rationalize the system of permits through the adoption and early implementation of the draft Law on the Authorization System in Economic Activities. Implement the "one-stop shop" principle for the issuance of permits to entrepreneurs.
 - Extend coverage of the licensing law to the sectors that still remain outside its scope.
 - Protect businesses from arbitrary inspection. Limit the power to conduct inspections to the agencies that are responsible for the safety of food, medicines, and buildings.

5. Improve skills of regulatory officials.
6. Simplify the system of taxation, accounting, and reporting.
7. Make the commercial registry work.
8. Strictly limit the information that officials can request from companies.

5.3. Competition Policy and Regulation of Network Industries

1. Broaden the responsibilities of the Anti-Monopoly Committee.
 - Monitor state aid. Adopt new legislation to prevent the central authorities from providing state aid without AMC approval. Limit to the courts the power to overturn AMC decisions.
 - Monitor government bodies, particularly at the local level. Empower the AMC to report violations to the public, the government, the Parliament, and the judiciary, and to impose immediate fines and other sanctions on state bodies that ignore its decisions.
2. Increase AMC efficiency by concentrating on large enterprises that represent real monopoly threats. Develop methodologies to assess the impact of state aid, and guidelines set to differentiate between pro-competitive and anti-competitive vertical integration schemes.
3. Strengthen independent regulators in network industries.
 - Establish independent regulatory authorities in public utilities and transportation.
 - Insulate sectoral regulators from political interference.
4. Create a proper regulatory framework for state aid, through the adoption of a reshaped Law on State Aid. Base the new law on international standards, namely non-interference, adequate institutions, accountability, transparency, and limited scope and duration. Put all state aid schemes (except social benefits) under the AMC's jurisdiction.
5. Promote competition in network industries.
 - Set efficient tariff policies.
 - Strengthen payments discipline.
 - Support efficient tariff setting.
 - Complete privatization.
6. Harden budget constraints and promote the exit of insolvent firms.
7. Prohibit administrative interference in commercial activities.

Chapter 6. Ukraine's International Economic Integration: Possibilities and Challenges

6.1. WTO Accession is Top Priority

1. Accede to the WTO in 2005.
2. Create a policy coordinating mechanism.
3. Adapt legislation to WTO requirements.
4. Adopt a law on state aid incorporating European standards, namely non-interference, adequate institutions, accountability, transparency, and limited scope and duration of state aid.

5. Publicize Ukraine's commitments among officials and the business community.
6. Streamline tariffs.
7. Dismantle non-tariff barriers.
8. Enforce intellectual property rights.
9. Reduce agricultural subsidies.

6.2. Seeking a Free Trade Agreement with the EU

1. Negotiate an EU "neighborhood" plan.
2. Obtain market economy status from the EU and the United States.
3. Negotiate free trade with the EU.
4. Gain EU access for steel exports.
5. Embrace some EU legal norms, particularly on company legislation.

6.3. Promoting Free Trade within the CIS Region

1. Use WTO entry to make free trade agreements with other CIS countries fully operative.
2. Focus on the basics in the CIS. Resist the tendency to propose new schemes of cooperation rather than solve basic problems hampering trade. Steer clear of any customs or currency union.



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1, Kloviskiy Uzviz, Kiev 01021, Ukraine
tel.: (+380-44) 253-93-63, fax: 253-26-07
e-mail: administration@un.kiev.ua
www.un.kiev.ua