New Challenges for Economic Policy in Ukraine: Proposals for Immediate Action

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German Advisory Group on Economic Reforms with the Ukrainian Government
Abstract

The authors analyse the new economic situation in Ukraine which is determined by a complex interplay of both external and domestic factors. It is argued that new challenges – most of which have been previously latent and frequently not really perceived as challenges – require appropriate policy responses.

Based on analysis of the nature and scope of these challenges, the authors propose immediate policy measures to deal with problems in the field of fiscal and social policies, the external sector, energy and utilities, agriculture and rural development, and investments.

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List of abbreviations

APF  Accumulative Pension Fund
aop  average of period
bn   billion
CA   current account
CMU  Cabinet of Ministers of Ukraine
ESCO Energy Saving Company
EU   European Union
FAT  fixed agricultural tax
FDI  foreign direct investments
GDP  gross domestic product
GNI  gross national income
IER  Institute for Economic Research and Policy Consulting
IFS  International Financial Statistics
IPA  investment promotion agency
LGE  local government entity
m    million
MFN  most favoured nations
MTEF medium term expenditure framework
NBU  National Bank of Ukraine
NERC National Electricity Regulation Commission
OECD Organization for Economic Cooperation and Development
PAYG pay-as-you-go pension system
PFTS First Trading Securities System
PIT  personal income tax
PPP  public-private partnership
QES  Quarterly Enterprise Survey
SPS  Sanitary and Phytosanitary Agreement
TBT  Technical Barriers to Trade Agreement
Tcm thousand cubic meters
TRIPS Trade-Related Aspects of Intellectual Property Rights Agreement
UAH  hryvnia
USD  US dollar
VAT  value added tax
WTO World Trade Organization
1 Introduction

In the recent past, economic debate in Ukraine has primarily focused on economic stabilization and growth and the need to support them with appropriate economic policy (reforms). Ukraine can be proud of its economic performance in this regard: in the years 2001 to 2004 annual real GDP growth averaged 9.0%, while inflation averaged 6.7%. As a result, economic welfare also grew. Ukraine enjoyed external stability, combining a trade surplus, a strong hryvnia, a reduction of foreign debt and an increase in its international reserves.

In 2000 to mid-2004, the major factors behind growth were favourable external conditions combining a devalued currency, low energy prices, relative fiscal stability and slow, but nevertheless more or less continuous reforms. The list of these reforms includes a reduction of the tax burden, initiation of pension reform, gradual development of financial markets, simplification of the regulatory environment for business, and an increase in monetary discipline.

At the same time, however, comprehensive structural and institutional reforms were not implemented, although their importance was acknowledged and some decisions were taken\(^1\).

Where do we have today?

Currently Ukraine faces a new situation and new challenges. It should be stressed that most of these challenges were previously latent and frequently not perceived as challenges. The list of these challenges includes:

- increasing gas prices, which will likely continue growing until they reach competitive levels for the regions;
- higher competition on external markets for key export products, especially metals;
- an investment climate in the country that still does not favour investments activities that are needed to the modernize economy despite numerous declarations by top state officials;
- further opening of domestic markets – in particular due to long-awaited WTO membership which is expected in the near future – leading to increased foreign competition on domestic markets especially for agricultural products and consumer goods;

surging social spending as well as an unbalanced structure and dynamic of state debt, which endanger fiscal stability;

- persistently large Pension Fund deficits, which also endanger fiscal stability;

- lack of reforms in agriculture with obvious implications; and

- a privatisation process that has practically stopped, coupled with the burning, unresolved issue of protection of property rights.

The combination of these challenges has resulted in the currently observed decrease in real GDP growth rates and growing inflationary pressures, while the earlier current account surplus has become a deficit.

**What does this mean?**

This new situation is a result of both a changed external environment and unwise domestic policies, e.g. surging social spending from the end of 2004 onwards and an acute lack of structural and institutional reforms in a number of key sectors. Without immediate steps the situation will further deteriorate, increasing the threat to economic development and welfare growth. In other words, the absence of reforms will lead to the further rapid accumulation of economic and social difficulties. Only prompt, appropriate and consistent actions today will prevent further deterioration and help the economy return to a high rate of economic growth that can increase standards of living.

**What to do and why?**

The role of the government is to provide correct signals and a framework that stimulates growth, and not to further destabilize the situation with unsustainable policies. To this end, the Government must adopt a medium-term perspective in designing its policies in all areas and sectors, including fiscal policy, energy, agriculture and investments. Furthermore, the government must start working immediately.

**What do we propose and why?**

Compiling a list of challenges and identifying policy areas where immediate action is most needed was not an easy task. To achieve our goal we adopted the following approach:

- first to identify the nature and the scope of the challenge;

- second to explain why the problem matters and outline possible consequences if no measures are taken; and

- third to propose a set of immediate measures to meet the challenge in an appropriate manner.

In this book, we consider five spheres of economic policy in which the new challenges are the most profound and in which proper and prompt government actions are the most necessary.

**Fiscal policies.** During the years 2000-2003 Ukraine enjoyed macroeconomic and fiscal stability. Major budget reforms were implemented, including the introduction of the Budget Code, a personal income tax reform and a reduction of the enterprise profits tax. But since
mid-2004 fiscal discipline has been abandoned and relevant legislative provisions have been ignored.

The government has triggered a fiscal expansion through multi-stage, sharp increases in minimum wages, pensions, and other social obligations. Successive governments have continued to this loose fiscal policy. To cover the large deficit of the Pension Fund, the government has had to significantly increase budget transfers to it. Furthermore, the predominance of expenditure on inefficient budget items such as state aid and the old system of services provision has contributed to an unbearable fiscal burden.

We believe that growing fiscal imbalances have became a serious threat to macroeconomic stability: Ukraine has entered a vicious circle in which higher income transfers are translated into higher prices and higher inflation, resulting in increasing pressure on politicians to raise the subsistence minimum, further fuelling inflation and so forth.

External sector. Over the last years Ukraine has enjoyed a current account (CA) surplus that has allowed it to rebuild its foreign reserves which were depleted by the 1998 crisis, to keep the exchange rate stable, and not to worry about either the sustainability of the structure of the CA or the profile of the capital account.

In the second quarter of 2005, however, the merchandize trade balance became negative, gradually pushing down the CA balance. The CA balance became negative in the fourth quarter of 2005. Increased competition and lower prices on world metal markets, growing prices for gas imports, and high consumer-oriented imports are expected to contribute to the maintenance of a CA deficit for at least the next several years.

The challenge of a CA deficit in the coming years requires a clear response by the Ukrainian authorities. The government has to think medium-term, adopting policies that ensure that the CA deficit remains sustainable.

Energy sector. The price increase of Russian gas supplies in January 2006 triggered an energy price shock in Ukraine. It is likely that the price for imported gas will continue to rise until it reaches a competitive level in the region. The evident most dramatic implication of the price shock will be significant increases of prices for gas and electricity for both households and industrial consumers. Another inevitable consequence will be increases in public utility prices because expenditures for electricity and gas account for major shares of the costs of water and heat provision.

Ukraine is the leading energy consumer in Europe in terms of energy consumption per unit of GDP. Hence, the energy price shock highlights an urgent need for reforms in the sector.

Agriculture and rural development. Due to expected WTO membership, Ukrainian agriculture and rural areas are approaching a new phase in their development. WTO membership is a unique chance to implement and leverage a broad range of policy reforms that have been postponed until now.

After fifteen years of wishful thinking, Ukraine’s agriculture and rural economy more than ever need new approaches in formulating agricultural
and rural development policies’ objectives as well as in implementing measures to unleash the country’s natural potential.

**Investment activities.** Last but not the least is the challenge of revitalizing investment activities. Outdated technology, equipment, and capacities have been increasingly hampering Ukraine’s economic development and undermining the prospects for stable economic growth. Industrial enterprise managers who consider outdated technology and lack of capacities to be impediments to production growth stress that this problem has increased in recent years.

* * * *

Responsible policy-makers must understand that there are no magical prescriptions for dealing with these problems that will lead to immediate results. Nevertheless, immediate actions are badly needed. By immediate actions we mean priority decisions which either initiate necessary reforms or change approaches to policy-making, and which can be taken within a more or less short period of time.
2 Fiscal and social policy: changing approaches and policies mix

2.1 New challenges

During the years 2000-2003 Ukraine enjoyed macroeconomic and fiscal stability. Major budget reforms – in particular the introduction of the Budget Code, a personal income tax reform and a reduction of the enterprise profits tax – were implemented. However, beginning in mid-2004 fiscal discipline was abandoned, and corresponding legislative provisions were ignored.

The government started a fiscal expansion through multi-stage, sharp increases in minimum wages, pensions, and other social obligations. Successive governments continued these loose fiscal policies. Consequently, consolidated fiscal expenditures increased from 26.7% of GDP in 2000 to 33.4% of GDP in 2006.

This imbalance in the fiscal sphere increasingly became a threat to macroeconomic stability as rapidly growing transfer payments lead to inflation. A vicious circle started, whereby higher income transfers translated into higher prices and higher inflation, increasing pressure on politicians to raise the subsistence minimum, resulting in further rises in transfer payments, fuelling inflation, and so forth.

In this situation, several existing problems became more acute, since the narrow tax base and weaknesses in tax administration did not provide the revenues required to finance all promised expenditures. The situation deteriorated even more at the local level, where local budgets suffer from underfinancing and low revenue autonomy. Furthermore, the bias of expenditures towards low-efficiency budget items such as state aid and the old system of services provision became increasingly burdensome.

The need to finance social obligations forced the governments to find ad hoc solutions and cut state support to commercial activities that had been seen as priorities in previous periods.

At the same time, the government introduced measures on the revenue side, attempting to increase revenue collection to match ballooning expenditures. However, these measures proved to be insufficient to cover the additional burden of social expenditures. Instead, the growing deficit was initially covered with nonrecurring privatization revenues.

Currently, the government is planning a budget deficit for the year 2006 of 2.6% of GDP. However, this planned deficit does not include the additional means necessary to finance measures related to the recent gas price increases. Furthermore, the revenue side of the budget will very likely be underexecuted in 2006 due to the economic slowdown.
2.2 Problems faced by the fiscal system

A whole set of acute challenges was aggravated by the expansionary fiscal policy which started in mid-2004.

Expansionary path and consumptive nature of fiscal expenditures

Between 2002 and 2005, Ukraine’s real GDP grew by 26%, while consolidated fiscal expenditures were increased by almost 80% in real terms. During the same period, spending on social protection items more than doubled in real terms. However, not all fiscal expenditures grew at the same pace. Priority was given to social protection items, while the growth rates of expenditures for health care, defence, education and culture were lower. The largest share of relevant spending was directed towards the expanding wage bill.

Therefore, the structure of expenditures changed substantially (see Table 2.1). Social protection expenditures, which accounted for 5.6% of GDP in 2002, are planned to reach 8.1% in 2006, mostly due to higher fiscal transfer to cover the persistent Pension Fund deficit. Transfers to the Pension Fund will increase to 3.4% of GDP, from nearly 0.9% in 2002.

Table 2.1
Consolidated budget expenditures (functional classification) (% GDP)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>General public services</td>
<td>3.80</td>
<td>3.75</td>
<td>3.56</td>
<td>3.64</td>
<td>4.29</td>
</tr>
<tr>
<td>Defence</td>
<td>1.57</td>
<td>1.97</td>
<td>1.79</td>
<td>1.42</td>
<td>1.44</td>
</tr>
<tr>
<td>Public order</td>
<td>2.23</td>
<td>2.19</td>
<td>2.28</td>
<td>2.40</td>
<td>2.52</td>
</tr>
<tr>
<td>Economic activity</td>
<td>3.19</td>
<td>4.57</td>
<td>5.42</td>
<td>4.50</td>
<td>5.23</td>
</tr>
<tr>
<td>Environment protection</td>
<td>0.29</td>
<td>0.34</td>
<td>0.34</td>
<td>0.29</td>
<td>0.35</td>
</tr>
<tr>
<td>Housing and utility services</td>
<td>0.62</td>
<td>0.68</td>
<td>0.77</td>
<td>0.92</td>
<td>0.52</td>
</tr>
<tr>
<td>Health care</td>
<td>3.34</td>
<td>3.63</td>
<td>3.51</td>
<td>3.64</td>
<td>3.71</td>
</tr>
<tr>
<td>Culture</td>
<td>0.63</td>
<td>0.77</td>
<td>0.78</td>
<td>0.81</td>
<td>0.82</td>
</tr>
<tr>
<td>Education</td>
<td>5.43</td>
<td>5.60</td>
<td>5.31</td>
<td>6.30</td>
<td>6.44</td>
</tr>
<tr>
<td>Social protection</td>
<td>5.60</td>
<td>4.85</td>
<td>5.59</td>
<td>9.39</td>
<td>8.05</td>
</tr>
<tr>
<td>Transfers to the pension fund</td>
<td>0.88</td>
<td>0.50</td>
<td>1.74</td>
<td>5.42</td>
<td>3.38</td>
</tr>
<tr>
<td>Total expenditures</td>
<td>26.71</td>
<td>28.35</td>
<td>29.35</td>
<td>33.32</td>
<td>33.37</td>
</tr>
</tbody>
</table>

Source: State Treasury, Derzhkomstat, IER forecast of GDP

Social protection expenditures would be even higher if all legislation on social privileges for the population were fulfilled. Furthermore, a

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State Budget Laws usually contain provisions according to which not all social privileges foreseen in legislation are necessarily financed. According to the State Budget Law for 2006, for example, privileges for the “children of war” are to be financed taking available funds into account. The total amount of funds
substantial budget revision seems necessary in order to provide additional funding for social protection items, in particular, for financing utility subsidies to households in order to compensate for increased gas prices.

The spending increases for education and health care in Table 2.1 are mostly due to increasing wages, as over the whole period minimum wages, and, consequently, all wages nearly doubled. Thus, in the healthcare sector nearly 80% of all expenditures were directed to wage and utility payments in 2005, while less than 10% were channeled to investments in new equipment\(^3\). Hence, replacement of old infrastructure and equipment remains very slow (see Chapter 6).

The political pressure to finance social programs diminished the resources available for investments and maintenance of infrastructure, especially at the local level. Hence, maintenance and capital repair expenditures are currently planned for 2006 at the very low levels of 0.24% and 0.4% of GDP respectively.

After peaking at 6% of GDP in 2004, capital outlays are planned at the level of 4.8% of GDP for 2006. Although this level of public investment is comparable with levels in other transition countries\(^4\), the lion’s share of these funds is directed towards such questionable items as state support of commercial sectors, in particular subsidies to coal mining.

The largest increase in social protection expenditures occurred in 2005. Consequently the government faced severe difficulties in funding especially the increases in minimum pensions. In early 2005 the new government acted appropriately, cutting budget support to the commercial sector and stimulating a more effective use of capital outlays.

Nevertheless, any government should be extremely cautious when increasing social expenditures, as due to their redistributive nature it is politically very difficult to revise such decisions in the future. Because social expenditures are so-called protected expenditures, in the event of revenue shortfalls the government is obliged to cut spending elsewhere, for example in important areas such as investments in infrastructure and human capital.

Excessive social spending limits the government’s ability to manoeuvre in case of unexpected challenges, such as the recent gas price increases translating into higher utility tariffs. The government’s difficulties in financing social subsidies to households, which should be increased due to the increase in utility tariffs, spills over into the energy and utility sectors (see Chapter 4).

Furthermore, the lack of budget funds prevents the implementation of necessary reforms aimed at increasing the efficiency of fiscal expenditures. For instance, implementation of highly needed utility sector reforms and

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\(^3\) Handrich, L., Betyi, O. “First steps of reforming public health care: improve efficiency and get the private sector involved” GAG/IER policy paper U8, July 2005.

road construction projects could not be financed according to the schedule foreseen in the approved by Parliament Programs.

**Volatile ad hoc taxation and administration**

Starting in 2004, governments have frequently changed numerous legislative documents regulating the collection of tax and non-tax revenues in an effort to raise more funds to finance additional obligations. By introducing amendments to tax legislation, central fiscal revenues plans were increased by 7% in both 2003 and 2004, and by 23% in 2005. Consequently, by the end of 2005 the revenues of the consolidated budget amounted to 32% of GDP. Changes in tax legislation comprised:

- Administration of taxes, i.e. changes in the tax calendar for the enterprise profit tax, and in the terms and procedures of VAT refunding;
- Increases in tax rates, i.e. higher excises and rates for rent payments;
- Broadening the tax base by eliminating sector privileges and cancellation of special economic zones;
- Increasing the rate of transfer of state-owned enterprises to the budget to 50% in 2005.

Additional measures to strengthen the administration of taxes were introduced via special programs such as “Kontrabanda Stop” (“Stop Smuggling” campaign). Besides, the government regularly accumulated sizeable VAT refund arrears to gain more operating funds during certain periods of time.

During the last three years revenue increases were needed to fund ballooning fiscal expenditures. This pressed the government to resolve problems such as the narrow tax base, and to strengthen the tax administration. However, the changes were made rapidly. Frequent and rapid changes in tax legislation and excessive pressure on taxpayers both hamper investments and are obstacles to economic growth. In weak institutional settings such policies engender corruption and tax avoidance.

**Fiscal deficit financing**

Good fiscal discipline and high privatization receipts together with stable macroeconomic conditions made it possible to reduce the state debt from 45% of GDP at the end of 2000 to 14% by the end of 2005. During this period, the average debt maturity was prolonged and the cost of government borrowings declined. This contributed to debt sustainability and reduced roll-over risks while freeing fiscal space. However, Ukraine’s current state debt structure is biased towards foreign borrowing, which reached a share of 80% by the end of 2005. Furthermore, although in 2005 a record volume of domestic bonds (OVDPs) was sold, nearly 60% of this volume was purchased by non-residents. In comparison, the transition countries’ average share of foreign debt to total public debt is about 58%.

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5 The number of amendments of the budget that also influenced the revenue part of the budget was 12 in 2003, 5 in 2004 and 8 in 2005.
The 2006 budget foresees a significant central fiscal deficit (2.9% of GDP) and a nominal growth of state debt. Government borrowings are planned to reach UAH 11.6 bn, of which UAH 7.0 bn shall be foreign borrowings.

The dominance of foreign borrowing in Ukraine’s debt structure increases the vulnerability of the economy to adverse changes in the national economy and the external environment. Recent capital outflows triggered by external shocks put pressure on Ukrainian foreign reserves and endangered the stability of the exchange rate. Early in 2006 foreign investors sold USD 192 m of government bonds (OVDP’s) on the secondary market. This volatile situation was managed in an ad hoc manner by bond purchases by Oshchadbank and by currency market interventions by the NBU. However, there is no guarantee that similar situations could be handled the same way in the future. Lastly, the biased debt structure contributes to increased credit risks (see Chapter 6).

**Intergovernmental relations**

The fiscal expansion of the central government has made the problems of local finances even more acute. Rapidly increasing and centrally determined local expenditures in combination with a lack of revenue autonomy have resulted in under-funding of delegated tasks and deterioration of the capacity of regional authorities to fulfil their responsibilities. Consequently, this negatively affects the quality of public services provided at the local level. It is hard to evaluate the extent of this problem, since the government does not conduct regular audits of local expenditures, even though this is required by legislation. Furthermore, there are no standards for the services provided at the local level.

During 2002-2005 the share of local expenditures in GDP increased from 12.5% to 12.9%. It is planned to reach 13.5% in 2006. In comparison with other countries, the weight of local expenditures in consolidated budget expenditures in Ukraine is relatively high, with a share of over 40%. However, the share of local expenditures corrected for the execution of the own tasks of local government entities (LGEs) was less than 10%.

Furthermore, a substantial part of own local expenditures is regulated by the central government via such expenditures parameters as employment limits and wage levels. Due to wage increases in recent years, the structure of local expenditures has become increasingly biased towards wage payments, the share of which in local expenditures increased from 36% in 2002 to 45% planned in 2006. At the same time, local infrastructure remains poorly developed.

The revenues of local budgets consist of own revenues, assigned taxes, and transfers from the central budget. Own LGE revenues are primarily raised by the land tax and own revenues of budget entities (see Table 2.2), and local government can only influence both to a limited extent. The land tax is defined as a central tax and, thus, its rate and administration are defined at the central level, although local governments can differentiate...
rates to some extent\textsuperscript{7}. Furthermore, the central government grants numerous tax privileges without compensating local budgets for the resulting losses. Besides, the legislation defining the base and procedures for land tax collection contains loopholes, and improper administration leads to declining local revenues.

The share of resources that are under the control of Ukraine’s LGEs does not exceed 3%. The list of genuine local taxes consists of 15 local taxes and duties. However, thirteen of these taxes and duties account for less than 0.75% of local revenues. The potential of the more important taxes, such as advertisement tax and the market duty, are not realized in full. Furthermore, between 2002 and 2005 the weight of assigned central taxes, the most important of which is PIT, declined from 48.8% to 39.5% in local revenues. This decline can be attributed to PIT reform (the new law was implemented in 2004) which replaced progressive rates and brackets with a 13% flat tax.

The overall decline in the assigned central revenues and own revenues of local budgets was compensated by central fiscal transfers, which increased from 31.2% to 43.4% of total local revenues between 2002 and 2005. The formula of transfers is unstable and varies from year to year. Moreover, this formula does not provide for compensation for losses caused to local budgets by central government decisions. Hence, local governments lack revenue autonomy, as their revenues are mostly defined at the central level both in terms of their rates and administration procedures.

Local budgets are important because they finance such important tasks as education, health care, and social protection. In 2006 the funds allocated to finance these tasks constituted about 70% of total local budget expenditures. The funds assigned and transferred from the central to the local budgets do not suffice to cover all delegated responsibilities. This forces LGEs to re-direct their own resources, which are then no longer available for the fulfilment of local responsibilities, such as maintenance and investment in local infrastructure.

\textsuperscript{7} The rates can be differentiated according to the purpose of the land use and the location of the land plot. However, the land tax rate can not exceed the average tax rate by more than 100%.
Table 2.2
Composition of local budgets revenues in Ukraine, % GDP

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net-of-transfers revenues</td>
<td>8.6</td>
<td>8.4</td>
<td>6.6</td>
<td>7.3</td>
</tr>
<tr>
<td>Own revenues, including</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Land tax</td>
<td>0.8</td>
<td>0.7</td>
<td>0.7</td>
<td>0.7</td>
</tr>
<tr>
<td>- Vehicle owner tax</td>
<td>0.3</td>
<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
</tr>
<tr>
<td>- Genuine local taxes</td>
<td>0.2</td>
<td>0.2</td>
<td>0.2</td>
<td>0.1</td>
</tr>
<tr>
<td>- EPT from LGEs’ enterprises</td>
<td>0.1</td>
<td>0.1</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>- Own revenues of budgetary entities</td>
<td>0.7</td>
<td>0.7</td>
<td>0.7</td>
<td>0.7</td>
</tr>
<tr>
<td>- LGEs’ property sales</td>
<td>0.3</td>
<td>0.4</td>
<td>0.3</td>
<td>0.5</td>
</tr>
<tr>
<td>Assigned revenues</td>
<td>6.1</td>
<td>5.9</td>
<td>4.6</td>
<td>5.1</td>
</tr>
<tr>
<td>- Including PIT</td>
<td>4.8</td>
<td>5.0</td>
<td>3.6</td>
<td>4.0</td>
</tr>
<tr>
<td>Central budget transfers</td>
<td>3.9</td>
<td>4.4</td>
<td>4.9</td>
<td>5.6</td>
</tr>
<tr>
<td>Transfers, formula-based</td>
<td>1.9</td>
<td>2.2</td>
<td>2.1</td>
<td>2.7</td>
</tr>
<tr>
<td>Other transfers (subventions)</td>
<td>2.0</td>
<td>2.2</td>
<td>2.7</td>
<td>3.0</td>
</tr>
<tr>
<td>Total revenues</td>
<td>12.5</td>
<td>12.8</td>
<td>11.5</td>
<td>12.9</td>
</tr>
</tbody>
</table>

Source: State Treasury of Ukraine Reports, own calculations

Note: The revenues are classified according to Ukrainian legislation. The strict division between own and assigned revenues was set by the Budget Code (2001)

The increasing financing of local expenditures through central transfers distorts the incentives of LGE to provide quality public goods and services at the local level, and introduces uncertainty in the planning of local budgets. To sum up, present intergovernmental fiscal relationships are an additional obstacle to long-term local development.

The growing deficit of the PAYG pension

The loose fiscal policies of recent years have had an especially negative impact on the compulsory state pension system. In 2003 Ukraine embarked on a comprehensive pension reform that introduced a three-pillar pension system. This reform package followed the lead of more advanced transition countries and international best practice. The reform was designed to put the pension system on sustainable financial foundations. A stable mandatory first pillar in the form of a Pay As You Go (PAYG) pension was to be combined with an individually funded mandatory second pillar and a voluntary (private) third pillar outside the state pension

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system. The third pillar went into operation in 2005, while the introduction of the second pillar was postponed for the time being.

Since 2004 several disproportionately high administrative pension increases have outpaced GDP and wage growth in real terms. From 2003 - the year of the passage of the pension reform bill - until 2005, Ukraine’s real GDP increased by 15% while the minimum wage increased by almost 30% and the average wage by 78%. However, the real minimum pension increased by 191% (Table 2.3).

Table 2.3  
Indices of real economic indicators (2003=100)  

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP</th>
<th>Average wage</th>
<th>Minimum pension (aop)*</th>
<th>Minimum wage (aop)</th>
<th>Pension Fund transfers from the State Budget</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>2004</td>
<td>112</td>
<td>117</td>
<td>170</td>
<td>106</td>
<td>407</td>
</tr>
<tr>
<td>2005</td>
<td>115</td>
<td>178</td>
<td>291</td>
<td>130</td>
<td>1,339</td>
</tr>
<tr>
<td>2006E</td>
<td>118</td>
<td>232</td>
<td>289</td>
<td>141</td>
<td>881</td>
</tr>
</tbody>
</table>

Source: Derzhkomstat, Treasury reports, own calculations

Consequently, the PAYG pension fund accumulated a large deficit (Table 2.4) and transfers into the fund from the state budget increased considerably.

Table 2.4  
The Pension Fund (PAYG) budget (UAH bn)  

<table>
<thead>
<tr>
<th></th>
<th>2005, plan</th>
<th>2006, plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>49.2</td>
<td>62.9</td>
</tr>
<tr>
<td>Own revenues</td>
<td>41.6</td>
<td>50.6</td>
</tr>
<tr>
<td>Central fiscal transfer (excl. central fiscal transfer for deficit financing)</td>
<td>6.7</td>
<td>9.7</td>
</tr>
<tr>
<td>Other</td>
<td>0.9</td>
<td>2.6</td>
</tr>
<tr>
<td>Expenditures</td>
<td>65.5</td>
<td>70.2</td>
</tr>
<tr>
<td>Expenditures at the expense of own revenues</td>
<td>59.9</td>
<td>62.0</td>
</tr>
<tr>
<td>Expenditures at the central fiscal transfers</td>
<td>5.3</td>
<td>7.9</td>
</tr>
<tr>
<td>Deficit</td>
<td>-16.3</td>
<td>-7.3</td>
</tr>
</tbody>
</table>

Source: Resolutions of the CMU #426 from June 8, 2005 (with amendments from February 1, 2006) and #309 from March 15, 2006

Currently, pension payments account for 43% of total social transfer payments and 21% of total household income. The expenditures of the pension fund are now close to 15% of GDP, a very high share in international comparison.
The most important sources of own revenues of the pension fund are compulsory pension contributions by employees. Under the standard scheme, 33.8% of the gross wage are deducted and transferred to the pension fund. Employees working under the so-called fixed agricultural tax (FAT) and individuals eligible for simplified taxation also contribute to the PAYG pension fund at substantially discounted rates (Table 2.5).

**Table 2.5**

Contributions to PAYG pension fund revenues by groups in 2005

<table>
<thead>
<tr>
<th>Number of individuals (m)</th>
<th>Share in economic active labour force (%)</th>
<th>Contributions (UAH bn)</th>
<th>Contributions (%)</th>
<th>Average monthly contribution per individual (UAH)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard compulsory contributions (33.8%)</td>
<td>12.5</td>
<td>61.27</td>
<td>39.6</td>
<td>96.59</td>
</tr>
<tr>
<td>Contributions under FAT</td>
<td>4.1</td>
<td>20.10</td>
<td>0.8</td>
<td>1.95</td>
</tr>
<tr>
<td>Contributions under Simplified taxation</td>
<td>2</td>
<td>9.80</td>
<td>0.4</td>
<td>0.98</td>
</tr>
<tr>
<td>Transfer from the Unemployment fund</td>
<td>1.5</td>
<td>7.35</td>
<td>0.1</td>
<td>0.24</td>
</tr>
<tr>
<td>Transfer from Work accident fund</td>
<td>0.3</td>
<td>1.47</td>
<td>0.1</td>
<td>0.24</td>
</tr>
<tr>
<td>Total</td>
<td>20.4</td>
<td>100.00</td>
<td>41.0</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Source: Derzhkomstat, own calculations

Table 2.5 illustrates that more than 96% of all compulsory contributions to the pension fund are paid by 12.5 m (or even less) individuals, or about 60% of the total labour force working under the standard social insurance scheme. This group is very likely also contributing a disproportionately high share of the tax financed part of pension fund expenditure (fiscal transfers and deficit). Hence, every Ukrainian participating in the standard compulsory social insurance scheme is supporting one pensioner. At the same time the rest of the labour force working under FAT and simplified taxation is mostly free riding on the contribution side of the PAYG system. However, when it comes to receiving pension payments, more or less all pensioners in Ukraine are equal.

The recent sharp minimum pension increases created a situation in which the level of the minimum pension exceeded the level of the minimum wage (Figure 2.1). When personal income and compulsory social taxes are deducted from the gross minimum wage, the gap to the non-taxable
maximum pension widens further. Because of the sharp pension increases, there is no longer any meaningful relationship between work income and pension income. This situation is exacerbated by the abandonment of differentiated pension payments according to the length and amount of contribution. By the end of 2004, around 83% of all pensioners received an equal – the minimum - pension. By the end of 2005 due to further and now more selective pension increases - based on occupational and other criteria but not related to contributions paid - the share of pensioners receiving the minimum pension declined to 44%. Consequently, this pension policy has created strong incentives for individuals to maximize their utility by contributing as little as possible to the PAYG system.

Together, unjustified high pensions, uneven contributions to the PAYG pension fund and the almost equal participation on the payment side have undermined the pension system and caused a large pension fund deficit, planned to reach roughly 10% of expenditures in 2006.

**Figure 2.1**
Monthly minimum pension and minimum wage

![Minimum pension vs Minimum wage graph](image)

Source: Relevant legislative acts of Ukraine

The dramatic imbalances of the PAYG pension system have effectively terminated the ambitious pension reform of 2003. Urgent and radical measures are necessary to stabilize the pension fund and to prevent more serious threats to fiscal and macroeconomic stability.
2.3 Most urgent reform steps

To tackle the existing problems, we propose two sets of recommendations: immediate steps to reduce the acuteness of the problem; and the introduction of a medium-term expenditure framework to ensure long-term stability of the fiscal system in the country.

As immediate steps for reform, we propose the following:

- **Taxation and tax administration:**

  The government of Ukraine should further expand the tax base by continuing the elimination of tax privileges, especially for agricultural producers. The government should abstain from reintroducing sector privileges that have already been eliminated.

  Further improvements in tax administration are necessary in order to increase the revenue potential. But tax legislation should not be violated and should not be amended in the course of a fiscal year.

  State-owned enterprises should be required to transfer more stable shares of their profits to the budget. The management of these enterprises should be strengthened, and more attention should be paid to their investment needs.

  In general, the government should avoid targeting revenues to previously increased expenditures. Instead it should make revenue policies more coherent with the overall economic policies.

- **State debt policy:**

  The Ukrainian government should favour investment loans provided by international financial institutions. Foreign commercial borrowings for the general funding of the budget should be reduced.

  The legislation and procedure for the issuance and circulation of domestic bonds should be improved. In particular, the government should ensure transparency by adhering to pre-announced borrowing plans and auction schedules, and by establishing special investor relations programs. The government should also improve market infrastructure for domestic bond sales at both the primary and secondary levels. Last but not least, the government should foster the development of investment products, life insurance and voluntary and compulsory accumulation pension insurance schemes.

  The government should diversify its borrowing instruments and make them more accessible to investors by establishing bond yields at a level close to the inflation rate. The government should offer to the primary market both short-term and medium-term bonds. The scope of government guarantees granted to state agencies and enterprises should be reduced.

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- **Intergovernmental relations**

The continuation of current policies will further worsen both the quality of the public services provided at the local level, and local infrastructure. Reforming local budgets and intergovernmental fiscal relations should be a priority for the new government.\(^{10}\)

In general, the government should introduce rules according to which all relevant decisions taken by the central government should consider possible consequences for LGEs. Where such decisions worsen the situation at the local level, additional central funds should be transferred to this level. Since the land tax is one of the most important local sources of revenues, the central government should ensure full compensation for any land tax exemptions and privileges that it grants. Rapid implementation of land reform and creation of land markets would substantially broaden the local tax base and improve the flow of revenues to LGEs.

In addition, the upper limits for the advertisement tax should be increased, and the tax calendar should be changed. The administration of the market duty should be improved. To improve efficiency and transparency, regular audits of local spending should be implemented.

- **Pension system reform**

Financial stabilization always involves cutting expenditures and increasing revenues. However, sharp cuts in minimum pensions are at present not a viable political option. Neither is an increase in compulsory pension contributions above the present 33.8% rate, already one of the highest in Europe. Hence, the Pension fund deficit needs to be covered by the budget. However, tax financing should be increased only for the short term with clear time limits (e.g. for 2 years with additional transfers decreasing over time to zero by the end of 2007) in order to gain the time needed to implement institutional changes and rebalance the pension system.

A swift measure that should be taken immediately is to stop further minimum pension increases. To this end, the minimum pension should be de-linked from the rather problematic subsistence minimum.\(^{11}\) The misuse of the pension system as an alternative social security system should be stopped. Targeted social assistance to the poor should be the responsibility of a tax-financed social welfare system.\(^{12}\)

The formula for pension increases with an automatic indexation to inflation plus 20% of nominal wage growth should be suspended for the time being. Only after a sizeable real adjustment - when wages earned are significantly higher than the relevant pensions received - should the indexation of

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\(^{11}\) For a more detailed discussion of the subsistence minimum see: Handrich, L., Betliy, O., Bilan, L. "Administrative increases of the minimum wage – facing the poverty-unemployment trade-off" GAG/IER policy paper T38, June 2004.

\(^{12}\) See Handrich, L., Betliy, O. "A social welfare system to lift Ukrainians out of poverty” GAG/IER policy paper V2, February 2006.
pensions (including minimum pensions) to inflation be reactivated. A sound relationship between wages and PAYG pensions would be in the range of 50 to 70% of wage income in the last year prior to retirement.

The contribution period required to become eligible for a minimum pension should be lengthened for women to 25 years (as it is currently for men), as this would effectively cut pension payments.

The government should provide the financing for so-called ‘privileged’ pensions from the budget. Furthermore, these pensions should either be paid only upon attainment of the retirement age, or be subject to income and social taxes if paid before an individual reaches retirement age.

Early retirement schemes should be moved outside the PAYG system and become part of wage bargaining at the enterprise level because otherwise, in a market economy based on private property, such early retirement schemes are implicit subsidies to the respective industries. Individual early retirement schemes should belong to the third pillar of the pension system.

An increase in the retirement age should be considered as a long-term measure, as it would affect only new pensioners and do little to reduce the present pension fund deficit. At the same time, a parallel increase of the minimum contribution period and the retirement age for women may be possible. We recommend that incentives for additional contributions should be linked to the second pillar of the pension system. The PAYG system should be limited to the provision of a differentiated but basic pension.

A significant cost reduction measure would be the streamlining of Ukraine’s compulsory insurance system. We recommend elsewhere that both the work accident insurance and the temporary disability insurance fund be abolished. The functions performed by these two institutions could be redistributed without loss of quality to other institutions, while substantially reducing administrative and transaction costs.

Since raising the already prohibitively high compulsory pension contribution rate of 33.8% is not an option, any improvement on the revenue side of the PAYG pension fund must originate from broadening of the contribution base. At the same time, broadening of the contribution base should be used to rebalance between different occupational, social and tax groups so that fair participation on the payment side is matched by a fair distribution of contributions. Most measures listed until now would not only reduce expenditures, but also substantially broaden the contribution base. In addition, we propose that the government implement the following steps:

Contributions by individuals subject to simplified taxation must be raised. Payers of simplified taxes should contribute at least at the level of contribution from the set minimum wage (at the moment, UAH 118.3 per month). This measure would increase annual revenues by about UAH 2.4 bn. But before any such increases take place, contradictory legislation

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14 Currently, the 2 million or so payers of simplified taxes contribute 42% of their maximum UAH 200 tax rate to the fund, which translates into pension contributions of up to UAH 84 per month, while the average contribution is only around UAH 16.7.
should be clarified. Furthermore, the maximum amount of the simplified tax should be regularly and gradually adjusted. We propose an immediate increase to the level of the UAH 350.

The special rate of pension contributions set for payers of the flat agricultural tax should be brought up to the full pension contribution rate by the end of 2007.

The reform of the PAYG pension system will make it possible to speed up the introduction of the second pillar. This will make it possible to both increase the welfare of pensioners and increase the demand for investment opportunities on capital markets (see chapter 6 on Investments).

*International experience shows that of all the various policies tried and implemented in response to fiscal imbalances, the introduction of a Medium Term Expenditure Framework (MTEF) has delivered the best results in terms of reducing fiscal imbalance, improving macroeconomic stability, and increasing the efficiency of fiscal expenditures.*

MTEF is a multi-year budgetary approach that links planning, budget policies, policy objectives, and budgeting for a medium term period. The implementation of an MTEF allows policy makers to balance short-term policy achievements and longer-term necessities to contribute to the socio-economic policies required for the development of the country. The use of an MTEF can increase the efficiency of public funds allocation.

The government of Ukraine has already developed some preliminary elements of a medium term budget expenditure framework and a concept for its implementation. However, these elements are of a rather declarative nature and currently play an insignificant role in the budget process.

In order to set up an MTEF, the government of Ukraine should develop a three-year fiscal plan, which is regularly updated. Its elements include:

1. A top-down resource envelope consistent with macroeconomic stability and broad policy priorities;
2. A bottom-up estimate of the current and medium term cost of existing national programs and activities;
3. An iterative process of decision-making, using rolling baselines that reconcile these costs and new policy ideas with available resources.

The MTEF could play a crucial role in overcoming Ukraine’s current fiscal challenges. The successful introduction of an MTEF would increase budget discipline. It would be a helpful tool to put the social and especially the pension system on solid footing. With an MTEF in place, the ability of politicians to pursue loose fiscal and social policies without providing the necessary long term funding would be limited. Furthermore, an MTEF could increase the efficiency of government expenditure and the achievement of policy goals. Finally, an MTEF would facilitate investments by ensuring more predictable taxation, interest rates, and government spending. It would also signal government priorities and the schedule of reforms to economic agents.

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3 The external sector: resurgence of a current account deficit

3.1 New challenges

Over the last seven years Ukraine has enjoyed a current account (CA) surplus (Figure 3.1) that has allowed the country to rebuild its foreign reserves which were depleted by the 1998 crisis, to keep the exchange rate stable, and not to worry about either the sustainability of the structure of the CA or the profile of the capital account.

The core reasons behind the merchandise trade surplus, the largest and most volatile component of the CA balance, were a devalued national currency that lost almost half of its value in 1998-1999, a favourable situation on key export markets, especially for metals, and low energy prices.

Figure 3.1
Current account balance (% of GDP)

The CA surplus was maintained almost until the end of 2005, despite the worsening of the merchandise trade balance. In the second quarter of 2005 the merchandise trade balance turned negative, gradually pushing down the CA balance as well. However, other components of the CA balance –
specifically the balance of trade in services and current transfers – helped maintain an annual CA surplus. Nevertheless, the CA balance became negative in the fourth quarter of 2005, and this deficit continued in the first quarter of 2006 the CA. It is expected that the CA deficit will persist for at least the next several years.

The changes that resulted in the switch from a CA surplus to deficit can be broadly grouped as domestic and external. Among the external factors, in 2005 Ukrainian metal exports were hurt by increased metal production in China, leading to higher competition on external markets for metals and a substantial reduction of metal exports to China itself. Furthermore, prices for metals, after growing rapidly for several years, fell and became much more volatile, thus reducing the price competitiveness of Ukraine’s metallurgical sector (Figure 3.2).

**Figure 3.2**
Evolution of steel prices in 2001-2006

![Graph showing the evolution of steel prices from 2001 to 2006, with different indices for Global, Europe, and Asia.](source: CRU Steel Price Index, www.cruspi.com)

In 2006, an additional severe external shock came in the form of an over 60% increase in imported gas prices. This price jump pushed up the value of imports and hurt metal and chemical exports, as these industries are the heaviest consumers of gas among Ukraine’s manufacturing industries. In 2005 the shares of metal and chemical exports were 41% and 9% of total merchandise exports respectively. It is expected that gas prices will grow further, putting additional pressure on exports and boosting imports.

Domestically, the steady increase in households’ final consumption, fuelled by increased social payments (see chapter on fiscal and social policies for description of situation), has stimulated the growth of consumer-oriented imports during last several years. In 2005 this trend was supported by a significant reduction in import tariff rates implemented as a part of
Ukraine’s drive to join the WTO. Furthermore, the sharp one-shot revaluation of hryvnia in April 2005 worsened the international competitiveness of Ukrainian enterprises that compete mostly on prices.

To the already manifest challenges of higher energy prices and higher competition on both external and domestic markets, more challenges will be added in the near future. Ukraine is approaching the end of its WTO membership talks. WTO membership is expected to stimulate both exports and imports, with imports likely leading in the first years after accession.

Thus, the times of a strong external position and large CA surpluses seem to be over. In 2006 and for the near future a deficit of the trade account and, as a result, a CA deficit can be expected.

### 3.2 The current account deficit: meaning and economic implications

A CA deficit in a certain year means that the country has increased its net debt with non-residents. That is, the country is filling its saving-investment gap by attracting external financing. Hence, a CA deficit can be compatible with continuous economic growth. For instance, all of the East European transition economies ran CA deficits in 2000-2005 (Table 3.1). However, as in any case of borrowing, the key question is whether the CA deficit is sustainable.

Generally speaking, sustainability refers to a stable state in which a CA deficit generates no economic forces of its own to change its trajectory, and thus does not cause jarring movements in other economic variables, such as the exchange rate, domestic interest rates, or some other variable. However, an unsustainable deficit is not necessarily an ‘excessive’ deficit, so the size of the current account deficit does not give rise to normative judgements; what matters, rather, is the source of the deficit and the size and the time profile of the balancing adjustment, or deficit financing.

Considering the sources of deficit, special attention is paid to the composition of commodity trade flows. In an open economy, a CA deficit is an additional source of financing for domestic investment. Thus, the appearance of a current account deficit is fine if it is associated with higher and productive investment in the country. But CA deficit is not rational, if the investment activity does not improve. In such a case, the deficit only replaces domestic savings and enables higher domestic consumption.

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### Table 3.1
Current account deficit and real GDP growth rates in East European countries in 2000-2005

<table>
<thead>
<tr>
<th>Country</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>CA balance, % of GDP</td>
<td>-5</td>
<td>-5</td>
<td>-6</td>
<td>-6</td>
<td>-2</td>
</tr>
<tr>
<td></td>
<td>real GDP growth, %</td>
<td>3.9</td>
<td>2.6</td>
<td>1.5</td>
<td>3.2</td>
<td>4.7</td>
</tr>
<tr>
<td>Estonia</td>
<td>CA balance, % of GDP</td>
<td>-5</td>
<td>-6</td>
<td>-10</td>
<td>-12</td>
<td>-13</td>
</tr>
<tr>
<td></td>
<td>real GDP growth, %</td>
<td>7.9</td>
<td>6.5</td>
<td>7.2</td>
<td>6.7</td>
<td>7.8</td>
</tr>
<tr>
<td>Latvia</td>
<td>CA balance, % of GDP</td>
<td>-5</td>
<td>-8</td>
<td>-7</td>
<td>-8</td>
<td>-13</td>
</tr>
<tr>
<td></td>
<td>real GDP growth, %</td>
<td>6.9</td>
<td>8.0</td>
<td>6.5</td>
<td>7.2</td>
<td>8.5</td>
</tr>
<tr>
<td>Lithuania</td>
<td>CA balance, % of GDP</td>
<td>-6</td>
<td>-5</td>
<td>-5</td>
<td>-7</td>
<td>-8</td>
</tr>
<tr>
<td></td>
<td>real GDP growth, %</td>
<td>3.9</td>
<td>6.4</td>
<td>6.8</td>
<td>10.5</td>
<td>7.0</td>
</tr>
<tr>
<td>Hungary</td>
<td>CA balance, % of GDP</td>
<td>-9</td>
<td>-6</td>
<td>-7</td>
<td>-9</td>
<td>-9</td>
</tr>
<tr>
<td></td>
<td>real GDP growth, %</td>
<td>6.0</td>
<td>4.3</td>
<td>3.8</td>
<td>3.4</td>
<td>5.2</td>
</tr>
<tr>
<td>Poland</td>
<td>CA balance, % of GDP</td>
<td>-6</td>
<td>-3</td>
<td>-3</td>
<td>-2</td>
<td>-4</td>
</tr>
<tr>
<td></td>
<td>real GDP growth, %</td>
<td>4.2</td>
<td>1.1</td>
<td>1.4</td>
<td>3.8</td>
<td>5.3</td>
</tr>
<tr>
<td>Slovenia</td>
<td>CA balance, % of GDP</td>
<td>-3</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>-2</td>
</tr>
<tr>
<td></td>
<td>real GDP growth, %</td>
<td>4.1</td>
<td>2.7</td>
<td>3.5</td>
<td>2.7</td>
<td>4.2</td>
</tr>
<tr>
<td>Slovakia</td>
<td>CA balance, % of GDP</td>
<td>-3</td>
<td>-8</td>
<td>-8</td>
<td>-1</td>
<td>-3</td>
</tr>
<tr>
<td></td>
<td>real GDP growth, %</td>
<td>2.8</td>
<td>3.2</td>
<td>4.1</td>
<td>4.2</td>
<td>5.4</td>
</tr>
</tbody>
</table>

Source: Eurostat, IER calculations

The classical example of a healthy CA deficit is Norway in 1975-1978. In the mid-1970s, Norway’s CA deficit grew sharply and averaged 10% of GDP between 1975 and 1978, always exceeding 5% over this period and peaking at 14% in 1978. The large deficit was mainly caused by heavy investment in North Sea oil development. As a proportion of GDP, fixed capital formation reached 36.3% in 1976. When investment tailed off and oil revenues increased, the CA deficit soon shrank again. With the exception of two years, Norway has recorded a CA surplus since the early 1980s.\(^{18}\)

The second component of the CA deficit sustainability is the profile of its financing. Even if the CA structure is healthy, a CA deficit has to be appropriately financed to ensure minimal liquidity and default risks. Appropriate means that the primary source should be equity financing, preferably FDI. If debt financing is unavoidable, which is frequently the case, it should be long-term and at low interest rates. If these rules are

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fulfilled, the CA deficit involves limited risks, even if its use of the additional resources does not turn out to be very productive. Alternatively, the financing of the CA deficit via short-term borrowing at high interest rates is dangerous for economy even if the use of CA deficit is relatively productive, and this risk multiplies if the CA deficit is not used productively.

The riskiness of an inappropriate profile of CA deficit financing can be illustrated by the experience of Thailand. By 1997, Thailand had experienced an economic upswing lasting around three decades. Economic growth averaged more than 7% over the period 1990-1997, there was an impressive public sector surplus and domestic saving was running fairly high, although the CA deficit was around 5-7% of GDP. This deficit was largely the result of the investment boom. In the course of the 1990s, the profitability of investment apparently became increasingly doubtful, especially in the real estate market, where a price bubble had formed. With a wide differential between foreign and domestic interest rates, many smaller finance companies profited by borrowing short-term abroad and re-lending long-term at much higher rates in domestic currency. Thus the CA deficit was to a large extent funded by foreign short-term borrowing. In the first half of 1997 investors and creditors lost their confidence in Thai economic policy, capital outflow ensued and a speculative attack was launched on the baht, which was devalued in July 1997. The outcome was a collapse of the Thai currency and a 12% contraction in GDP in 1997-1998.19

Thus, a CA deficit is not necessarily an evil that must be fought. If properly used and properly financed, it can benefit the economy. However, a mismanaged CA deficit can become unsustainable, seriously hurting the economy.

3.3 Most urgent reform steps

The challenge of a CA deficit in the coming years requires a clear response from the Ukrainian authorities. In particular, the government has to make sure that the expected CA deficit is sustainable. For this, the government must introduce policies now that encourage the development of healthy CA structure and its appropriate financing. Furthermore, a shift in exchange rate policy is necessary. The government has to be precautious and think medium-term to avoid problems in the future. The list of recommended policies include:

 Improvement of the sources of the CA deficit

Under current conditions in Ukraine there is a risk that the CA deficit will be used to ‘finance’ consumption, especially in view of higher gas import prices. Consequently, the government should adopt policies to increase overall investment activity (see Chapter 6). In particular, investment aimed at increasing energy efficiency (see Chapter 4) should be treated with high priority, since such investment would reduce gas imports and the risk of an even higher and unsustainable CA deficit.

19 Arnór Sighvatsson “The current account deficit in an international and historical context” Monetary Bulletin 2001/1.
Like any debt, a CA deficit must eventually be repaid, thus becoming a CA surplus. For this, the Government has to facilitate the restructuring and development of export-oriented sectors. Ukraine is already a relatively open economy with exports constituting 54% of GDP in 2005. Further penetration into world markets seems the only way to ensure the stable economic development of the country.

Therefore, the government should conduct export-stimulating policies using WTO-compatible instruments. These include export facilitation policies, in particular the development of export promotion organisations that conduct informational and consulting functions. To ensure their efficiency, these institutions should not compete with but rather complement private sector export facilitation activities. Also, the government should continue its efforts to improve the access of Ukrainian exporters to foreign markets via continued trade liberalization policy.

**Improvement of the financing of the current account deficit**

The sustainability of a CA deficit depends crucially on its financing. The lower the risks involved in the financing, the more sustainable the deficit becomes. In order to lower the risks of financing the CA deficit, Ukraine should first of all attract more foreign direct investments (FDI). This form of financing cannot easily be withdrawn from one day to the next. Foreign direct investors have usually long time horizons, and even if they wish to liquidate their investment they need much time to do so, because of the need to search for buyers and settle the deal. Besides, FDI involves no currency risk, since the value of domestic assets is linked to the value of the domestic currency. Furthermore, and in contrast to loans and bonds, FDI foresees no obligation to pay interest independently of the economic situation. Consequently, in times of external hardship, capital outflows linked to FDI (i.e. repatriation of profits) can diminish and thus contribute to the stabilization of the external situation. In addition to its role in financing a CA deficit, FDI is extremely important as a means of increasing investment and the production capacity of Ukraine. To stimulate FDI, it is necessary to improve the investment climate (see Chapter 6).

Currently, Ukraine is lagging behind the most of emerging economies in terms of inward stock of FDI per capita (Figure 3.3). Hence, given appropriate investment-stimulating policies, Ukraine has a good chance to attract much more FDI, thus financing the CA deficit in the best possible way.

Financing through loans from multilateral financial institutions should also be expanded. These loans are typically long-term and have very favourable conditions. The fact that some of these loans are tied to some kind of conditionality should not be seen as a negative or limiting factor. On the contrary, conditionality ensures that the financial resources are used well, which will enable the country to pay its debt back in the future. Thus, conditionality improves also the sources of the CA deficit.
In June 2006 the Cabinet of Ministers approved the ‘Strategy of cooperation with international financial organisations (IFOs) in 2006-2008’\textsuperscript{20}. If this strategy is realised, it should lead to more efficient relations with the IFOs and improved access to loans that are necessary for the economic development of Ukraine\textsuperscript{21}.

Any financing through debt denominated in foreign currency entails major risks, since it is impossible to know with certainty the long-term development of the exchange rate. This problem is especially acute in the case of a twin deficit, namely simultaneous deficits of the CA and the budget. Excessive foreign currency financing of a fiscal deficit aggravates both currency and refinancing risks, while fiscal misbalance against the background of a CA deficit can result in severe destabilisation of the economy as a whole. Consequently, we advise the Ukrainian government to rely more on debt denominated in domestic currency, even if this involves paying higher interest rates. Higher interest payments should not be considered merely as higher public expenditure, but also as a gain in stability and sustainability (see Chapter 2).

\textsuperscript{20} Resolution of the Cabinet of Ministers ”On approval of the Strategy of cooperation with international financial organisations (IFO) in 2006-2008”, June 20, 2006, No. 844.  
\textsuperscript{21} Although it is stated that relations with the IMF will center on consultation and technical assistance and not include further borrowing, the strategy foresees extensive borrowing from other IFO.
Implementation of a more flexible exchange rate policy

The sustainability of a CA deficit also depends on the country’s exchange rate policy. If serious problems appear in financing a CA deficit, then a moderate reduction in the external value of the national currency can contribute to solving the problem. A slight depreciation/devaluation improves international competitiveness and thus contributes to reducing the CA deficit. Thus, a moderate loss in the external value of the domestic currency is an important complementary instrument for dealing with CA deficits. However, the ability of the monetary authorities to use this instrument depends largely on the existing exchange rate system. Lowering the value of the national currency under a fixed exchange rate (i.e. devaluation) is complicated, since it can negatively affect the credibility of the central bank and create insecurity in the population. Besides, a decision to devalue cannot always be insulated from political pressure, if the central bank is not independent. Because of this, as shown by international experience, central banks have often missed the optimal moment for devaluing the currency. As a result of this timing problem, devaluation comes too late and has to be correspondingly larger, thus creating additional problems. By contrast, under a more flexible exchange rate system, a loss in the external value (i.e. depreciation) is much easier. In particular, the timing problems typical for the fixed system are of a much lower magnitude. Consequently, in light of the expected CA deficit, we recommend that the National Bank of Ukraine follow the announcement made by its Chairman Mr. Stelmakh in May 2006 and to start conducting a more flexible exchange rate policy.

The implementation of the policies suggested above would make it possible to maintain a sustainable CA deficit, thus providing Ukraine with extra funds for financing investments without exposing the country to the risk of economic destabilisation.
4 The energy and utilities sectors: the energy price shock as a catalyst of structural reforms

4.1 New challenges

In the beginning of 2006 Ukraine was hit by an energy price shock caused by a 60% increase in the price of Russian gas supplies to Ukraine. It is likely that the price of imported gas will continue to rise further until it reaches a competitive level in the region\(^{22}\). The clearly most dramatic implication of the price shock will be a significant increase in consumer prices for gas and electricity. Another inevitable consequence will be increases in public utility prices because expenditures for electricity and gas account for a major share of the costs of water and heat provision.

Defining an appropriate reaction to this energy price shock is challenging. First, it must be ensured that price increases are not larger than absolutely necessary and that neither energy companies nor public utilities are able to abuse their market power. At the same time, investments in the infrastructure of energy and utility providers must be stimulated to ensure secure supplies of these economically and socially crucial services. Finally, consumers as well as public utilities and energy providers must have stronger incentives to save energy and to invest in efficient, energy-saving technologies.

4.2 The need for reforms

Over the past 20 years, Ukraine’s energy and public utilities sector has been severely restricted by regulation under predominantly monopolistic structures and has largely met demand using inherited capital stocks. As a result, the sector had already accumulated significant problems prior to the recent energy price shock. For example:

- Regional electricity distributors (Oblenergos) have been facing increasing losses in their distribution systems. However, they lack incentives to invest in new equipment, mainly due to restrictive price regulation and the weak payment discipline of electricity consumers.
- Domestic producers of natural gas have no incentives to invest in production because domestic gas is under-priced on the domestic market and cannot be exported.

\(^{22}\) With gas prices Germany of about 225 USD/tcm at the end of 2005, and transport costs of roughly 50 USD/tcm, this competitive price would be around 175 USD/tcm.
- Public utilities have been suffering from a lack of investment funds and hence, depleting assets which results in increasing costs of services and lower quality.
- The persistently low payment rates of several clusters of utility and energy consumers continue to hurt the financial position of service providers, which further reduces their capacity to finance investments.

**Figure 4.1**
Energy use per GDP in selected countries (kg of oil equivalent per USD of GDP at constant 1995 purchasing power parity US dollars)

These problems already existed long before the energy price shock occurred. Hence, any appropriate reaction to the new challenges must also be able to eradicate the causes of these problems. These causes include:

- Tariffs below the full costs of service provision, which reduce the commercial viability of operations in both the energy and utility sectors (in particular, the costs of investments can hardly be recovered).
- Cross-subsidization of households by industries imposes additional burdens on industrial consumers and reduces incentives for households to save energy and to increase energy efficiency. As a consequence, Ukraine is one of the most energy inefficient countries, even by regional standards (see Figure 4.1).
- Operations in both sectors are largely monopolized without strong competitive pressure. As a consequence, energy providers and utility
companies have few incentives to cut costs by increasing their efficiency levels.\(^{23}\)

- The payment discipline of some consumer groups such as households and public utilities is low because service providers still have insufficient legal means to enforce payments.

Obviously, simply increasing all energy and utility prices to cost-covering levels will not automatically solve all these problems and, thus, does not represent an appropriate response to the new challenges. First, simple tariff increases fail to provide incentives for using the significant potential for cost reductions, such as:

- **Reduction of losses** in distribution systems for electricity, water and district heating, where even slight improvements could reduce the costs of operations significantly (at present, average losses account for about 40% of water, up to 50% of heat and 20% of electricity consumption).

- **Use of energy-saving technologies.** Since energy consumption accounts for the largest share of the total costs of electricity generators and utility providers (with shares of 57% for heat provision, 32% for water supply and 31% for sewerage\(^ {24}\)) reduction of energy use could bring down the costs of these services substantially. State-of-the-art technologies have a huge potential for reducing energy costs. For example, the technology and equipment that is still used in most thermal power plants was installed in the 1960s and 1970s. These plants typically convert only about 35% of their thermal energy input into electricity, while modern thermal generation technologies attain up to 60% conversion. In the case of water supply, energy consumption in one-third of the regions in Ukraine exceeds the internationally relevant threshold of 1 kWh per m\(^3\) of water. Indeed, by this standards only three oblasts can be considered sufficiently efficient (\(<0.7 \text{ kWh per m}\(^3\))). Finally, the energy efficiency of heat production is about 16% below the average level for developed countries.\(^ {25}\)

Second, current price-setting mechanisms are vulnerable to political intervention so that energy and utility prices are still influenced by populist political decisions. Hence, tariffs for services will likely remain unpredictable over a medium perspective, thus failing to provide one of the most important preconditions for attracting investment. However, given fiscal deficits in Ukraine, commercially financed investments are desperately needed to prevent the collapse of utility provision.

Third, should cross-subsidization of households by industrial users continue, this will cause even stronger distortions as price increases for industries will be unnecessarily high and will cause stronger economic

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23 Ukrainian water suppliers have extremely different efficiency levels that do not appear to follow a clear economic logic. In contrast, similar firms in other countries that operate under incentive-based regulation schemes have higher average efficiency levels and less deviation. For details, see Pavel, F., Chukhai, A. "Assessing efficiency of water supply in Ukraine" IER/GAG analytical paper A01, 2005.

24 According to the former State Committee for Housing and Communal Services.

25 In Ukraine 171 tons of coal equivalent is needed to produce 1 Gkal while in developed countries 145 tons is needed.
losses than necessary. At the same time, incentives for lower household consumption will remain lower than they should be so that consumption of energy and utility services will remain fairly high.

To summarize, even if all energy and utility prices are raised to cost-covering levels, Ukraine’s energy and utility sectors are still in urgent need for reforms in order to prevent excessive price increases while at the same time guaranteeing supply security. In the following section we will lay out the cornerstones for such reforms.

4.3 Most urgent reform steps

Energy:

Responding to the energy price shock, the government has already started to implement the most urgent measures. The regulatory authority NERC has started to gradually increase prices for households to cost-covering levels for gas and electricity, thereby reducing the extent of cross-subsidization. Moreover, a second retailer “Ukrugazenergo” has entered the Ukrainian wholesale market for gas as part of a new agreement on gas imports with Russia. This could potentially mark the start of competition in the gas market in Ukraine. Although these steps are all necessary, they are – for the reasons outlined above – not sufficient to stimulate a sustainable development towards more efficient energy and utility markets in Ukraine.

Accordingly, the government needs to fundamentally reorient its energy policy. The following objectives should be envisaged. First, tariff policy should allow firms to make profits on their operations and contract enforcement should be guaranteed by the state, so that the sector becomes more attractive for private sector participation. Accompanying these steps, an efficient regulator must be put in place to regulate access to the network segments and to provide more transparency in the market, to create the necessary conditions for fair competition. Only after these steps are taken can significant private capital investments into the industry be expected. Otherwise, the lack of regulated competition will continue to lead to undesired outcomes and create loopholes that generate rents.

In more detail, we recommend that the government implement the following measures, in order of priority:

**Tariff reform and contract enforcement.** Most importantly, the government must stop trying to determine the prices for energy supplies. Instead, it should introduce a ‘regulated-competitive pricing policy’ under which energy tariffs are set by the companies involved, subject to hard-budget constraints. At the same time, a mix of competition and regulation is needed to rule out the possibility of extraction of monopoly rents. Only in this way can cost-recovery and incentives to improve efficiency be provided at the same time. If hard budget constraints lead to the default of inefficient structures, bankruptcy procedures should be allowed to separate profitable, productive assets from indebted structures. The current moratorium on bankruptcy simply allows inefficient structures to prevail without solving any problems.
The move to tariffs that cover costs would make it impossible to sustain universal subsidies to all households. Instead, targeted subsidies for low-income households are called for. Indeed, increased profitability in the energy sector (since firms will no longer suffer the losses that stem from artificially low tariffs and servicing privileged consumers) would lead to an increase in tax collection, and hence to increased budget revenues. Thus, the government’s capacity to deliver help to the truly needy would increase, and ‘regulated-competitive pricing policy’ would deliver more social justice.

Tariff reform should be accompanied by stimulating contract enforcement with respect to payments for energy and energy-intensive public utility services. Contract relations should be established with all users of energy services, and it should be possible to enforce each contract in the event of non-compliance, regardless of whether the customer is a business client or a private household. Furthermore, ensuring contract enforcement implies settlement of the issue of accumulated debts in the sector. These should be restructured and repaid according to an agreed schedule which does not allow for manipulations of payments for current consumption.

Regulatory reform. Current practices and principles of price regulation in the energy sector must be rethought. In particular, NERC – the regulating authority – should seek to create a framework for competition in the energy sector. At first, regulatory efforts should be concentrated on tariffs for network access (e.g. to power and gas grids) rather than on tariffs for final services. Instead, the formation of other components (such as retailing of power and gas or power generation) can be left to competitive market forces. Second, NERC’s regulation should be designed to provide more incentives for cost reduction and increased efficiency. This in particular means changing from the current system of cost-plus (profit cap) regulation with normative profit rates, to ‘price cap’ regulation under which reduced costs translate into higher profits for the operating company. This would increase efficiency in the sector and generate incentives for investments (because of higher profits), leading to increased quality and reliability of service provision.

In addition to such changes in the modes of operation, NERC’s legal foundation also needs to be improved. Until now, NERC only operates on the basis of presidential decrees. Hence, its independence is limited and its decisions can fairly easily be politically overruled. To improve this situation, the relevant laws “On the NERC” and “On the wholesale electricity market” should be enacted by parliament. Rules for ensuring the NERC’s financial independence should also be included. NERC could be financed out of a special fund in addition to direct state financing. This fund would receive a fixed percentage of the revenues of the market operators. Financing the NERC from two sources would increase its independence from political influence and avoid incentives for the NERC to unduly increase tariffs for market participants. A law on the functioning of the wholesale market is also necessary, as the
current system is not sustainable and continues to accumulate debts. This system also allows for arbitrary decisions with regard to the management of financial flows, and the present piecemeal approach to limit arbitrary decisions only brings more complications and does not guarantee sustainable wholesale market operation.

Finally, it is vital to introduce regulatory norms or a national regulator in the public utilities sector (see our recommendations below), since these utilities are among the largest consumers as well as debtors of the energy sector. Without meaningful reforms in the utilities sector, the sustainability of the energy sector is seriously compromised.

**Promotion of competition in the marketplace.** In line with the ‘regulated-competitive pricing policy’ proposed above, competition should be encouraged wherever possible (e.g. retail competition in the electricity and gas markets). This would increase efficiency at much lower costs than regulation, and it would also allow new independent providers to compete with existing distribution companies, spurring innovation and increased efficiency.

As for domestic gas extraction, it would be beneficial to allow for exports of these resources once the issue of tariff policy is solved. Then, provided the exported energy resources are valued at internationally competitive levels, there will be increased incentives for more efficient use of energy fuels, and entry into the extraction market will be stimulated. This would bring investment into these fields and contribute to a reduction of Ukraine’s energy dependence.

**Commercialisation and private sector participation.** The Ukrainian energy sector is in dire need of investments and the capacity of the private sector to undertake these investments should be used to its full extent. Although privatisation in the energy sector was recently frozen, it is still possible to invite the private sector to participate in public-private partnerships and other forms of cooperation which do not involve property rights transfers. In order to create a favourable investment climate it is necessary to allow businesses to operate profitably in the sector, which presupposes the reform steps mentioned above.

**Rethinking the approach to the energy sector.** Finally, it is also advisable to embark on a full-fledged public awareness campaign to save resources and increase energy efficiency. Local governments can contribute, e.g. by providing initiatives to create energy saving companies (ESCOs) which implement energy-saving projects and finance their operations out of the fuel savings realized by their clients. Growth in primary energy consumption should not be taken for granted or considered a goal in and of itself. A growing Ukrainian economy does not require the growth of primary energy, but rather the growth of energy services. These can also be achieved through energy saving projects. A new and serious approach to the issue of renewable energy resources is also required, as these are currently being ignored or wasted in Ukraine.
Utilities:

The new ministry of construction, architecture and utilities has already prepared a draft action plan of primary steps to reform public utilities. The plan foresees the following important steps:

- To stimulate a competitive environment through different schemes of private sector involvement into the management and operations of utility enterprises. In particular, the signing of management, lease and concessions contract with private companies is foreseen.
- To improve tariff policy by giving independent regulatory institutions the power to set tariffs.
- To stimulate maintenance and investment activities by establishing a Borrowing Fund that will provide loans to public utility enterprises. It is planned that the state supports such loans by compensating a part of the interest due, providing guarantees and taking part in investment projects. This support will be conditional on adequate tariffs and improved performance at the enterprise level.
- To establish social support policy in the sector it is planned to lower the threshold for eligibility to payment privileges (from a utility bill of currently 20% of respective household income to 15%) and to allow consumers to choose between in-kind and monetary compensation.

In general, these steps go in the right direction. However, given the current deficits in both central and local budgets, the extent to which public support to investment finance can be provided is highly uncertain. Moreover, it remains unclear how firms can improve their performance and how they will be stimulated to do so. Accordingly, appropriate incentives for a commercially oriented development of the sector with sufficient potential to attract private finance still have to be provided. We argue that these objectives can best be achieved by simulating competitive pressure to improve performance and by reducing costs through appropriate regulatory measures. To this end, we suggest the following measures to be implemented in two stages:

In the first stage:

- Set up a central regulator to supervise the activities of the three main utility sectors (water supply, sewerage and heating). The appropriate legislation in independent regulation should guarantee coherency, predictability and capacity of the regulations. The regulator must be independent, accountable, and his actions must be transparent.
- To ensure equal starting conditions for all firms we propose introducing price-cap regulation for an initial period of 2 to 3 years. Therefore, prices should be set for each firm separately at recent historical cost levels (e.g. at the average of reported costs for 2004 and 2005). In order for tariffs to account for changes in inputs prices an indexation

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26 For further details about efficient independent regulation see Pavel, F., Chukhai, A. “Regulatory scheme for utilities: proposal for Ukraine” GAG/IER policy paper U12, November 2005.
system will also be necessary. This would provide incentives for first cost-reducing measures that – if necessary – can be supported by initial investment provisions during the first years of regulation. Any saved ‘tariff-costs’ difference will increase the attractiveness of utilities enterprises for private investors, while independence of the regulator ensures a reliable long-run perspective.

- Central and local governments must be held responsible for providing direct transfers to needy consumers under the auspices of their social policies. Initially, such measures might be supported by lifeline consumption schemes.\(^{27}\)

- In order to actively promote investments in energy-saving technologies, the state should inform enterprises about different energy-saving projects initiated by international institutions and encourage municipalities to apply for investment ratings. Moreover, the state could provide guarantees for loans that utilities apply for, e.g. in the frame of the foreseen Borrowing Fund.

**In the second stage:**

- After the initial transition period, the regulator should move to a more advance incentive-based regulation, which simulates competitive pressure across regionally separate utility providers.\(^{28}\)

- The state should further stimulate private participation in the sector through institutional and legal support, assistance in the preparation of tenders for private investment, etc. To avoid public resistance to such changes, these initiatives must be openly discussed.

The proposed reform steps would make operations in both sectors – energy and utilities – commercially viable. The companies would have enough funds to finance necessary investments, and they would be attractive for different forms of private participation. The proposed regulatory reforms would create conditions conducive to competition. As a result, utilities enterprises would face strong incentives to improve the efficiency of their operations and to cut costs. At the same time, the prices of services would reflect economically justified costs and would be no higher than necessary. As a result of implementation of the proposed reforms, consumers would be protected from the abuse of monopoly power, while secure supply of services will be guaranteed.

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\(^{27}\) A lifeline consumption scheme is a tariff scheme under which tariffs for subsistence minimum levels of service are lower than tariffs for consumption in excess of these subsistence minima.

5 Agriculture and rural areas: a new phase of development

5.1 New challenges

Due to expected WTO membership, Ukrainian agriculture and rural areas are approaching a new phase in their development. Tariff reductions might challenge domestic producers in the short-run, but WTO membership also offers interesting long-term opportunities. It will increase the competitiveness of the food value chain, facilitate access to dispute settlement mechanisms, and clearly define trade standards through SPS, TBT and TRIPS agreements. It will thus stimulate structural change, food quality and food safety development and necessary policy and legal reforms. WTO membership is a unique chance to implement and leverage a broad range of policy reforms that have been postponed until now.

5.2 What are the causes of stagnation and slow recovery in Ukrainian agriculture?

After fifteen years of wishful thinking, Ukraine’s agriculture and rural economy more than ever need new approaches to the formulation of agricultural and rural development policy objectives as well as of implementing measures to unleash the country's natural potential. Many observers ask: "Why is the gap between the evident potential and the actual performance of the agriculture and food sector in Ukraine so dramatically high?"

To answer this question it is helpful to look at farm performance indicators. Farm productivity and consequently farm income are very heterogeneous in Ukraine. Moreover, the gap between 'good' and 'bad' farms is widening. This is particularly dangerous in Ukraine, because market disciplines that steer farm performance are only partly functioning. Pressures in the form of bankruptcy and competition on the market for land are weak (due, for example, to monopsonistic land lease markets and the moratorium on land sales). Hence, there is little pressure on under-performing farmers to leave the sector and allow better performers to allocate scarce production factors in a more efficient way, to earn money and to invest in future market opportunities.

Conventional mixing of agricultural support for producers with rural development objectives is leading to conflicts of interests between maximizing agriculture's productivity and competitiveness on the one hand, and increasing the welfare of rural communities on the other. The expectation of some policy makers that farms or agribusinesses –

supported by producer subsidies – would produce food and at the same time deliver communal and social services for the rural population, has not lead to the expected results. Businesses usually follow their own business objectives to maximize profits. As a consequence, Ukraine has not been able to achieve considerable success in either agricultural productivity or rural development. Despite increasing and relatively high levels of fiscal support as well as border protection, Ukrainian agriculture continues to perform far below its potential. Empirical analysis shows that Gross Agricultural Output could be doubled and competitiveness could be improved if the so-called ‘productivity and efficiency gap’ was closed. Meanwhile, agricultural wages remain among the lowest in the economy.

The absence of a stable agricultural policy environment with clearly defined objectives and priorities that facilitate commercial activity blocks structural change and the inflow of investments that are needed to make farm production and food processing more efficient and competitive on world markets. Ad hoc reactions to market fluctuations as well as inadequate price, trade and fiscal policies undermine the long-term efficiency and competitiveness of the food value chain. For example, minimum farm-gate prices decrease the competitiveness of food processors and consequently the competitiveness of the entire value chain.

Rural areas in Ukraine are characterized by ongoing depopulation and economic degradation. Demographic processes and the fact that the brightest talents are attracted by higher incomes in urban areas lead to vicious circles in rural areas. Government policy biased towards agriculture contributes to this situation. Over the last several years, rural development programs have received only a tiny and insufficient fraction of the budget funds pumped into the agricultural sector. On the other hand, despite significant fiscal inflows, agriculture has not provided social and physical infrastructure to the rural population.

Rural development and agricultural policies might complement each other, but they are nonetheless different. Rural development policy should provide sustainable livelihood for the rural population. The fact that a large share of the Ukrainian rural population works in agriculture formally or informally represents an important challenge for rural development policy. Technical progress will continue to release labour from agriculture. Increasing rural unemployment, unless new jobs in the non-agricultural sectors are created, implies significant social and economic problems for rural areas, e.g. increased rural-urban migration, increased rural poverty and reduced local tax bases, etc.

Paradoxically, agriculture and rural development problems are increasing and sector performance remains unsatisfactory despite significantly increased Government spending. Hence, the answer to these problems can not lie in the amount of Government spending in agriculture, but rather in improving how scarce resources are spent. We argue that markets generally allocate resources much better than civil servants, and that markets have not been allowed to function to the necessary extent in Ukrainian agriculture so far. The current fiscal policy of the Ukrainian Government in agriculture does not facilitate the restructuring process within the sector. Instead it preserves its problems and creates additional risks for the fiscal and macroeconomic stability in the country. Total fiscal
support to agriculture, i.e. budget subsidies and tax breaks, have grown almost threefold over the last four years, fluctuating around 2% of Ukraine’s GDP (see Table 5.1), which is high by international standards.

Table 5.1
Total fiscal support to agriculture in Ukraine, UAH bn

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<tbody>
<tr>
<td>Total agricultural budget expenditures (TABE)</td>
<td>1.47</td>
<td>2.83</td>
<td>3.25</td>
<td>4.38</td>
<td>6.68</td>
</tr>
<tr>
<td>MAP programs (in % of TABE):</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Production subsidies (in % of TABE)</td>
<td>22.1</td>
<td>21.4</td>
<td>32.8</td>
<td>34.89</td>
<td>38.40</td>
</tr>
<tr>
<td>Growth-Enhancing measures(^{30}) (in % of TABE)</td>
<td>65.0</td>
<td>47.0</td>
<td>51.6</td>
<td>54.5</td>
<td>53.3</td>
</tr>
<tr>
<td>Other Ministries’ programs (in % of TABE)</td>
<td>4.3</td>
<td>8.6</td>
<td>8.9</td>
<td>9.6</td>
<td>21.7</td>
</tr>
<tr>
<td>Share of TABE in total public expenditures, %</td>
<td>3.3</td>
<td>5.0</td>
<td>4.1</td>
<td>3.7</td>
<td>4.9</td>
</tr>
<tr>
<td>Total tax breaks:</td>
<td>3.35</td>
<td>3.42</td>
<td>3.56</td>
<td>5.67</td>
<td>5.77</td>
</tr>
<tr>
<td>Including: Value Added Tax</td>
<td>1.81</td>
<td>2.18</td>
<td>2.97</td>
<td>4.26</td>
<td>4.10</td>
</tr>
<tr>
<td>Fixed Agricultural Tax</td>
<td>1.38</td>
<td>1.38</td>
<td>1.36</td>
<td>1.4</td>
<td>1.4</td>
</tr>
<tr>
<td>Other Fiscal Support</td>
<td>0.01</td>
<td>0.32</td>
<td>0.18</td>
<td>0.21</td>
<td>Na</td>
</tr>
<tr>
<td>Total fiscal support to agriculture (TAFS)</td>
<td>4.84</td>
<td>6.57</td>
<td>7.00</td>
<td>10.27</td>
<td>12.45</td>
</tr>
<tr>
<td>Share of TAFS in GDP, %</td>
<td>2.1</td>
<td>2.5</td>
<td>2.0</td>
<td>2.3</td>
<td>2.4</td>
</tr>
<tr>
<td>Ratio of tax proceeds from agriculture to TAFS, %</td>
<td>34.6</td>
<td>19.6</td>
<td>23.6</td>
<td>Na</td>
<td>Na</td>
</tr>
<tr>
<td>Ratio of tax proceeds from agro-food sector to TAFS, %</td>
<td>120.5</td>
<td>87.6</td>
<td>87.9</td>
<td>Na</td>
<td>Na</td>
</tr>
</tbody>
</table>


Notes: * - actual budget expenditures; ** - planned budget expenditures; Na – data not available

Total agricultural budget expenditures grew from UAH 1.47 bn in 2002 to UAH 6.68 bn in 2006, and total fiscal support grew from UAH 4.84 to 12.45 bn over the same period. The ratio of tax proceeds from agriculture to total fiscal support to agriculture shows that the agricultural sector received about three to four times more from the state budget than contributed to

\(^{30}\) Estimates of the growth-enhancing measures as % of TABE include other ministries’ programs as well.
However, sector performance did not increase accordingly. This clearly demonstrates that the current support policy is inefficient. Why should a sector in which Ukraine has such a clear comparative advantage be taxing the rest of the economy so strongly?

The structure of the budget support has not changed significantly over the last five years, being increasingly in favour of production subsidies. However, these subsidies have done little to increase the productivity and competitiveness of the sector. The reason for increasing production subsidies is probably that policy makers continue following planned economy principles, targeting gross output goals instead of efficiency and productivity increases. Furthermore, the procedures (often non-transparent) for granting aid to specific producers lead to high risk of corruption and unequal distribution. Budget as well as total fiscal support is mainly accessible for well-connected and large agricultural producers. Quantitative analyses show that only about 7% of Ukraine's livestock producers received almost 75% of the total subsidies to the sector in 2004. In this biased manner policy makers preserve existing farm structures and provide little stimulus for necessary structural change.

A further interesting aspect of the state budget is the low fraction of other Ministries' expenditures in the total agricultural support expenditures. This probably reflects an implicit assumption that the Ministry of Agricultural Policy must be responsible for, in addition to agricultural policy, the whole range of rural development issues, such as social development in rural areas, rural infrastructure, health, education, as well as the development of small and medium enterprises in rural areas.

Huge tax privileges compared to other sectors (mainly in the form of value added tax exemptions) have also failed to improve the competitiveness of agriculture. As Table 5.1 shows, tax expenditures have not been less than UAH 2 bn annually over the last several years, while enterprises in the automobile, airplane and ship construction, space, and metallurgical industries received only UAH 0.9 bn in three years from 2001-2003.

In summary, there is clear evidence that the above described massive producer support has not lead to the expected results. The major characteristic of the agriculture and food sector in Ukraine is heterogeneity. A relatively small group of individuals, farms and agribusinesses benefit from the current situation, absorbing large amounts of fiscal support on the basis of their connections or production scales, and benefiting from limited competition on markets. As efficiency, productivity and farm incomes are linked, farm wages remain low.

A well functioning land market is an essential element for the development of agriculture as well as rural livelihoods. In general, a fledgling land market has emerged in Ukraine. However, the legal and institutional framework is not yet conducive to the formation of an agricultural land market where land move from low to higher performing farmers. Land ownership is widely dispersed. Often only one or at best a few farmers in a particular region lease land. These lessee in many cases have monopsony power in their regions of operation. Also, lessees have more rights and opportunities to influence the leasing conditions. As a result, the value of agricultural land has remained relatively low, and land transactions from low to higher performing farmers are hindered leading to reduced
structural change and limited investments in the sector. The moratorium on land sales exacerbates this situation. Purchase and sale of land could also contribute to the development of rural financial markets. However, expectations should not be exaggerated. High transaction costs and low land values will limit the use of land as collateral at least in the short term.

A land market will only properly function if many farmers competitively bid for the right to use or purchase a plot of land. If competition is lacking, then a less efficient user may have preferential access to the land and prevent more efficient users from bidding. For the economy as a whole this means that a given amount of output will be produced at higher costs than necessary, or that with a given amount of money less output will be produced than would otherwise be possible. Thus, with imperfect land markets a few gain but the majority loses: a) farmers have limited access to land; b) owners of land lose land value; c) the state budget gets less tax income; and d) the whole economy including consumers loses welfare.

5.3 Most urgent reform steps

Three immediate steps are necessary:

1) Separate rural development policy goals and instruments from agricultural support policy goals and instruments;

2) Reform fiscal support to agriculture – replace non-transparent, inefficient, unequal and inconsistent production support measures by direct income support and growth enhancing measures;

3) Lift the moratorium on land sales - institutionalize and activate rural land markets.

Separate rural development from agricultural policy

The absence of a stable agricultural policy environment that facilitates commercial enterprise in Ukraine has been the major factor impeding the sector's development. Therefore, the following two steps should be taken.

a) Draft and adopt a strategy program for Ukrainian agricultural development that would enable and stabilize the agricultural policy environment in Ukraine. This explicit strategy would contain a realistic set of agricultural policy goals and measures. It would also define priorities. First of all, agricultural policy should not strive to assume responsibility for the whole range of rural development issues. It should focus on (i) improving efficiency and competitiveness, (ii) ensuring food quality and security, (iii) contributing to preserving nature and the landscape. The measures should be consistent with the goals set. International experience, empirical analysis, WTO membership constraints, and limited funds in the Ukrainian budget all suggest that current production subsidies should be phased out. Free funds should instead be invested in people to raise the educational standards of the agricultural labour force and develop farm advisory services, implement sanitary and phytosanitary measures, upgrade food inspection services, and maintain environmental
standards. WTO membership would leverage these necessary developments by imposing international binding standards (SPS, TBT, TRIPS). Further harmonisation of the legal and institutional environment with the EU would also have healthy effects on the perception of farmers and agribusinesses regarding the stability of the policy framework. This would stimulate domestic and foreign direct investments.

b) **Draft a separate strategy program for rural development.** This strategy should cover the following two issues: i) deliver public social and communal services and infrastructure in rural areas, and ii) support non-agricultural economic development in rural areas by support of small and medium sized rural enterprises. The following goals might be proposed: i) reduction of rural poverty; ii) modernization and diversification of the rural economic base including small and medium enterprises; iii) economic integration of subsistence agricultural households; and iv) creation of non-farm employment to absorb labour released from agriculture. This set of goals encompasses the primary responsibilities of different ministries, so the corresponding policy would have to be designed and implemented by a rural development support system that would include a rural policy coordinating council and a process for public participation in policy development and monitoring.

**Reforming fiscal support to agriculture**

Fiscal support should be directed towards increasing the productivity and competitiveness of the agriculture and food value chain. This has not been the case in Ukraine so far. We believe that reforming of fiscal support should follow some basic principles.

a) **Introduce medium-term planning of budget expenditures on agriculture.** This planning would facilitate investment decisions by lowering risks of *ad hoc* policy changes. Investors – including foreign ones - would benefit from more stable framework conditions. Farmers, regional authorities and communes would know what they could expect from the central authorities. The EU 7-year programming cycle could serve as an example.

b) **Differentiate state support to a) agricultural producers and b) rural areas.** Rural areas should receive more targeted public support for delivering social and communal services to the rural population. This new rural development policy should be based on the principles of fiscal decentralization.

c) **Move from production subsidies towards decoupled payments.** First, this measure would limit arbitrary decisions by agricultural administration because every farmer would know exactly what he should get from the system. Second, income transfers from the state to producers would be more evenly spread over the country leading to a fairer distribution of support to all forms of farms. Third, it would limit the distortions in agricultural markets by reducing government interference.
d) Improve the share of expenditures on 'green box' structural policy measures at the expense of 'amber box' measure expenditures. The re-direction of state support to rural and social infrastructure, quality-ensuring mechanisms etc are urgently needed. Investment decisions in the sector, in particular in food processing, depend on the availability of reliable infrastructure, i.e. roads, energy supply, electricity, water etc. Also ensuring food quality and security is of top priority for the state. However, the means of support must be further developed. Regional or structural support mechanisms similar to the EU’s funds could be considered.

e) Phase out tax breaks. Tax privileges cuts will reduce distortions in the agro-food sector and the whole economy. Cutting the tax privileges of agricultural raw material suppliers will have an impact on the food value chain. It will strengthen the competitiveness of holding structures with vertically integrated structures. Only small farms and enterprises might continue operating according to the simplified tax system.

f) Create an equal level playing field and equal access for all types of farms. The future and the market mechanism will reveal the competitiveness of each farm type. It is not the role of the state to define priorities in this regard.

g) Make support more transparent and fair by clearly defining eligibility criteria. Arbitrary decisions by the administration should be made impossible.

The proposed reform contains many elements that would greatly improve the efficiency of agricultural policy in Ukraine. In many respects it represents a move away from old and discredited models of agricultural policy towards goals and instruments that are cutting-edge worldwide. What the agriculture and food sector needs and economists have stressed for years is now in sight. The reform would lead to more competitiveness, transparency and increased investment, and it would contribute to developing the agriculture and food sector in the expected direction.

Land market development

A functioning agricultural land market is a precondition for increasing the efficiency and competitiveness of agriculture, and would create an additional source of income for the rural population. Currently, the rural population does not have the same property rights as the urban population, widening the income gap between rural and urban areas. Therefore, the following reform steps are proposed.

a) Lift the moratorium on the sale of agricultural land. Land would have a real value and contribute to rural livelihoods, the development of rural financial markets and investments. This reform would also greatly facilitate the movement of land to the more efficient producers.

b) Allow foreigners to purchase agricultural land. This measure would create additional competition on the land market, positively affecting the value of land. To preserve the rights of the local
population, foreign ownership could be limited by size and by the obligation to actually cultivate the land (owner-farmer).

**c) Accelerate the development of a multifunctional cadastre and land registration system.** This measure would comprise policy decisions on the legal and institutional set up of the cadastre and land registration system currently concentrated in the State Land Committee of Ukraine. The creation of one national registration system for ownership rights on land according to the Central European 'Grundbuch' system (Austria, Germany) should be considered. In this system two important elements have to be distinguished, the cadastre and the land plot registry. The cadastre describes the physical characteristics of the land plot, consisting of a map and a registry of land plots where these characteristics are filed. The system is usually implemented using Geographical Information Systems techniques. The registry of land plots in the so-called 'Grundbuch' describes the property status of the land plot. The current and previous owners of the plot are recorded, as are all property-related transactions. Moreover, rights and obligations towards the state or third parties are mentioned as well as mortgage rights of banks. It is important to note that the legally binding document is the land plot registry document. This system would have various benefits because it provides legal and institutional checks and balances in a fledgling market economy. It is a fool-proof system that minimizes the risks of land transactions and provides transparency for all participants.

**d) Make the land leasing market more transparent.** This could be done by providing information on lease terms and information on lessee and lesser to the public, e.g. on a specific website.

The proposed immediate reform steps would activate market force and increase the transparency and efficiency of policy measures, creating a business enabling and stable environment for farmers, agribusiness and the rural population. In turn, this would stimulate investments and structural reforms in the sector leading to higher efficiency and food value chain competitiveness. Reform of fiscal support would reduce market distortions and increase the allocative efficiency of public investment, thus contributing to macroeconomic and fiscal stability in the country. Functioning land markets would accelerate structural change in the sector so that the best agricultural land moves to the most efficient producers. In turn, structural change and efficiency increase would improve the competitiveness of products that have a comparative advantage in Ukraine. Evidence shows that these products include grains, oilseeds, milk and dairy products. If the above reform steps are implemented quickly, Ukraine could double its grain, oilseeds, and milk production\(^\text{31}\).

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\(^{31}\) These estimates are based on rough productivity estimates. For example, the current wheat yield is about 3 t/ha on average. However, the best 10% of the farms reach 6 t/ha using almost the same amount of inputs with improved farm practices and farm management. The same reasoning applies for milk with a current milk yield of about 3 t/cow and year. The genetical potential of the Holstein-Frisian breed is 8 t/cow. So, 6 t/cow is feasible with improved dairy farm management and investments in imported breeding animals.
The proposed steps for rural development would have a profound impact on rural livelihoods and contribute to reviving rural economic growth. Clearly defined rural development objectives and instruments would promote gradual but sustained rural economic growth and development, an increase in entrepreneurial activity, strengthened rural small and medium enterprise development, rural employment creation and increased rural finance and investment. All that is needed is the political will of policy makers to place more trust in market forces and the entrepreneurial skills of Ukrainians.
6 Investments: promotion through consistent policies

6.1 New challenges and old problems

It is widely recognized that investments are crucial for sustaining high levels of economic growth and ensuring the job creation. The modernization of equipment and the implementation of new technologies is vital for making Ukrainian products more competitive on international and domestic markets and thus for restoring a high pace of economic growth in Ukraine. Currently, investments are much lower than is necessary for the stable development of the economy.

Although in 2001-2004 gross fixed capital accumulation increased by more than 50% in real terms, this growth was evidently not enough to improve the production capacities of many enterprises. The level of obsolete capital remained about 50%. According to the results of the IER Quarterly Survey of industrial enterprise managers (QES), in 2005 almost two third of the surveyed enterprises said that the need to replace depreciated equipment was an incentive for investment (Figure 6.1). Moreover, the problem of outdated technology, equipment, and capacities is becoming more and more important for the Ukrainian business hampering the growth of production. Around 20% of the surveyed managers consider outdated technology as an impediment to production growth. In 2003-2004, faced with growing demand, enterprises lacked not only modern, but simply new equipment.

Ukraine lags behind most emerging economies in the share of value added it spends on capital accumulation. In 1996-2004 the respective share for Ukraine was approximately 20%, while the absolute leader was China with almost 40% of GDP on average directed to investment purposes. In the East European countries the average share was around 25% in 1996-2004. The relatively low share of value added spent on fixed capital accumulation is explained by the dominance of consumption in the distribution of the additional value added that resulted from real GDP growth.

During the first years of economic recovery in Ukraine, consumer demand was the main domestic contributor to real GDP growth. Another key growth engine was external demand that led to a boost in exports and had an important indirect influence on the development of domestic demand. At the same time, the direct contribution of investments to overall real GDP growth was far less significant (Figure 6.2)\(^{32}\). Hence, the increase in real value added was predominantly consumed, and not invested.

\(^{32}\) In particular, in 2003 and 2004 – the years of the highest growth of gross fixed capital accumulation – it contributed 45% and 35% to total real GDP growth respectively, while the contribution of final consumption was 79% and 62%.
Figure 6.1
Purposes of investments, % of surveyed enterprises

Source: Quarterly Enterprise Survey, IER

Figure 6.2
Structure of real GDP growth by uses of income in 2001-2005 (percentage points contributions of total real GDP growth)

Source: Derzhkomstat, IER estimates
The problems were aggravated when in 2005 gross fixed capital accumulation decreased by 0.3%, indicating a virtual stop in the progress of investment activity in Ukraine. Although investments revived in the first quarter of 2006, the challenge of avoiding a repetition of the 2005 experience remains.

Another underutilized source of investments in Ukraine is foreign direct investments (FDI). While domestic financial resources in the country are limited, the world’s financial resources can be considered unlimited for a small economy such as Ukraine. In 2004, the stock of Ukraine’s inward FDI accounted for around 0.1% of the world’s inward stock of FDI. In comparison, Poland attracted 0.7% of the world’s inward stock of FDI. Ukraine clearly has the room for attracting more FDI, investment climate permitting.

6.2 Factors behind low investments

The key to stimulating investment activity in the country is the development of a favourable investment climate. There were several reasons behind the deterioration of the investment climate in Ukraine and the corresponding reduction in investment activity in 2005. Among them are:

Reprivatisation. The reprivatization initiated in 2005 by Tymoshenko’s government to restore social justice and achieve a maximum price for privatized state enterprises generated significant uncertainty in the Ukrainian economy, adversely affecting investment activity. Especially harmful were the rumours about the government’s reprivatization intensions. The hints that several hundred or thousand enterprises might be listed for the revision of earlier privatization deals caused fears about the security of property rights. As a result, potential investors postponed their decisions until ‘better times’.

Inconsistent tax policy. At the beginning of 2005 the government undertook steps to widen the tax base. In particular, pre-term cancellations of privileges to enterprises in special economic zones and territories of priority development provoked the justified discontent of investors. Such an abrupt cancellation of privileges fuelled fears about legal security and the commitment of the government to the rule of law that is an extremely important component of the investment climate. As a result, entrepreneurs were convinced to temporarily postpone important investment decisions.

Besides these temporary factors that reduced investment activity in 2005, there are traditional problems hampering investments in Ukraine.

Taxation of investments. There are at least two important implicit taxes on investments in Ukraine. First, there are tariffs on imports of machinery. Non-zero import tariffs on machinery and equipment are clearly inconsistent with a commitment to more investment. Moreover, Ukraine’s

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33 According to the World Investment Report 2005, UNCTAD.
import tariffs on machinery and equipment are higher than the tariffs applied by both emerging economies such as Turkey, Armenia, Azerbaijan, Kazakhstan and Moldova, and by developed countries such as the EU, the USA or Japan (Table 6.1). The latter is the absolute leader in liberalization of machinery imports, applying zero MFN tariffs.

Table 6.1
MFN applied tariffs for machinery and equipment

<table>
<thead>
<tr>
<th></th>
<th>transport equipment</th>
<th>non-electric machinery</th>
<th>electric machinery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Armenia</td>
<td>3.2</td>
<td>0.3</td>
<td>3.7</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td>4.4</td>
<td>3.6</td>
<td>9.4</td>
</tr>
<tr>
<td>Belarus</td>
<td>10.8</td>
<td>9.1</td>
<td>12.2</td>
</tr>
<tr>
<td>Canada</td>
<td>5.7</td>
<td>1.4</td>
<td>2.3</td>
</tr>
<tr>
<td>EU</td>
<td>4.1</td>
<td>1.7</td>
<td>2.5</td>
</tr>
<tr>
<td>Japan</td>
<td>0.0</td>
<td>0.0</td>
<td>0.2</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>7.4</td>
<td>0.5</td>
<td>0.0</td>
</tr>
<tr>
<td>Moldova</td>
<td>2.0</td>
<td>0.1</td>
<td>3.5</td>
</tr>
<tr>
<td>Russia</td>
<td>10.5</td>
<td>9.1</td>
<td>12.2</td>
</tr>
<tr>
<td>Turkey</td>
<td>4.3</td>
<td>1.9</td>
<td>2.6</td>
</tr>
<tr>
<td><strong>Ukraine</strong></td>
<td><strong>7.0</strong></td>
<td><strong>3.0</strong></td>
<td><strong>5.5</strong></td>
</tr>
<tr>
<td>USA</td>
<td>3.1</td>
<td>1.2</td>
<td>1.9</td>
</tr>
</tbody>
</table>


Second, the pension fund tax of 1.3% on purchases of non-cash foreign currency acts as a detriment to imports of capital goods. 

**Poorly developed institutional mechanisms for attracting foreign investments.** The institutional mechanism for attracting foreign investment in Ukraine remains underdeveloped. The investment promotion agencies that have been created since 1991 were temporary with no clear prescription of the tasks they were to execute. In addition, implementation mechanisms functioned weakly due to the overlapping of tasks of different agencies. Finally, the level of transparency of each investment agency was low since the creation of these agencies was often driven by political rather than economic aims.

The newest Investment Promotion Agency (IPA) – called the Ukrainian Centre for Facilitation Foreign Investment – was set up in August 2005 by a Cabinet of Ministers Resolution with the purpose of improvement the investment climate and facilitating the process of attraction foreign investments.

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36 CMU Resolution “On the creation of Ukrainian Centre for Facilitating Foreign Investment” No.666, 02.08.2005.
Investments into Ukrainian economy. Although this newly created investment institution is meant to fulfil almost all classical functions of an investment promotion agency, the implementation mechanisms that would assist in the efficient realization of these functions are still absent. Furthermore, the level of transparency of the agency is also rather low, as investors have only recently received access to its web information. It remains an open question whether this agency will be more efficient than its predecessors.

**Excessive regulation.** In spite of the attempts to simplify its regulatory mechanism, Ukraine still lags behind the other countries. Registration procedures in Ukraine are relatively complicated. According to the World Bank, Ukraine ranked 110 out of 155 investigated countries in 2005 in terms of the challenges of launching a business. Entrepreneurs can expect to go through 15 steps to launch a business over 34 days. In the OECD countries, this takes on average 20 days. Registration costs equal 10.6% of gross national income (GNI) per capita in Ukraine, while in the OECD it costs only half as much. In Ukraine, it takes 10 steps and 93 days to register property, while in the OECD the entrepreneur needs only 32 days. Attempts to streamline the procedure of registration have been made with the establishment of the Investment Promotion Agency in 2005, which is expected to perform the function of a ‘one stop shop’.

**Corruption.** The problem of corruption in Ukraine damages the overall business climate and hinders enterprise development. The level of corruption remains high despite attempts by the government to fight it, e.g., the program “Smuggling – Stop!” launched in 2005. In Ukraine, 44% of the firms that responded to the Business Survey conducted by the World Bank reported to be expected to give gifts in meetings with tax inspectors, and this is 40% higher than average in other countries.

**Low protection of minority shareholders’ rights.** The other problem in Ukraine has been the poor protection of minority shareholders’ rights going back to the early stages of privatization in the beginning of 1990’s, and the deficiencies of the appropriate legislation aimed at the equal protection of all interest groups. Currently there is no law in Ukraine that explicitly protects the rights of minority stakeholders. The process of the adoption of the law “On joint-stock companies” is highly politicized and still has not been implemented.

**Underdevelopment of the capital markets.** One of the important obstacles that prevent Ukrainian companies from investing in new equipment are the high costs of borrowing. Commercial banks charge relatively high interest rates. According to the NBU, in May 2006 the interest rate was 14.9% on average for hryvnia lending and 10.5% for USD lending to legal entities. Improved capital markets could reduce the costs of borrowing. The major reasons for the underdevelopment of capital markets in Ukraine are:

- opaque corporate governance and financial reporting systems, a large share of shadow transactions, and as a consequence absence of reliable

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and relatively cheap credit risk assessment services undermine the efficiency of capital markets and discourage market participation;

- capital controls\(^{38}\), a lack of institutional investors (thanks to practically non-existent private pension funds and small assets of insurance companies and mutual funds) as well as the lack of a large and affluent middle class limit important sources of demand on capital markets;

- cumbersome regulations increase the cost of borrowing and as a result make raising funds on capital markets unsuitable to all but “blue-chip”/big companies.

So far, the intentions of the government to restore the confidence of investors have not been matched with concrete measures and thus, have failed to bring the expected results. Thus measures to improve investment climate in Ukraine are badly needed.

### 6.3 Most urgent reform steps

In the majority of cases, private investment has proved to be more efficient than public investment. Thus, the role of the state is first and foremost to create a favourable investment climate that facilitate both domestic and foreign private investments.

The restoration of the investment climate should become among the key policy priorities for ensuring the stable development of the Ukrainian economy in the future. The huge scope of the problems existing in Ukraine that were discussed above hampers the investment process and must be resolved efficiently.

The first issue that is to be addressed is **reprivatization** in any form. Private owners should obtain the long-term guarantees of the security of their rights. With the purpose of guarantying the private property rights, the government authorities must adhere to the Ukrainian Constitution and provide all stakeholders equal rights in the face of the law. The key aim in the area of property relations should become the security of property rights, and the only acceptable ground for the revision of a privatization deal should be the inadequate execution of investment obligations, which must be proved in the court. Also, there should be no official rhetoric about reprivatization intentions.

**To ensure the security of property rights we propose the following steps:**

- In the medium term it is necessary to reform the legal system and improve the procedure of the juridical and extra-juridical protection of the property rights of any size.

- To avoid future disputable privatization deals and ensure the confidence of domestic and foreign investors it is necessary to develop an efficient and transparent mechanism of privatization and control for the execution of investment obligations.

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\(^{38}\) Kirchner, R., Giucci, R. "Managing Capital Flows: Ensuring Long-Term Benefits while Controlling Short-Term Risks” GAG/IER policy paper V3, February 2006.
• The legal status of the State Property Fund must be determined with a special law. The Fund should become an efficient legal body that is accountable for state property management, ensures the transparency and efficiency of the privatization process and also controls the execution of investment obligations on the privatized objects. The law must correspond to the Constitution, Economic and Civil Codes of Ukraine.

• Coordination between the Cabinet of Ministers, Parliament and the State Property Fund must be clearly assessed. The level of political influence must be minimized and the dialog should be transfered purely into the economic field.

• The rights of minority shareholders must be guaranteed in the recently adopted special law “On joint stock companies” that must be effectively implemented.

The regulatory policy should be reconsidered and brought up to international standards. Although some attempts have been made to simplify the registration procedure for new enterprises, further steps to decrease the level of bureaucracy should be done. In particular, the main concern is to provide investors with easier and more efficient ‘one-stop-shop’ registration procedures, reduce the cost of registration and fight corruption.

Currently a large share of investments comes from offshore territories. This structure of investments reflects the insecurity of the Ukrainian environment, as offshore investments in the Ukrainian economy are more the consequence of the unfavourable investment climate than of any inherent advantage of offshore investments. This problem can be resolved by providing the property rights guarantees, in particular in the form of a capital amnesty that could be established with a specially adopted law.

Additional taxes on investment in the form of non-zero import tariffs on machinery and equipment and the pension fund duty on non-cash purchases of foreign currency discourage investors from renewing outdated technology and equipment and should be reconsidered. Import tariffs on machinery should be reduced, and the pension fund duty cancelled to make tax policy more consistent with investment commitments.

To improve the structure of investments, the sources of investment financing must be reconsidered. The most urgent issues that should be addressed are the following:

• Investment privileges, if any, should be set up in accordance with precise and transparent mechanisms. The problem of investment privileges is one of the most painful in recent times. The unexpected cancellation of free economic zones deteriorated the confidence of investors. While in the Ukrainian case the creation of special economic zones was designed to stimulate investment via tax incentives, the efficiency of this scheme was not proved in full due to the active misuse of these incentives. Therefore, implementation of any tax incentive mechanism requires the elaboration precise and transparent rules. Tax incentives for investors should be mainly focused on research and development. Tax incentives account for almost half in the total incentives provided for research and
development in developed countries, but there are pitfalls in this area that must be carefully treated when designing the policy. The definition of research and development expenditures must be precisely elaborated in order to avoid unnecessary spending in the face of growing competition on the market.

• **Public-private partnership should be developed.** Infrastructure investments such as investments in energy, utilities, transportation, communication etc. should be either completely privately financed or based on public-private partnership (PPP) agreements. PPP agreements should be recognized as a ‘second best’ choice after privatization when investor obtains the possibility to manage the enterprise with minimum investment obligations. This is an additional mechanism for restoring the confidence of investors in Ukraine.

• **In the long run the pension system and life insurance must be developed as alternative sources of investment capital** The most promising domestic source of additional funds for capital markets is the potential savings accumulated by pension funds at the expense of the compulsory state accumulation pension system and the voluntary non-state system of pension savings\(^{39}\). The successful implementation of pension reform promises to create a significant supply of “long money”, that can be invested in bonds and shares. However, the second pillar of the pension system has not been introduced yet, while non-state pension funds are rather young and had accumulated only around UAH 45 m by the end of 2005\(^{40}\). **Therefore, the government should continue pension reform.** The policies described in *Fiscal and Social Chapter* will make it possible to introduce the second pillar of the pension system in 2008. This would insure future pensioners against possible negative demographic trends, and increase the total amount of pension benefits by investing money of the APF. Thus, it would create additional sources of financing for investment in the national economy. So far the importance of the third pillar of pension system for the capital markets has not been large. One of the major problems is the low level of awareness of the population\(^{41}\). Thus, it is important to disseminate information on third pillar of the pension reform. We recommend making the information on the new pension system more accessible, especially for trade unions and labour representatives. Also, initiating cooperation with employers to introduce pension schemes at the company level could be considered.

• **Another source of “long money” is life insurance**, which is a larger source of capital at the moment. By the end of the third quarter of 2005, the reserves of the life insurance companies equalled nearly UAH 300 m. In 2005, shares and bonds accounted for 22% of all reserves. However, as in the case of third pillar of the pension system, the lack of awareness of the population as well as lack of trust in insurance

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40 Interfax-Ukraine information agency (Kyiv, Ukraine), January 30, 2006.
companies restricts the development of life-insurance in Ukraine. Thus it is important to disseminate information to increase awareness of the reliability and efficiency of life insurance.

- **The role of capital markets development in investment financing must be strengthened.** To develop capital markets, the government has to tackle both their demand and the supply sides. On the demand side, it is expedient to use stock exchanges (including PFTS) in future privatisations of state companies, for instance, by floating 10% to 25% of the shares of “strategic” companies on the stock exchange. The supply side of capital can be developed through the swift implementation of the second pillar of the new pension system (see above) and popularising the existing third pillar.

- **Improved regulation aimed at less costly securities issues and relatively low-cost intermediaries will ease access to capital markets as it will give access to capital markets to smaller companies.** In particular, improvement of currency regulation\(^{42}\) will stimulate the supply side of the capital markets. Wider access of world-class credit rating agencies and a more complete regulatory environment will foster competition between credit agencies, provide for professional analysis free of conflict of interest. This will make it easier for lenders to assess risks and will help structure market according to risk level. Overall, more developed capital markets and investment banking institute will allow more efficient flow of funds and give companies cheaper source of funding, thus fostering investment in Ukraine.

To ensure stable economic development, Ukraine badly needs investments. Unfortunately, in 2005 the investment climate deteriorated, stopping the progress of investments in the country. In this situation, the government should direct its efforts towards overcoming the credibility gap and restoring the investment climate in the country, thus stimulating both domestic and foreign investment. The introduction of proposed steps would improve the confidence of investors, stir up investment activity that would lead to the creation of new employment, and keep the Ukrainian economy on a long-term growth path.

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7 In lieu of conclusions

We hope that the new Government with the support of Parliament will be able to adequately react to the challenges that Ukraine faces today. To be able to do so, the government has to clearly understand the nature of these challenges and what can be done to respond to them in a clear way. Thus, instead of traditional conclusions, we decided to once again draw the attention of politicians, experts and public to the list of high-priority problems that require immediate actions.

FISCAL AND SOCIAL POLICY

During the years 2000-2003 Ukraine enjoyed macroeconomic and fiscal stability and major budget reforms were implemented. However, in the summer of 2004 the government abandoned fiscal discipline and initiated a fiscal expansion through sharp multi-stage increases in minimum wages, pensions, and other social obligations of the state. These policies led to growing inflationary pressures and burdened the budget with recurrent expenditures. This made already existing problems of the fiscal system more acute. Furthermore, the ambitious pension reform was derailed and the Pension Fund went into a large deficit.

The challenges in the fiscal system require the implementation of immediate measures and in the long run the implementation of comprehensive reforms. The government should avoid targeting revenues increases to ballooning expenditures and ensure a stable tax policy. At the local level, the government should avoid underfinanced mandates and improve local tax administration. When designing pension policies, the government should reduce the large pension fund deficit by avoiding further minimum pension increases, broadening the contribution base, matching fair participation in the pension payment with a fair participation in contributions to the pension fund, and move early retirement schemes outside the PAYG system. Furthermore, the government should fully implement a Medium Term Expenditure Framework to ensure that fiscal policy is coherent with other policy goals.

THE RESURGENCE OF A CURRENT ACCOUNT DEFICIT

After seven years of current account surplus, a current account deficit emerged in the fourth quarter of 2005. Increased competition and lower prices on world metal markets, growing import gas prices, and high consumer-oriented imports are expected to contribute to maintenance of CA deficit at least for the next several years.

The challenge of a CA deficit requires a clear response by the Ukrainian authorities. In particular, the government has to make sure that the expected CA deficit is sustainable. For this, the Government must improve the sources of the CA deficit, stimulating investments and conducting export-facilitating policies using WTO-compatible instruments. The Government should also continue the policy aimed at improving access for Ukrainian exporters to foreign markets, and trade liberalization policy. To
improve the financing profile of the CA deficit, Ukraine should attract more foreign direct investment, drawing more on the multilateral financial institutions and reducing commercial borrowings abroad. Also, we recommend that the NBU conduct a more flexible exchange rate policy.

ENERGY AND UTILITIES SECTORS

The price increase of Russian gas supplies in January 2006 triggered an energy price shock in Ukraine. It is likely that the price for imported gas will continue to rise until it reaches a competitive level in the region. The immediate implication of the price shock will be significant increases in consumer prices for gas, electricity and public utility services since expenditures for electricity and gas account for the major shares of the costs of utility provision. Given that Ukraine’s energy and utilities sector has already accumulated a range of chronic problems prior the energy price shock, we argue that a simple tariff increase is not an appropriate reaction to this new challenge. The sectors are still in urgent need of reforms to prevent higher-than-necessary price increases while at the same time guaranteeing secure service provision.

To support the measures already undertaken by the Ukrainian authorities we propose number of further regulatory and tariff-setting reforms aimed at creating competitive pressures and providing strong incentives to save energy and to invest in efficient energy-saving technologies. We also propose improving performance and reducing costs of operations thorough appropriate regulatory measures.

AGRICULTURE AND RURAL DEVELOPMENT

Due to expected WTO membership, Ukrainian agriculture and rural areas are approaching a new phase in their development. WTO membership offers a unique chance to implement and leverage a broad range of policy reforms that have been postponed until now.

Three immediate steps are of particular immediate importance: to separate rural development policy goals and instruments from agricultural support policy goals and instruments; to reform fiscal support to agriculture – replace non-transparent, inefficient, unequal and inconsistent production support measures by direct income support and growth enhancing measures; and to lift the moratorium on land sales.

The agriculture strategy program should concentrate on how to improve efficiency and competitiveness, ensure food quality and security, and contribute to preserving nature and the landscape. The rural development strategy program, on the other hand, should deal with delivering social and communal services and infrastructure in rural areas, and supporting non-agricultural economic development in rural areas by supporting small and medium enterprises.

It should be emphasised that a functioning agricultural land market is a precondition for increasing the efficiency and competitiveness of agriculture and an additional source of income for the rural population.
REVITALIZING INVESTMENT ACTIVITY

Currently, investments in Ukraine are much lower than is necessary for the stable development of the economy. Although gross fixed capital accumulation increased by more than 50% in real terms in 2001-2004, this growth was evidently not enough to sufficiently improve the production capacities of many enterprises. The level of obsolete capital remained about 50%. In 2005, almost two-thirds of surveyed enterprises said that the need to replace depreciated equipment was an incentive for investment. Aggravating the problems, in 2005 gross fixed capital accumulation fell by 0.3%, indicating a virtual stop in the progress of investment activity in the country. Although investments revived in the first quarter of 2006, the challenge of avoiding a repetition of the 2005 experience remains. Another underutilized source of investments in Ukraine has been foreign direct investments (FDI).

Reprivatization, inconsistent tax policy, poorly developed institutional mechanisms, excessive regulation and corruption are among the key problems that hamper investment activity in Ukraine. To facilitate investment activities, the state should conduct policies aimed at improving the investment climate. In particular, to renew the confidence of investors, the key issue is to provide long-term guarantees of the security of property rights. Besides, tax policy should be more consistent with investment commitments, and import tariffs on machinery should be reduced. To improve the structure of investments the sources of investment financing must be reconsidered. In particular, public-private partnership (PPP) schemes for infrastructure investments have to be developed, and the role of capital markets strengthened.
# Appendix

## List of proposed reforms

<table>
<thead>
<tr>
<th>Challenges (problems)</th>
<th>Stages and directions of reforms</th>
<th>Proposed steps</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal expansion through multi-stage sharp increases in social obligations</td>
<td>Immediate steps to improve revenue policy</td>
<td>abstain from reintroducing already eliminated sector privileges&lt;br&gt;expand the tax base by continuing the elimination of tax privileges, especially for agricultural producers&lt;br&gt;avoid targeting revenues to previously increased expenditures&lt;br&gt;improve tax administration without violating or amending tax legislation in the course of a fiscal year&lt;br&gt;improve the management of and increase attention to investment needs state owned enterprises</td>
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<td></td>
<td>Immediate steps to improve debt policy</td>
<td>reduce foreign commercial borrowings to the general fund of the budget&lt;br&gt;diversify state borrowing instruments, including offering both short-term and medium-term bonds&lt;br&gt;increase the accessibility of borrowing instruments by establishing bond yields at a level comparable</td>
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with the inflation rate
decrease the scope of government guarantees granted to state agencies and enterprises.

improve the legislation and procedure for domestic bond issuance and circulation:
- ensure transparency by pre-announcing government borrowing plans and auction schedules
- establish special investors relations programs
- improve market infrastructure for domestic bonds’ sales on primary and secondary markets
- foster the development of life insurance, voluntary and compulsory accumulation pension insurance schemes

favour investment loans of the international financial institutions

| Immediate steps to improve intergovernmental relations | ensure full compensation of revenue shortfalls to LGE if land tax exemptions and privileges are granted by the central government
introduce rules according to which all relevant decisions taken by the central government should consider possible consequences for LGE and additional funds must be made available in case of worsening the situation at the local level |
<table>
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<tr>
<th>Immediate steps to facilitate pension system reform</th>
<th>stop further minimum pension increases:</th>
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<tr>
<td></td>
<td>- decouple the minimum pension from the subsistence minimum</td>
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<td></td>
<td>- stop misusing the pension system as an alternative social security system</td>
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<td></td>
<td>- introduce targeted social assistance to the poor as a tax-financed social welfare system</td>
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<td>cancel the formula for pension increases with an automatic indexation to inflation plus 20% of nominal wage growth</td>
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<td></td>
<td>lengthen the contribution period required for women to become eligible for a minimum pension to 25 years</td>
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<td></td>
<td>provide financing for so-called ‘privileged’ pensions from the budget</td>
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<td>revise the payment condition of ‘privileged’ pensions, so that they either be paid only upon attainment of retirement age, or be subject to income and social taxes if paid before an individual reaches retirement age</td>
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<tr>
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<td>move early retirement schemes outside the PAYG</td>
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<tr>
<td>Medium-term steps to reform fiscal policy</td>
<td>Develop and introduce a Medium Term Expenditure Framework</td>
</tr>
<tr>
<td>Current account deficit</td>
<td>Immediate steps to improve the sources of CA deficit</td>
</tr>
<tr>
<td></td>
<td>stimulate overall investment activity</td>
</tr>
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<td></td>
<td>conduct export-stimulating policies using WTO-compatible instruments:</td>
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<td></td>
<td>– develop export promotion organisations that conduct informational and consulting functions</td>
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<td></td>
<td>– continue improving access for Ukrainian exporters to foreign markets</td>
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<td></td>
<td>– continue trade liberalization</td>
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<tr>
<td>Immediate steps to improve the financing of the CA deficit</td>
<td>attract more foreign direct investment (FDI)</td>
</tr>
<tr>
<td></td>
<td>expand the financing through loans from multilateral financial institutions</td>
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<tr>
<td>Increased energy prices</td>
<td>Other immediate steps to ensure the sustainability of CA deficit</td>
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<tr>
<td></td>
<td>rely more on state debt denominated in domestic currency</td>
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<td></td>
<td>start implementing a more flexible exchange rate policy</td>
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<td></td>
<td>stop trying to determine the prices for energy supplies</td>
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<td></td>
<td>introduce a ‘regulated-competitive pricing policy’, under which energy tariffs are set by the companies involved subject to hard budget constraints,</td>
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<td></td>
<td>allow bankruptcy procedures</td>
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<td></td>
<td>introduce targeted subsidies for low-income households to compensate for higher energy prices</td>
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<td></td>
<td>stimulate contract enforcement with respect to payments for energy and energy-intensive public utility services:</td>
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<tr>
<td></td>
<td>- establish contract relations with all users of energy services</td>
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<td></td>
<td>- make it possible to enforce each contract in case of non-compliance regardless of whether the customer is a business client or a private household</td>
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<td></td>
<td>- settle the issue of accumulated debts via restructuring and repayment according to an agreed schedule that does not allow for manipulations of payments for current...</td>
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</tbody>
</table>
| Immediate steps in regulatory reform in energy sector | rethink the current practices and principles of price regulation in the energy sector create a framework for competition in the energy sector:
- concentrate regulatory effort on tariffs for network access (e.g. to power and gas grids) rather than on tariffs for final services
- leave the formation of other components (such as retailing of power and gas or power generation) to competitive market forces redesign the NERC’s regulation to provide more incentives for cost reduction and increased efficiency by switching from the current system of cost-plus (profit cap) regulation with normative profit rates, to ‘price cap’ regulation improve the NERC’s legal foundation by enacting the laws “On the NERC” and “On the wholesale electricity market” ensure the NERC’s financial independence by introducing NERC financing out of a special fund fed by a fixed percentage of the revenues of market operators in addition to direct state financing introduce regulatory norms or a national regulator in the public utilities sector |
| Immediate steps in other reforms in energy sector | encourage competition in the retail electricity and gas markets  
permit the export of domestic gas once the issue of tariff policy is solved  
invite the private sector to participate in public-private partnerships and other forms of cooperation  
allow businesses to operate profitably in the sector  
embark on a full-fledged public awareness campaign to save resources and increase energy efficiency  
initiate the creation of energy saving companies  
stimulate the development of renewable energy resources |
| Immediate steps in reforms in utility sector | set up a central regulator to supervise the activities of the three main utility sectors (water supply, sewerage and heating)  
adopt appropriate legislation to establish independent regulation that guarantees coherency, predictability and the capacity of the regulator, as well as its independence and accountability  
introduce price-cap regulation for an initial period of 2 to 3 years  
make central and local governments responsible for providing direct transfers to needy consumers within their social policies  
inform enterprises about different energy-saving |
<table>
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<tr>
<th>Projects initiated by international institutions encourage municipalities to apply for investment ratings provide guarantees for loans that utilities apply for, e.g. in the frame of the foreseen Borrowing Fund</th>
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<tbody>
<tr>
<td>Second stage of reforms in utility sector move to more advanced incentive-based regulation stimulate private participation in the sector through institutional and legal support, assistance in the preparation of tenders for private investment etc.</td>
</tr>
<tr>
<td>WTO membership as a challenge for agriculture and rural development Immediate steps to separate rural development from agricultural policy draft and adopt a strategy program for Ukrainian agriculture development that would enable and stabilize the agricultural policy environment in Ukraine draft a separate strategy program for rural development</td>
</tr>
<tr>
<td>Immediate steps in reform of fiscal support to agriculture introduce a medium-term planning of the budget expenditures in agriculture differentiate state support to a) agricultural producers and b) rural areas move from production subsidies towards decoupled payments increase the share of ‘green box’ expenditures (especially structural policy measures) at the expense of ‘amber box’ measure expenditures</td>
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<tr>
<td>Phase out tax breaks</td>
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<tr>
<td>create an equal level playing field and equal access for all types of farms</td>
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<td>make the support more transparent and fair by clear definitions of the eligibility criteria</td>
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<tr>
<th>Slow progress in investments</th>
<th>Immediate steps to ensure the security of private property rights</th>
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<tr>
<td></td>
<td>improve juridical and extra-juridical protection of property rights of any size</td>
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<td></td>
<td>develop an efficient and transparent mechanism of privatization and control of the execution of investment obligations</td>
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<td></td>
<td>adopt the law defining the legal status of the State Property Fund and its mechanism of collaboration with Cabinet of Ministers and Parliament</td>
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<td></td>
<td>implement efficiently the law “On joint stock companies”</td>
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<td></td>
<td>continue the simplification of registration procedures (i.e. getting permits) for new enterprises</td>
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<td></td>
<td>introduce capital amnesty</td>
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<tr>
<td>Immediate steps in improving the sources of investment financing</td>
<td>reduce import tariffs on machinery and equipment</td>
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<td>---------------------------------------------------------------</td>
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<tr>
<td>set up a precise and transparent mechanism of investment privileges, if any</td>
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<tr>
<td>streamline the incentives for research and development</td>
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<tr>
<td>develop public-private partnership (PPP) schemes as a “second best” choice for infrastructure investments</td>
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<tr>
<td>develop the pension system and life insurance as alternative sources of investment capital</td>
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<tr>
<td>develop capital markets:</td>
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<tr>
<td>− use stock exchanges (including PFTS) in future privatisations of state companies</td>
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<tr>
<td>− implement the second pillar of the new pension system</td>
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<tr>
<td>− popularise the third pillar of the new pension system</td>
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<tr>
<td>− support the development of credit agencies</td>
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<tr>
<td>− improve currency regulation</td>
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</table>
About the Institute for Economic Research and Policy Consulting

The Institute for Economic Research and Policy Consulting (IER) was founded in October 1999 by top-ranking Ukrainian politicians and the German Advisory Group (GAG) on Economic Reforms with the Ukrainian Government. The IER is jointly financed by the Ukrainian and the German Governments.

Aims of the Institute:

• Work as an independent research organisation that provides decision-makers, inside and outside the Ukrainian government, with analyses of the Ukrainian economy and economic policies;
• Support economic training and analytical capacity of Ukrainian scholars;
• Provide policy advice on the basis of sound economic research.

Principles of work

The IER is dedicated to the principles of democracy and free market economy. Political independence is a prerequisite for the IER if it is to find appropriate answers to questions of economic policy and avoid the manipulation of results. At the same time, close contacts to political decision-makers are needed in order to implement political advice. While the IER develops its own long-term research agenda, it is responsive to short- and medium-term policy issues in Ukraine.

The structure of the Institute and research team

The IER is directed by Igor Burakovsky, Professor at the National University "Kyiv-Mohyla Academy". The Institute is working in close co-operation with the German Advisory Group on Economic Reforms. An intensive know-how and information transfer between the Institute and numerous international and foreign universities and research institutions is pursued. The IER consists of the following Departments:

1) Department of macroeconomic analysis
   • Ukraine and world economy (trade, trade policy, capital flows, competitiveness, WTO accession);
   • Monitoring of the national economy and preparation of short-term forecasts;
   • Monetary and exchange rate policy, development of financial markets and the banking sector.

2) Department of structural reforms
   • Corporate sector reform (privatisation, regulation, competition policy, restructuring of privatized enterprises administration of the state's corporate holdings);
   • Development of small and medium-sized enterprises;
   • Reforms especially in the energy and agricultural sectors and infrastructure.

3) Department of public finance
   • Fiscal policy (budget deficit, tax policy, subsidies, government debt);
   • Regional policy;
   • Social policy and labour markets

Publications

The IER research results are available to the public. The IER issues a Working Paper series, including studies of current Ukrainian topics in economic policymaking. Other publications of the Institute include the MEMU (Monthly Economic Monitoring of Ukraine), IMU (Infrastructure Monitoring for Ukraine), QES (Quarterly Enterprise Survey), Macroeconomic Forecast Ukraine and conference proceedings. Contributions come from the Institute’s staff, the German Advisory Group, and
outside experts. All publications are available on the Internet (http://www.ier.kiev.ua).

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Today the Institute offers its partners and clients various analytical products and services:

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- Economic analysis of legislation
- Working Papers
- Monitoring Products:
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  - Infrastructure Monitoring of Ukraine
  - Business tendencies survey (Quarterly Enterprise Survey),
  - Macroeconomic Forecast for Ukraine,
  - Tax Revenue Outlook for Ukraine
- Comments and articles for mass media
- Statistical databases
- Training seminars for researchers and analysts
- Research on special request

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Academic research at the institute is done in close cooperation with leading international institutions such as:

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- German Institute for Economic Research (DIW) – Berlin (Germany)
- Swiss Institute for Business Cycles Study (KOF/ETH)
- University of Göttingen (Germany)
- The University of Arizona (USA)
- Simon Fraser University (Canada)
- Institute of Economic Forecasting (Russia)
- Institute for Privatisation and Management (Belarus)
- Gdansk Institute of Market Economics (Poland)

Research and policy advisory projects at the institute are done in close cooperation with the following Ukrainian and international institutions:

- Ministry of Economy and European Integration
- National Bank of Ukraine (NBU)
- The World Bank
- United Nations Development Program (UNDP)
- Department for International Development (DFID)
- International Renaissance Foundation
- East West Institute Kyiv Centre
- Institute for European and Regional Studies
- Charles Mott Foundation
- KfW - Bankengruppe
- International Labour Organisation (ILO)
- European Bank for Reconstruction and Development (EBRD)
- Organisation for Economic Co-operation and Development (OECD)
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