

ECONOMIC REFORM AGENDA FOR THE NEW GOVERNMENT

A Proposal by The Bleyzer Foundation

Short-Term Challenges: Improving Public Finances

- Budget revenues fell sharply in 2009.
- But expenditures remained virtually unchanged, thanks to a 50% decline in capital spending, and despite a 7% increase in current expenditures.
- Public finances are under significant strain in 2010 due to:
 - slow economic recovery
 - pre-election hikes in social standards (pensions, minimum wages)
 - the 2009 practice of collecting taxes in advance
 - the delays in tariff increases to population for natural gas and utilities.
- A comprehensive revision of Ukraine's fiscal policy is needed..... otherwise Ukraine may lose control over inflation, public debt, and face another large depreciation.

Rebalancing Public Finances

- International experience suggests that:
 - Successful fiscal adjustments are almost always expenditure based, which require public administration reform, public expenditure management reform, and privatization.
 - Fiscal deficit reductions are more likely to improve economic growth if they involve cuts in transfers and government wages.
- The high tax burden in Ukraine leaves little scope to raise taxes.
- But introduction of a local real estate tax may be appropriate, if accompanied by transfer of specific functions to local levels.
- This will also help to reduce budget transfers to local budgets:
 - The share of local governments in total government spending increased from 35% in 2000 to 41% in 2008
 - while the local governments' tax share declined from 38% to 26% respectively.

Sustaining Ukraine's Public Finances

In order to make public finances sustainable, Ukraine needs to:

- Rebalance the finances of Naftogaz by raising natural gas tariffs to population and utility sector;
- Increase cost-recovery of other utilities and transportation services;
- Reform the pension system, including early retirement schemes:
 - Pension spending account for about 16% of GDP
 - The retirement age is one of the lowest in Europe
 - Early retirement pensioners account for ~20% of total.
- Reform Public Administration by eliminating overlapping/duplicative functions and decentralizing functions to local authorities.

Deficit financing in the short term

- Over the short-term Ukraine has no alternative but to resume the IMF program and/or secure other multilateral or bilateral financing.
- Although privatizations may provide fiscal revenues, in the short term political instability makes this option unfeasible.

Medium-Term Economic Prospects

- Past sources of economic growth (exports and domestic consumption) will be limited in the future: exports prices are unlikely to increase as fast as in the past; credit will not be available to boost consumption.
- Therefore, Foreign Investments must become the new GDP growth engine, not only to induce growth but to diversify exports and output.
- Ukraine has a number of comparative advantages for FDIs:
 - Borders with the EU
 - Posses abundant and educated labor
 - Wages are 1/3 of those in Eastern Europe
 - Ukraine's 46 million population is an attractive market
 - Agricultural potential is quite high
 - Infrastructure and technological base are reasonable.
- But to realize this potential, Ukraine needs to make a quantum jump in economic reforms to improve its investment climate.

Future Economic Reform Agenda

- The quality of the business environment in Ukraine remains unsatisfactory – Ukraine is ranked **145th** out of **180** countries in terms of Ease of Doing Business by IFC/WB.
- Domestic and foreign businesses still face an onerous burden of excessive and costly regulatory, licensing and taxation procedures.
- Some of the major competitive disadvantages of Ukraine originated from Weak Judiciary and Legal Systems, Inadequate Protection of Property Rights, Poor Public Governance and Institutions, Excessive Taxation, Corruption and Macroeconomic Instability.
- The reform agenda in Ukraine is large and has been stated and re-stated by many international and domestic agencies over-and-over.
- By now, the authorities know well “**what**” should be done and there is no need to re-state this agenda one more time.
- The lack of reform progress is not due to ignorance on **what** has to be done, but it is due to implementation failures.
- These implementation failures are due to a combination of:
 - “resistance” from vested interests,
 - lack of reform priorities with an excessive number of reform proposals by many agencies that just paralyzes the administration, and
 - lack of knowledge on “**how**” to proceed with implementation of key reforms based on best practices in successful countries.
- The support from the international community should recognize these problems and should:
 - Concentrate in a limited number (about three) key priority reforms that may have synergetic effects.

- Put the entire emphasis in assisting on implementation, rather than just enunciating in great detail what has to be done. This requiring showing “**how**” other similar countries implemented the reforms.
- We also feel that the international community (multilateral, bilateral agencies and NGOs) should closely coordinate and even jointly support the implementation of these key reforms.
- As a starting point, we propose the following three reforms
 1. Fast agreement & implementation of an enhanced FTA with the EU
 2. Deep business de-regulation by implementing the Regulatory Guillotine TM
 3. Carry out strong anti-corruption measures.

1. Free Trade Agreement (FTA) with the EU

- One of the main reasons for failures in reform implementation has been the lack in Ukraine of a middle class with vested interest in reform implementation and who could lobby and apply pressure to authorities to achieve their implementation.
- A FTA is one of the few measures that may help in creating a strong constituency in favor of reform implementation.
- As a tactical step, we believe that a FTA should be entered as quickly as possible, without excessive prior actions and conditionality on reforms that may just delay indefinitely its approval.
- Most reform conditions should be agreed under a Plan of Action, with the expectation that once the FTA is signed, a constituency of vested interest will push for the implementation of the reforms.
- FTA+ would also:
 - Facilitate approximation to European standards
 - Favor Ukraine’s competitiveness through the use of new technologies
 - Improve institutions and governance
 - Help to diversify industrial and service sectors
 - Improve the investment environment, thus encouraging FDI inflows
 - Bring Ukraine into the European food supply chain, facilitating exports
- International experience shows that countries entering FTAs experience higher export and GDP growth, and larger FDI inflows.
 - Chile has about 25 FTAs including with the US (2003) and EU (2002).
 - Real GDP growth averaged 5.2% over 2003-2006 vs. 3.4% in 1999-2002; exports grew by about 35.5% pa vs. 4.4% pa over the periods respectively.
 - Mexico has more than 40 FTAs. The pace of economic growth doubled in the years succeeding the year of enforcement of the most powerful FTAs (NAFTA (1994), the EU (2000)).

2. Deep Business De-Regulation

- Most studies show that businesses in Ukraine are over-regulated:
 - More than 2,000 activities require licensing
 - 85 controlling bodies. Different ministries have several controlling bodies (e.g., there are 10 in the Ministry of Agricultural Policy).
 - Dealing with construction permits is one of the worst in the world
- International experience suggests:
 - A comprehensive approach, such as “The regulatory guillotine TM” is likely to be more successful in achieving deep de-regulation.
 - If it is designed with a clear and transparent sequence of actions, it can produce good results even when resistance against reform is high

- Essentially, it is an orderly and transparent process of rapidly reviewing and evaluating a large number of regulations against clear criteria, to select for future use only those regulations that pass the criteria.
- Any regulation that is not successfully justified as needed for policy reasons in a market-led economy will be eliminated; and any regulation that is needed but is not business-friendly will be simplified to the extent possible.

Implementation of the Regulatory Guillotine TM

- Adopt a legal instrument – usually a law -- that sets out the entire guillotine process, schedule, and institutions. The reform should be completed in less than 18 months.
- Create a central guillotine unit that manages the whole reform process and carries out the independent reviews.
- Each regulation must be justified as meeting three basic criteria:
 - Is the regulation legal and needed for the smooth operations of the market?
 - Is the cost of administering the regulation substantially lower than its benefits?
 - Is the regulation business-friendly?
- The regulation passes three levels of review – by ministries, business, and the central unit. In each review, only necessary, simple and easy to administer, business friendly rules are identified.
- Surviving regulations are sent as a single package to the Parliament.
- After clearly specified date, all other regulations not approved are cut off.
- A comprehensive electronic regulatory registry is maintained and any new proposed regulation would be subject to a thorough evaluation.

3. Anti-Corruption Measures

- Transparency International ranked Ukraine as 146th out of 180 countries in its degree of perceived corruption (the lower position, the worse the situation).
- Ukraine should implement corruption prevention measures to make corruption more difficult and costly to do (with transparency and eliminating corruption opportunities).
- It should then create a high level Anti Corruption Bureau, with power to:
 - Investigate public officials against corruption.
 - Constantly monitor expenditures of the government officials and their families against their incomes.
 - Monitor draft legal acts to eliminate possible opportunities for corruption.
 - Launch a broad public awareness program.
- It should undertake a fundamental reform of the Judiciary to improve judges' decisions and enforcement and to minimize abuses of power.
- Other measures may include:
 - Approve the Criminal Procedure Code
 - Make trial and court documents open to the public
 - Ensure implementation of the new Anti-corruption law (enforced in April 2010)
 - Reduce corruption at Ukrainian Customs, by outsourcing custom management (e.g., international Crown Agents team is assisting the Government of Bulgaria since 2002; custom revenues grew by 53% during 2002-03 and by 182% in 2006).