

The Ukrainian Crisis, Opportunities, and the Economic Reform Agenda of the New Government

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The current economic and military crisis in Ukraine has had a devastating impact on the country's wellbeing. In 2014, GDP is expected to decline by 7%, the fiscal budget would show a deficit of 12% of GDP, inflation would reach 24% pa, public debt would increase to about 70% of GDP, exports would decline by 10% in the last two years, and the Hryvnia devalued by 100% since the beginning of the year.

But this crisis also provides a unique opportunity to the country to break away from its past Soviet institutions and systems that have restrained economic growth and social development since independence. The country has now the possibility to implement economic and social reforms that could put the country on a sustainable path to prosperity. This would be facilitated by the fact that both the Ukrainian government and parliament are now controlled by pro-European parties for the first time since independence. The new government is fully aware that its success will depend on three developments. First, military stability in the East of the country needs to be secured, with support from the EU and the US. Second, the country needs to implement urgently a major economic reform program that could convince foreign lenders and investors that Ukraine will resume investments and growth, despite its military difficulties with Russia. And third, based on this strong economic reform program, significant external financial support needs to be secured from international organizations, the EU and the US.

The new Government of Ukraine led by President Poroshenko and PM Yatsenyuk has announced the main elements of the economic reform program that the new government will undertake to address the current economic crisis. A review of the program shows that it is quite strong and its implementation should ensure that Ukraine will close the current gap with other Eastern European countries in its investment and economic climate. According to the government's plan, these reforms will be implemented during the course of 2015 and 2016. The main aspects of the reform program are outlined below. They are grouped following the nine investment drivers identified by The Bleyzer Foundation as the key determinants of investment climates, investments and growth in Emerging Markets.

1. Macroeconomic Stabilization

- a. The tax system will be reformed to reduce the tax burden on business. In particular:
 - i. the number of main taxes will be reduced from the current 22 taxes to 9 taxes;
 - ii. tax and accounting bookkeeping will be unified and harmonized with international accounting standards to simplify tax administration and to improve the quality of financial reporting, which should faster economic decision-making process, attract foreign investors, and provide more accurate and reliable financial market information.

- iii. starting the first quarter of 2015, the rate of the unified social security contribution by businesses (levied on payrolls) will be gradually reduced from current 41% of salaries to 15% of salaries;
 - iv. the tax burden for small and medium enterprises will be reduced thanks to twofold decline in the single rate tax and imposing moratorium on inspections of business entities for 2015-16;
 - v. compulsory income declaration will be introduced; to achieve full declaration of the existing assets, a tax compromise will be installed;
 - vi. the government will reform transfer pricing practices, public procurement system (in particular, through establishing e-trading procedures), VAT administration process;
 - vii. to reduce the shadow economy and increase tax collections, the practice of paying wages in envelopes will be discouraged; the government and monetary authorities will take steps to reduce shadow cash flows.
- b. To reduce Naftogaz deficits (which today amount to 6.5% of GDP, contributing more than half to the large size of the fiscal budget deficit), the government plans to reorganize the state monopoly in accordance to the EU energy agreements:
- i. The functions of gas production, transportation (transit), and storage will be separated and transferred to newly created public joint stock companies;
 - ii. The financial position of Naftogaz will be fully restored by 2017. For this, energy prices and tariffs will be increased to market levels by 2017 and subsidies will be given to those that are poor and cannot pay higher prices;
 - iii. To stimulate domestic production of fossil fuels, the government will simplify and increase transparency of regulations related to development of mineral deposits.
- c. Over 2015 and 2016, Government expenditures as a share of GDP will be reduced by 10 percentage points, from 48% of GDP to about 38% of GDP. This share is more in line with public expenditure shares in similar countries (36% in Romania, 35% in Bulgaria, 32% in Georgia, 38% in Slovakia, and 38% on Estonia, Latvia and Lithuania).
- d. As part of the measures to reduce fiscal expenditures, the government foresees the following substantial correction of budget expenditures, except for defense programs:
- i. The size of the government will be reduced significantly and public procurement improved as noted in the section below on public administration reform.
 - ii. The social protection system will be reformed to make it more affordable and efficient (pension spending alone amounted to about 17.5% of GDP in 2013). In particular, the government will:
 - increase pension age to 65 years for men and women;
 - limit pension benefits to working pensioners to 90% of the granted pension;
 - freeze indexation of pensions and a reference average monthly wage at 2014 levels (the latter is used to compute the size of pension benefits for newly retired persons);
 - recalculate pension benefits applying a formula based on contributions;
 - reduce privileged pension benefits and bring to convergence with the general pension system (e.g., increase early retirement age and vesting period, and reduce the proportion to average wage of privileged pension benefits);

- review the eligibility for a number of social security benefits, subsidies and allowances depending on the financial situation of the family (household) or person's income.
- iii. The government will carry out a subsidy reform by making a comprehensive evaluation of existing privileges. Based on cost-benefit principle, a number of privileges will be removed, while the preserved ones will be monetized and/or will be provided based on stricter eligibility criteria (e.g., stipends for students, aspirants, doctorates, free public transportation for pupils and select other population groups, a number of privileges for military men will be removed, free lunches for primary school pupils will be eliminated, parents' fee for nutrition of children in the kindergartens will be increased from 30%-50% to 60%-80%, maternity benefits will be tied to household income, etc.).
 - iv. Optimization of the workload in the education system, consolidation of social infrastructure (schools, hospitals, etc.) in rural areas and setting the number of policemen, prosecutors and judges in a specified proportion to the number of inhabitants and other measures will reduce government expenditures on the humanitarian programs, law and order, etc.
 - v. The government is going to introduce provision of healthcare and education services on a paid principle, which will reduce government expenditures on these sectors.

We expect that these measures will allow narrowing the public sector fiscal deficit from about 12% of GDP in 2014 to 6% of GDP in 2015 and maintain it below 3% of GDP since 2017.

2. Public Governance & Public Administration Reform

- a. The size of the staff of the state administration was cut by 10 percent in 2014 (28 thousand officials), and will be cut by another 10 percent in 2015-2016. This will help to increase salaries of public servants and public employees by 10%. The government plans to optimize the number of state employees. In particular, the normative number of local self-governance employees and the number of judges will be tied to the population size. Thus, the number of judges should be reduced to 1.66 per 10,000 citizens, which is an EU-standard level, while the court staff size is proposed to be set in the proportion of 3.7 staff members per 1 judge in a particular court. Finally, the number of parliamentary assistants and consultants with civil servant status will be reduced from 4 to 2.
- b. A new law on civil service will be approved to install transparent and competitive procedures for hiring government officials and increase accountability of government officials.
- c. E-government procedures will be introduced to eliminate paper work and increase efficiency and transparency. In particular, the government is going to electronically issue ID cards for Ukrainian citizens, promote the usage of digital signature and other electronic official documents. The laws on unified system of electronic interactions and pen data and on e-governance will be approved in 2015 and 2016 respectively.
- d. The Government will amend the budget and tax codes to pursue decentralization reform and match the transfer of functions to local authorities with the allocation of resources.
- e. Local "transparent offices" are planned to be open in 2015 to increase efficiency and transparency of administrative service provision.

- f. The number of state enterprises which were not allowed to be privatized in the past will be reduced from 1,500 to 300. The others will be sold off at market prices, including sales of their stakes in international exchanges the procedure for which will be introduced in 2016-2017. Auction will become the major method of privatization string from 2016.
- g. In 2015, corporate governance will be improved and brought into compliance with the OECD standards through introduction of effective governance of the state property objects, international audit of the key SOE every year, and removing state employees from the management bodies of SOE.

3. Stability and Fairness of the Legal and Judicial Systems

- a. Ukraine continues harmonizing its legislation with EU legislation and adopting the best world practices in legal procedures. In connection with reforms to be carried out in other sectors of the country, the government and the parliament will consider any necessary reforms of the legal system, including amendments to existing legislation, lifting of obsolete and outdated regulations, and adopting new legal acts.
- b. Reform of the judicial system will aim at establishing fair and transparent courts in Ukraine. The current corrupt judiciary system has led to unlawful takeover of private and state assets and casted doubts on the security of property rights. The government will adopt a new law on the judicial system, the status of judges as well as complete re-certification of judges of Ukraine. To do this, a High Council of Justice will be formed to oversee the changes. The Government would initiate amendments to the Constitution of Ukraine for the introduction of a three-stage court system, in which the Supreme Court of Ukraine, as provided by the Constitution, would finally obtain the right of the highest judicial authority in the country. The new law would also simplify a number of judicial proceedings and ensure public access to the judicial system. In the framework of this work, amendments to all procedural codes of Ukraine would be submitted to the Parliament.
- c. The law enforcement system will be reformed starting with the Ministry of Internal Affairs in 2015. It will be reformed and a bill on the National Police is being submitted to the Parliament, abolishing of a number of non-core functions of the MIA, including those post-Soviet departments designed to combat crime and corruption, which in fact were plagued by corruption. Same as in the case of civil servants, the government proposes to tie the number of policemen and prosecutors to the population size in accordance with European standards. The number of policemen is proposed to be set at 300 per 100,000 inhabitants (instead of the fixed total number of policemen of 245,000 individuals), while the number of prosecutors is proposed to be set at 20 per 100,000 inhabitants.

4. Anti-corruption Program

- a. In the first-half of 2015, the government will make operational two institutions: (i) the National Agency for Corruption Prevention as a corruption preventive institution that will monitor the lifestyle of government officials; and (ii) the National Anti-Corruption Bureau as a law-enforcement institution that will take over the functions of an independent investigative body for corruption and related crimes by government officials (including ministers, MPs, civil servants, judges, employees of the Prosecutor General, military, senior officers, heads of state-owned enterprises) and prepare cases for prosecution. Rada has already approved the establishment of both institutions.

- b. The law establishing the National Anti-Corruption Bureau deprives the General Prosecutor's office of the functions of general legal surveillance and, therefore, of conducting investigations. In the past, this has been a major source for political authorities to exercise political control.
- c. In order to identify cases of civil service corruption, in 2015, a system to monitor the lifestyle of civil servants will be established. It will introduce the electronic declaration of incomes, expenditures, property and financial obligations of all public officials as well as monitoring of civil servants whether their declared income corresponds with their way of life.
- d. A major measure to prevent corruption will be the reduction (in the first half 2015) of regulatory bodies from 56 to 28 and a reduction of regulatory functions from 1031 to 680, bringing the number of supervisory bodies and their functions in full compliance with European standards (2016).
- e. To further minimize personal contacts, in 2015-2016, Ukraine will introduce e-governance, which will include: contactless electronic provision of public services, electronic identification and electronic signature by citizens, rejection of paper documents, the adoption of the law on a unified system of electronic interaction and adoption of the law on public data.
- f. Corruption preventive measures will also include the transparency of public information. Together with decentralization, in 2015 all local governments will be required to establish a Transparent Office to make public information available to the public.
- g. In 2015, corruption in the energy sector will be curtailed by bringing energy prices to international levels, as in the past powerful groups could buy energy at low regulated prices and sell it at higher market prices.
- h. Corruption in state enterprises will be addressed in 2015 with the implementation of corporate governance standards in accordance with the OECD, the appointment of recognized experts in leadership positions in key state-owned companies; involvement of international accounting firms to audit key state-owned companies (annually); and removal of public officials from the management of public companies. In 2016/17, about 1,200 out of 1,500 state enterprises will be subject to privatization.
- i. In 2015, Ukraine will establish a public register of all property and all enterprises with their beneficiary owners clearly identified. A law will be adopted regarding the disclosure of information about the real owners of businesses and assets owned by Ukrainian citizens, including officials.
- j. In 2015 the Ministry of Internal Affairs will be reformed based on the principle of “serve and protect” and a National Police force will be developed.
- k. In 2015 and 2016, corruption in the Judiciary will be controlled by the implementation of new system of justice. This will include better access to justice - a simplified procedure for civil and commercial cases; initiate amendments to the Constitution of Ukraine to complete judicial reform (introduction of a three-tier court system), re-certification of all judges, abolition of judicial immunity, elimination of political influence on the selection, career and responsibilities of judges; return of the Supreme Court of Ukraine powers of a higher court (amendments to all codes of procedure).

- l. Corruption in public procurement will be addressed by the development and promotion of the Law of Ukraine on Electronic Public Procurement (2015) and the introduction of electronic public procurement (2016), which will provide the public with transparent information on the entire process. Corruption in the procurement of drug and medicines in the health system will be addressed by the transfer of public procurement from the Ministry of Health to international organizations (2015-2016 years) and by making direct long-term contracts with manufacturers of drugs.
- m. In the first quarter 2015, the Ministry of Finance with the National Bank of Ukraine will adopt normative acts aimed at reducing shadow cash flows
- n. In November 2014, the Business Ombudsman Council was established as a permanent advisory body to the government. The Council consists of the Business Ombudsman, two deputies and employees of the secretariat. A former European Commissioner for Taxation, Customs, Statistics, Audit and Anti-Fraud has been appointed Business Ombudsman for Ukraine's Anti-Corruption Initiative. With the creation of this new institution, businesses will be able to report claims of unfair treatment and corruption. The office of the Business Ombudsman will assess the claims. Where it concludes that the alleged malpractice may have occurred, it will be able to request further investigation by the relevant bodies and seek to have these complaints addressed by governmental authorities. It will periodically report to the general public, including the business community, about the progress made in the fight against corruption.

5. Liberalization and Deregulation of Business Activities

- a. In 2015-2016, the government will introduce a new regulatory policy model in compliance with EU standards and with the Association Agreement between Ukraine and the EU.
- b. The number of government supervisory bodies will be reduced from 56 to 28 in the first stage from January to June 2015, while the number of supervisory functions will be reduced from 1032 to 680. The number of the supervisory authorities then will be brought in full compliance with European standards by the end of 2016.
- c. The Law of Ukraine on Technical Regulations and Conformity Assessment and the Law of Ukraine on Licensing Certain Types of Economic Activities will be amended in the first quarter of 2015. By the end of 2015, the government will ensure development and promote adoption of 1500 national standards which will be harmonized with the EU standards. Also the full-text electronic database of standards will be developed during the year. Upon adoption of the new standards all the correspondent standards of the former USSR will be terminated in Ukraine.
- d. Deregulation of the pharmaceutical market is planned for 2015-2016. In particular, registration of medications and medical appliances produced in the EU, the USA, Canada, Australia, and Japan will be acknowledged and the reciprocity principle will be applied to them afterwards. The government is also going to develop and promote adoption of the Law on Pharmaceutical Products and the Law on Medical Care Insurance.
- e. The government will use all reasonable efforts to enforce the Law on Metrology and Metrological Activity and the Law on Standardization adopted in 2014.
- f. The Ministry of Economic Development has already developed a draft law on deregulation and improvement of conditions for doing business. The draft law foresees introduction of transparent

and unified rules of doing business for all economic entities. Among other measures the draft law simplifies opening and operating business activities, decreases the number of permit and conciliation procedures, and strengthens protection of investors' rights. Overall, the draft law introduces amendments into 51 legal acts which set the general principles of administrative services provision and procedures for these services provision in various sectors of economic activities.

- g. For the purposes of labor market liberalization, the government will develop and adopt a new Labor Code of Ukraine in 2015.

6. Financial and Banking Sector Development

- a. To weather the current crisis, the National Bank of Ukraine will continue supporting the banking sector by providing necessary liquidity, strengthening supervision and monitoring of potentially weak institutions, addressing the problem of non-performing loans and enhancing bank resolution (by either raising capital or liquidating a bank).
- b. The NBU will develop strict criteria for a bank to be recapitalized by public funds.
- c. The operational capacity of the Deposit Guarantee Fund (DGF) will be strengthened by injecting sufficient funds to meet liabilities to repay insured deposits, which is important to enhance population confidence to the banking system. Necessary legislation will be approved to strengthen cooperation between the DGF and temporary administrations/liquidators of the bank.
- d. To deal with non-performing loans, necessary legislation amendments will be approved to allow voluntary debt restructuring and appeal schemes, out-of-court resolution of insolvency cases, improve business bankruptcy and allow personal bankruptcy procedures.
- e. The NBU will continue maintaining a flexible exchange rate regime and introducing measures necessary for switching to inflation targeting regime.

7. Liberalization of Foreign Trade and Capital

- a. By 2018, new free trade agreements will be signed with Canada, Turkey, Israel, the Cooperation Council of Arab States of the Gulf (GCC), and the Economic Community of West African States.
- b. Ukraine will introduce an active and aggressive export promotion policy, including maximum use of the advantages of free trade with EU countries. It will develop and promote the brand "Product Ukraine" (2015); and develop port and rail infrastructure for increasing exports (2015-2019 years); The aim is to double exports of domestic products by 2019.
- c. To facilitate trade with the EU, old Soviet technical standards related to trade will be abandoned and new 1,500 European standards will be introduced in line with the Association Agreement with the European Union. This will be completed by 2016. In 2015, all standards (about 28 thousand) will be put in a full-text electronic database.
- d. All medicines that are certified in Western countries will be allowed in Ukraine without the current local certifications: There will be recognition of registration of drugs and medical devices that are manufactured in the EU, USA, Canada, Australia, and Japan, followed by the application of the principle of reciprocity.

- e. Ukraine will strengthen its leadership in the global food market, by export promotion and the further opening of European markets for domestic producers with deeper food processing.
- f. In 2015, the government will introduce a new policy of international aid, which include: better implementation of cooperation programs with the IMF, World Bank, EBRD, EIB and other international financial institutions,
- g. The government will organize an international donor conference and approval of the international recovery plan for Ukraine 2015-2017 years. This will lead to the creation of a central coordinating donor and international technical assistance programs.

8. Image, Political Risks and Security

- a. To improve Ukraine's image in the international arena, several Ukrainian leading TV channels have started their broadcasting on Europe in English or have plans for 2015. There an on-going discussion in the Ministry of Foreign Affairs on immediate actions aiming to increase the role of Ukrainian diplomatic missions worldwide on promoting Ukraine's image. A new Ministry of Information was created to support these and other information activities.
- b. To meet the security threat in 2015, Ukraine will raise its military and internal security expenditures up to five percent of gross domestic product. Despite significant challenges for the country's budget in 2015 this norm will be included into the new budget.
- c. On "geopolitical security", the government will abandon the law of the non-bloc status of Ukraine, which had been adopted to appease Russia. Ukraine will adopt a new law on domestic and foreign policy fundamentals which will abandon its non-bloc status.
- d. The Ukrainian army will fully meet NATO standards. For this purpose, Ukraine will approve the Ukraine-NATO annual target action plan. Moreover, it is expected that as soon as Ukraine is ready to meet the NATO's requirements it would hold a referendum on NATO and then will apply for the full membership in this organization.

9. Social Policies

- a. Ukraine intends to introduce comprehensive health care insurance program. The first steps in this direction are encouraging. Ukraine will allow entering its domestic market all medicine which was already certified by EU, USA, Canada and Australia without any further certifications and permissions by the local agencies.
- b. Education financing will be based on achievements. Wherever possible, EU standards or assistance are being called for. It is expected that it would be a significant cut of budgets with a parallel increasing in quality of education and research. Moreover, the new budget foresees that majority of R&D activity should be financed by the private sector.