

Assessment of the Agenda of the Cabinet of Ministers of Ukraine

December 15, 2014

On December 11, Prime Minister Yatseniuk presented to the Verkhovna Rada a proposed “Agenda of the Cabinet of Ministers of Ukraine” which was subsequently approved by a majority of 269 votes. This document outlined the major elements of the reform process which the Cabinet intends to undertake over the coming two years. It will be critical in guiding the legislative and administrative implementation of the reforms outlined in the Coalition Agreement as well as serving as the basis for operational decisions of the government. Ukraine today is facing the dual crises of an external military aggression and the possibility of a financial meltdown. The actions of the government over the coming months will be critical for the direction and potential for success of the reforms so crucial for the survival of the country.

As international economists, with experience of Ukraine and post-communist economic reforms, we offer our assessment of the proposed Cabinet Agenda in the interest of promoting the best policies for Ukraine. This Agenda is the most progressive and reform oriented action program, which has emanated from any Ukrainian government. If properly implemented, this Agenda offers the potential for a true breakthrough in economic reform. It reflects actions we believe are central to rehabilitating the economy and setting the nation on a path to EU integration, growth and wellbeing for the citizens of Ukraine.

The three most important proposals of the Agenda is that it sees European integration as the anchor of Ukraine’s development, that it faces the financial crisis head on insisting on a cut of public expenditures of 10 percent of GDP, and that it wants to eliminate the main source of corruption through the unification of energy prices at a market level.

We appreciate that the Agenda includes serious measures for the deregulation of economic activity, such as cutting the number of regulatory agencies and transferring or essentially reducing their functions. This will greatly facilitate the operations of business and reduce the opportunity for corrupt bureaucratic practices. Introducing EU product standards will also greatly enhance EU trade and integration.

The creation of a National Anti-Corruption Agency as a preventive body and a National Anti-Corruption Bureau as a law enforcement entity in the first semester of 2015 together with the monitoring of state officials’ lifestyle through public disclosure and transparency of ownership regulation is a very welcome step in the fight against corruption. Properly implemented, such measures have the potential to create a much more hospitable economic environment. It is well established in economic studies that corruption inhibits economic growth and Ukraine is extremely poorly ranked internationally in this regard.

The proposed cancellation of judges’ immunity, re-assessment of all judges, elimination of political influence over the selection process and the renovation of the judiciary system and judicial corps are critical steps toward the establishment of the rule of law. The functioning of a market economy is highly dependent on proper institutions for the resolution of conflicts. As is well recognized in international ratings, Ukraine suffers from wide spread judiciary corruption. As a consequence, both domestic and international business investment is inhibited. Raider activities create major and unnecessary business

risks and prevent the level of investment required to capitalize on the many potential opportunities in the economy. Without the rule of law, international capital will not be attracted to Ukraine and will limit the growth of the economy and its capacity to provide job opportunities.

The Agenda recognizes the major risk to the economy created by the budget deficit and rightly calls for a reduction of expenditures by 10% of GDP in 2015-16. This is an essential step to avoid fiscal chaos because Ukraine's public expenditures are far too large, inefficient not to say corrupt, and no plausible sources of financing are available. The implementation of competitive procurement would help in reducing budget expenditures without social costs. Given the severity of the financial conditions, 10% of GDP in expenditures cuts may not be sufficient.

The proposed tax simplification from 22 to 9 taxes, harmonization of reporting standards and the lowering of the social contribution from 41% to 15% are commendable. Ukraine needs to stimulate small and medium size business to exit from the extensive shadow economy. By broadening the tax base, the rate of taxation can be held to lower levels providing stimulus for investors while still providing the needed funding of the government. At the same time, the control of transfer pricing to prevent tax avoidance and force oligarchic interests to pay a fair share of taxes is fully consistent with proper international practice and fairness.

The Agenda's proposed increase in the list of government owned properties subject to privatization by 1,200 is commendable, however privatization process should start only when transparency and accountability standards are implemented. Efficient regulation of monopolies also have to be in place to safeguard state interest over narrow private sector interests. If implemented properly, privatization provides numerous benefits. Private management reduces the potential for corrupt practises at the expense of the state. At the same time, private ownership reduces the potential subsidies required from the budget by inefficient operations and increases the level of economically efficient investments. A further benefit is one time support of the budgetary expenses which privatization funds can provide. For enterprises remaining in state ownership, the Government Agenda proposes to raise corporate governance standards. Ukraine has to draw on the experience of OECD countries and recent success stories (e.g. Lithuania), to considerably increase return on capital and dividends.

Of major importance is the Agenda's proposal to bring prices in the energy sector to market levels. This is a most critical reform, particularly in respect to the pricing of fuel (natural gas and coal) and heat. The subsidies provided to Naftogaz have in the past approximated 7.5% of GDP and this is the major source of the massive borrowing requirements of the State. The gas and coal market has always served as a major source of corruption. Russia has used improper pricing of gas as an economic weapon making Ukraine artificially dependent on imports from of gas. The underpricing of energy has left Ukraine's economy as one of the most energy inefficient countries in the world. Energy efficiency and diversification measures are of the highest short-term priorities. Energy conservation investments and protection of the most vulnerable groups in society should be supported by diverting part of the gas and coal subsidies being eliminated. These reforms should be implemented with due respect for the rights of foreign investors granted by Energy charter and bilateral treaties. The proposed move to market prices,

together, with the restructuring of Naftogaz, is a major step forward in reform. It should be undertaken now rather than with any delay.

The proposed decentralization of the budget with the allocation of funding and responsibility to lower levels of government is sound. The current system is excessively centralized and is the relic of the inefficient central planning system of Soviet times. Local government should have both the power and the resources to undertake activities which are local in nature. Most market economies function on this principle and the envisioned decentralization should improve efficiency.

The most disappointing area of the Agenda relates to the agricultural sector. The proposed actions exclude the early establishment of a market in agricultural land. Without a market in land, the financing of small and medium farming will continue to be inhibited, restricting the expansion of this sector. With the vast potential in the agricultural sector, it should not be saddled with the populist notion that land should not be traded. This policy works against the interests of the economy overall and, in particular, limits the opportunities of one of the poorest segments of society who are restricted in the choices they have to use their allocated land.

In conclusion, the proposed Agenda of the Cabinet of Ministers offers an exciting prospect of serious reforms with the potential for greatly enhancing economic growth and welfare of the citizens of Ukraine. It calls for some measures which are politically difficult but are unavoidable given the kleptocratic ruination of the economy by the previous regime and the rampant financial crisis. Without the proposed reforms, vital international support and financing from organisations like the IMF, EU, US, World Bank, EBRD and others will not be forthcoming. Political and public support for reforms is crucial and the Government needs to build broad consensus. The key to the future must be the cooperation of all levels of government, the Cabinet of Ministers, the Presidential administration and the Verchovna Rada to implement the proposed reforms and move the country to a European future.

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