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## Ukraine – Economic Reform Priorities

Past government administrations emphasized “gradualism” and “incrementalism” in the implementation of economic reforms that were often contradictory. The reform programs were viewed as a long menu from which a few actions could be chosen now and other delayed for the future. Furthermore, vested interest and large government bureaucracies, sabotaged the implementation of reforms as many of them would affect their private (and in most cases corrupt) interests. In most occasions, the government itself was the main bottleneck for the implementation of reforms.

The current crisis is perhaps one of the last opportunities that Ukraine may have to break its past vicious circles, and implement a “**shock-therapy-big-bang**” reform agenda that would break the country from its past Soviet structures, policies and institutions, and would revitalize economic growth. International experience in successful reform countries, such as Poland, Czech Republic, Georgia, show that only a “big bang” reform program has the chance to minimize opportunities of vested interest to contain or reverse reforms.

### Drivers for Rapid Sustainable Economic Growth

Ukraine must now implement a substantive **Economic Reform Program**, that ensure rates of economic growth increasing from about 2% in 2016 to a level of at least 7 % p.a. over the next 5 years.

The achievement of these growth rates will require major increases in both domestic and foreign investments as well as improvements in factor productivity. In turn, international experience shows that the best way to accelerate investments and productivity is to make fundamental improvements in the country’s investment/business environment. Furthermore, a number of international studies have shown that a limited number of nine “**investments drivers**” can achieve large improvements in the investment/business environment of a country.

These “Nine Investment Drivers” aim at **reducing the risks** faced by businesses and offering them the opportunities to **make reasonable profits** in a free and competitive market. The reforms are designed to provide businesses with:

- (i) **Macroeconomic stability** that would secure stable prices and stable foreign exchange rates.
- (ii) A **liberalized business environment** that provides a “most favored treatment” regime for businesses within a free and competitive market. This should result in lower costs of doing business, without corruption and undue government interferences, and with minimum barriers to business entry, exit and growth.
- (iii) Sound formal **institutions** that would ensure sound public governance, a fair and unbiased judiciary, and a positive county image.

The nine investment drivers that have proven to accelerate investment and growth are as follows:

1. *Eradicate Corruption to protect businesses from abuse of power by public officials and others.*
2. *Ensure the Rule of Law by reforming the Legal and Judiciary Systems.*
3. *Anchor Macroeconomic stability to minimize capital and operating losses resulting from excessive exchange rate volatility and price fluctuations.*
4. *Improve public administration to facilitate implementation of reforms and provide public goods efficiently and without corruption.*
5. *Deregulate business activities to enable firms to operate freely in a competitive market and significantly reduce the costs of doing business.*
6. *Develop the country's financial sector to facilitate investments and growth.*
7. *Accelerate international trade and free movement of capital to convert Ukraine into an international production hub for supply to the West.*
8. *Improve Tax and Customs Administration to reduce the cost of doing business.*
9. *Reduce Political Risks and Improving Country Image.*

## **Political Pre-Conditions for Successful Economic Reforms**

Economic reforms can only be successful in a **political environment** that would support changes with minimum disruptions and political risks. In this regard, the current political crisis must be resolved immediately, including issues such as the conflicts of power between the office of the President and the office of the Prime Minister, the continuous interference of parliamentarians in executive matters, and the ability of rich contributors to manipulate parliamentary elections. Constitutional changes would be required to address these issues. Furthermore, the conflict with Russian-back separatists in the East must be resolved based on political deals along the lines of the Minsk II agreement.

## **Priorities in the Implementation of Economic Reforms**

Although a comprehensive big bang program of reforms as noted above must now be implemented, there are some key reforms that have become “critical” **to re-establish public trust and confidence** in the state and the country's governance, which have been decimated by the current political crises.

For this purpose, from the above Nine Investment drivers, the two most urgent actions have to be, first, **fighting Corruption** and second, re-establishing the credibility and reputation of **the Judiciary**. Without success in these two areas, other reforms will not be effective. Most of the actions on these two drivers must be completed in the next few months, at most by the end of 2016.

Third, during 2016, the government must ensure investors, both domestic and foreign, that it has firmly secured **macroeconomic stability** and therefore the recent episodes of high inflation and rapid currency devaluations will not be repeated in the future.

And fourth, improvements in **public administration** are essential since public administration has inhibited rather than supported reforms. The bulk of the central government should be dissolved, principally through decentralization of central government functions.

## **Eradicating Corruption**

Although the country has taken a number of actions to eradicate corruption results are not yet visible. Over the short-term (next six months), the country has to show results in implementation. It needs to:

1. Remove the blanket immunity from prosecution currently enjoyed by members of Rada and the judiciary, to make them subject to legal actions against any corruptive practice. Also, as in most European countries, remove most “special” privileges, utility payments, other subsidies, housing and other prerogatives to Rada members and high level officials to establish the principle that they equal under the law to the rest of the society.
2. There must be an immediate increase in the number of corrupt officials and Rada members that are successfully prosecuted, convicted, and put in jail. Punishment for corruption cases should be strong and non-selective. Otherwise, anti-corruption will have no credibility.
3. Dismiss a number of public officials for whom evidence of corruption may not be available, but whose past behavior may be questionable, including the current General Prosecutor and other high level officials.

### **Other short-term anti-corruption measures:**

- Ensure that the recently created anti-corruption agencies (the National Anti-corruption Agency, National Anti-Corruption Bureau and State Bureau of Investigation) are independent from political pressures, fully staffed by qualified professionals, and fully operational.
- Regulate tightly lobbying activities to reduce opportunities by some people to influence illegally parliamentary members or government officials, which might affect the legislative process.
- Following the recent enactment of the privatization law, proceed quickly to privatize state assets and state enterprises, since asset stripping and control of the cash flows of state enterprises are the main targets for high-level political corruption and allure their managers to seek rents for themselves.
- Eliminate the need for discretionary decisions by the authorities which can change depending on the size of the bribe. For this, there is a need to eliminate multiple prices, tariffs and tax rates which provide too much discretion to officials, eliminate product subsidies (such as gas and other energy subsidies) which encourage re-commercialization schemes at higher prices, and all procedures applied by public institutions must be written down in a detailed manner so that as little as possible is left to discretion in practice.
- To ensure NGO and public support to anticorruption efforts, there must be more extensive publication of government activities and much better transparency in government actions. These publications would permit higher levels of surveillance by NGOs and the general public of decisions made by government bodies and officials. Furthermore, the level of transparency of government activities should be increased by broad introduction of the e-government.

## **Devolving Credibility and Reputation to the Judiciary and Legal System**

1. Public opinion about the reputation, ethics, fairness and competence of judges, prosecutors and law officers is very low. To regain public trust, blanket immunities should be abolished as noted earlier. And second, there should be **a complete re-evaluation of all judges** (about 10,000), prosecutors (about 20,000) and key law enforcement personnel. These re-evaluations should be extensive and not limited to the selective lustration of only a few. Every judge, prosecutor and key law officer must satisfy a rigorous independent evaluation (with international support) of their professional ability, integrity and financial assets.
2. The current inconsistencies between the Commercial Code and the Civil Code have been a major source of corruption in courts, allowing judges to permit illegal corporate raiding and unlawful transfer of business ownership. Right away, eliminate the Commercial Code and merge any necessary sections into the Civil Code.
3. The merge of the two codes during 2016 should be followed by a simplification of the entire business/commercial law environment. In particular, the entire business-related legislation must be replaced by a more business friendly legislation, possibly copying the best legislation of other former centrally-planned countries, such as Poland, Georgia, Estonia, and Slovakia. This should be accompanied by improved enforcement. The new business legislation should also be amenable to alternative dispute resolution, such as arbitration.

### **Other Legal/Judiciary Measures**

- In order to gain the broadest possible trust in the re-evaluation process, there must be a Special Re-evaluation Task Force that is established to carry out the assessment both quickly, but also with a world class degree of competency. This can be done by employing respected foreign judges and investigators to be part of the composition of the Special Task Force.
- Although necessary, the dismissal of corrupt/incompetent judges, prosecutors and law officers will not be sufficient if the judiciary and prosecutorial systems are not revamped. Simple changes in people will not provide the expected results. As important is to restructure the court system and to ensure the real independence of courts/judges and prosecutors from any of the branches of political powers.
- The structure of the court system as a whole must be reformed to limit the number of courts, both horizontally (general, commercial and administrative divisions) and vertically (District, Oblast, High Court, and Supreme Court.) In particular, the High Commercial Court should be eliminated and its jurisdiction transferred to the Supreme Court.
- It is also important to improve the transparency of court decisions by posting them online in the internet as soon as possible. Public attendance to the courts should be encouraged and in many cases televised. Judges should then be accountable for unjust or unethical decisions.

## **Anchoring Macroeconomic Stability**

1. The Fiscal Budget deficit should be significantly reduced, aiming at a maximum level of 2%-3% of GDP by 2018 and thereafter.
2. At about 45% of GDP, government expenditures are too high and must be cut drastically to about 35% of GDP, a level consistent with those of similar and competing countries, such as Romania (36%), Bulgaria (34%), Turkey (34%), Georgia (31%), Chile (23%), Mexico (26%). The main area for reducing expenditures must be on discretionary spending, such as the provision of energy subsidies and subsidies to state enterprises. This process can be facilitated by the introduction of Zero-Based Performance Budgets for all agencies, under which funds are provided on the basis of fully appraised programs, and not just additions to existing “departments”.
3. To have exchange rate predictability, decrease FX rate volatility, and control inflation, fully implement the IMF program to ensure that the country will have sufficient foreign exchange to cover its needs. Then remove all administrative measures in FX market regulation (but leave the possibility to apply them only under emergency conditions) and use only open market operations to mitigate the FX rate fluctuations.

### **Other Measures**

- The implementation of the law on public procurement, including the use of e-government, should be advanced to all categories of government purchases, in order to minimize government expenditures. In particular, there is a need to remove inconsistencies between the law on public procurement and other laws and to establish clear regulations under the law.
- In order to control the public cost of the pension system, it must be reformed by the implementation of a three-pillar system, similar to the Polish system: The first pillar should be based on the pay-as-you-go principle, while the second pillar should be funded through savings and investments. Both these pillars should be mandatory. The third funded pillar should be voluntary but would benefit from tax incentives.
- In the meantime, the pay-as-you go pension system should be reformed to reduce costs, based on measures such as increasing the number of work years to become eligible to a pension, increasing the retirement age, eliminating excessive pension preferences, reducing benefits from early retirement, limiting the size of maximum pensions, etc
- On the fiscal revenue side, additional budget revenues should be secured to fix budget gaps. This should include expanding the tax base by reducing the size of the shadow economy, increasing excise taxes, and securing privatization revenues to reduce public debt service.
- Social protection programs should only target poor and vulnerable groups of population, properly identified. Un-discriminatory grants or subsidies distort consumption behavior of households and should be eliminated.
- Carried out internal audits of budget executions in accordance with EU standards and make them available to the public through the internet.

## **Improvement of Public Administration**

1. Since independence, deficiencies in public administration have been major causes of for the poor implementation of economic reforms. Given the difficulties in reforming public administration, the only option today is just to dissolve the bulk to the central government through a large transfer of its functions to local administrations, as was successfully done in Poland, Canada, New Zealand, and other countries. Furthermore, the quality in the provision of public goods and services would be improved by decentralization, since this will bring the provision of services closer to the final users who can exercise better control.
2. This decentralization should be based on a national consensus about the functions and role of the government. This role should be to support, not to compete with the private sector. Ideally, this should be embodied in the Constitution. The goal should be to retain in the central government only those functions which are not able to be transferred either to local authorities, to the private sector, or to the rapidly maturing civil society institutions. In principle, the central government should only be responsible for strategy, policy formulation and overall control. It should also be responsible of matters of national interest, such as defense and the military. The implementation of government services and provision of most public goods should be decentralized to local authorities, in order to bring their provision closer to the final users.
3. Following the redefinition of the government, there should be a review of all government agencies, to clearly define its functions, operational procedures, and civil service practices. The extensive use of e-government should be implemented in all agencies