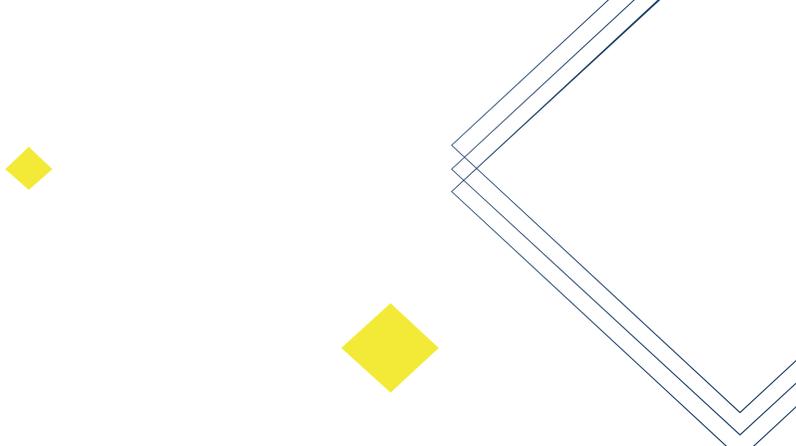


# WHITE BOOK ON REFORMS

2<sup>nd</sup> issue

UKRAINE  
ECONOMY  
WEEK

Productivity



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Kyiv School of Economics (KSE), founded in 1996, is a world-class academic institution with a reputation for excellence both in Ukraine and internationally. KSE offers programs in Economics, Management and Public Policy and Governance, educating the future generation of worldclass economists, business leaders and policy-makers. In doing so, it helps to improve the economic, business and policymaking environments of Ukraine and its neighbouring countries.

Ukraine Economy Week is a series of events organized by Kyiv School of Economics semi-annually — in spring and autumn. For the second year in a row the autumn week is organized in cooperation with ICU and centered around the international financial conference — Ukrainian Financial Forum in Odesa arranged by ICU. This year the Week is supported by the European Bank for Reconstruction and Development.

For the fourth time representatives of business, international organizations, policy makers, researchers and opinion leaders will gather to discuss Ukrainian economy, to share their opinions on recent developments and vision of the future. The objective of the week is to promote a meaningful and inclusive discussion focusing on the most important issues and invoking new ideas.

Kyiv School of Economics is grateful to ICU for the financial support of the Ukrainian Economy Week and this report in particular. The content of this report has been prepared solely by the authors and has not been reviewed by any other individuals or organizations. It represents the views of the authors but not necessarily those of the KSE or ICU.

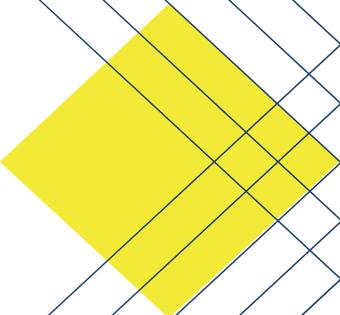
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# Introduction





In the last four years, reforms have been high on the Ukraine's agenda. And while [informed] foreigners are impressed by the progress, many Ukrainians are dissatisfied with the speed or the types of reforms<sup>1</sup>. Those disgruntled by «wrong» reforms can potentially provide electoral support for revanchist or populist forces in upcoming elections. Can those who think that the country is going in the right direction prevent the rollback of reforms? With joint systemic effort – probably yes.

Reforms can be compared to physical exercise. It is not always pleasant to get up early for a run or to sweat in a gym. But we don't do that for the sake of getting up early or sweating. The purpose of exercise is to stay fit to extend years of productive life and withstand possible future challenges.

Likewise, reforms are not done for the sake of reforms. Their objective is to increase productivity and efficiency of resource allocation. Reforms also help build up country's resilience to future shocks and crises and its capacity to exploit opportunities for development. And, like exercise, reforms require consistency and determination to achieve results.

Since 2014 Ukraine introduced multiple critical changes to the «rules of the game» in the economy and society. They serve to level off the playing field and enhance competition, which in its turn raises efficiency. While adopting the laws has not been always easy, the hardest part – implementation of changes – mostly lies ahead. It requires not only proverbial «political will» but professionalism, integrity and institutional capacity.

Unfortunately, as the experience of many countries, including

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<sup>1</sup> E.g. survey of the Centre for Economic Strategy shows that privatization, land market, healthcare and pension reforms are not supported by the majority of people who know their essence. [https://ces.org.ua/wp-content/uploads/2017/11/report\\_critical\\_thinking\\_ukr-FINAL-for-web.pdf](https://ces.org.ua/wp-content/uploads/2017/11/report_critical_thinking_ukr-FINAL-for-web.pdf).

Ukraine, shows, no change is irreversible. Slipping into a vicious circle of «bad policies — economic downturn — the same bad or even worse policies» is always a possibility. Compared to some areas that have undergone sweeping changes, Ukrainian politics remains surprisingly intact. Changing it requires consistent and committed involvement of the society, particularly its most active part — the business and NGOs, — into politics at different levels. This may range from episodic participation in discussions of government plans or watchdog initiatives to running for [elected or appointed] positions within the government, supporting candidates or parties, publicly speaking in favour or against certain policies etc.

Being «above» the politics is a popular narrative. But viewing politics as a «dirty business» is a self-fulfilling expectation. As observed by Plato some 2500 years ago, if good people do not run for an office they end up being governed by people worse than themselves<sup>2</sup>.

*This paper is organized as follows. First, we reconcile the major reforms emphasizing those that have been implemented or started during 2017-2018. Then, we discuss risks and challenges that Ukraine faces — both global and specific for our country.*

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<sup>2</sup> The exact quote: But the chief penalty is to be governed by someone worse if a man will not himself hold office and rule. It is from fear of this, as it appears to me, that the better sort hold office when they do, and then they go to it not in the expectation of enjoyment nor as to a good thing, but as to a necessary evil and because they are unable to turn it over to better men than themselves. (<http://www.perseus.tufts.edu/hopper/text?doc=Perseus%3Atext%3A1999.01.0168%3Abook%3D1%3Asection%3D347c>)

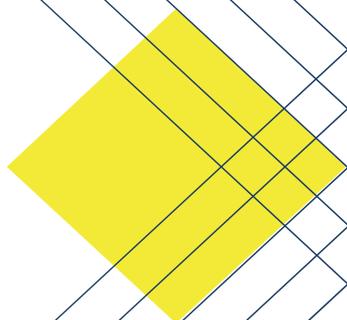




**Part I.**  
Major reforms  
in selected  
sectors



# Monetary policy and the banking sector





## *Prior to September 2017...*

Since the Revolution of Dignity in 2014, the National Bank of Ukraine (NBU) has been a leader of reforms. Indeed, now the landscape of the banking sector and monetary policy is dramatically different. A fixed exchange rate regime was replaced with inflation targeting. The central bank gained a lot of independence from the government. The NBU implemented a massive cleanup in the banking sector to ensure that the financial system has better governance and can withstand adverse shocks. The NBU also radically streamlined its own operations to concentrate on core activities of a central bank and to safeguard good policymaking practices.

Many of these reforms and policies were motivated by the poor macroeconomic performance of the banking sector (and more generally the economy) over the last 20 years.

## *...and recently*

As the NBU achieved macroeconomic stabilization, the central bank has shifted its focus on other aspects of the financial system that have been less critical in the heat of the 2014-2015 crisis but that remain unreformed and thus impede economic growth. These efforts can be grouped in several categories.

First, the crisis required tight capital controls and other regulatory measures to tame the panic and stop the run on banks and the hryvnia. Because the financial system has been gradually recovering from the crisis and gaining more trust of households and firms, the NBU has been steadily loosening these restrictive policies. For example, the NBU lifted a number of restrictions on transactions in foreign currencies. Relatedly, the new law on currency significantly liberalizes foreign-currency operations (subject to macroeconomic stability) and

stability) and modernizes the regulatory framework, which was set by an archaic presidential decree issued in 1993. This policy and subsequent steps will be instrumental in attracting foreign direct investment, an important source of economic growth for Ukraine.

Second, the central bank has been implementing macroprudential policies to align the Ukrainian banking sector with Basel III and other international standards. For example, stress-testing is an integral part of bank supervision now. The central bank is also changing its approach to supervision of banks. Instead of «blanket» inspections, the NBU now uses risk-oriented supervision which requires fewer resources and limits interventions. Finally, because a large share of the banking sector is controlled by state-owned banks (including the nationalized Privatbank) and historically these banks were prone to political pressure and poor performance, macroprudential policies would be incomplete without imposing high-quality governance structure on state-owned banks. While progress in this area has been more limited (largely because it requires action of the government rather than the NBU), the central bank works to keep this a priority. Given the history of banking panics, pervasive related-party lending, and political influence, these policies should reduce the probability of these extremely costly events and practices and thus build a backbone of future economic growth. Indeed, these measures not only integrate Ukraine into the international financial system, but also help build a more robust banking sector.

Third, the NBU has been making progress towards revitalizing credit flows in the economy. For a variety of historical reasons

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<sup>3</sup> «The law on currency and FX operations» #2473-VIII, of 21.06.2018, <http://zakon2.rada.gov.ua/laws/show/2473-19>. The law will come into force in February 2019.

and previous populist policies, banks and other creditors have had hard time in seizing assets of delinquent borrowers. Economic theory and practice are clear that in these circumstances credit is inhibited and allocated inefficiently and so the flow of resources and the level of activity in the economy are suboptimal. Strengthening rights of creditors is a necessary precondition to resume vigorous economic growth. The central bank has been spearheading efforts to alter legislation to give more protection to creditors (this is also one of the IMF's requirements for new tranches). The NBU was also behind efforts to establish a centralized credit registry<sup>4</sup>, a key element in disciplining borrowers and facilitating credit. Although such a registry is not implemented yet, the work is under way.

Fourth, the central bank has raised the policy interest rate on multiple occasions to keep inflation in check. While this anti-inflation policy is hardly popular and it conflicts with various objectives of the government, the policy is vital to establish credibility of the central bank and to protect macroeconomic stability.

### *Risks ahead*

There are two main risks in the monetary sector. First, given looming elections, one may anticipate that in the coming months there will be increasing pressure on the central bank to loosen its policy so that it does not offset expansionary fiscal policy. Whether the NBU succumbs to this fiscal dominance remains a source of uncertainty, but the recent pace of interest rate hikes suggests that the central bank is determined to fulfill its mandate of ensuring low and stable inflation. Second,

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<sup>4</sup> The law «On creation and operation of the NBU credit registry...» # 2277-VII of 06.02.2018, <http://zakon3.rada.gov.ua/laws/show/2277-19>

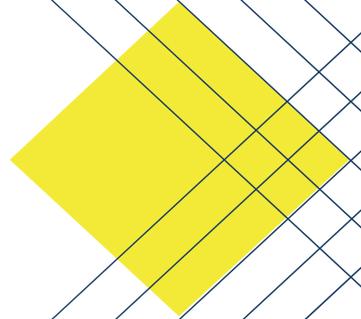
much of macroeconomic environment in Ukraine depends on whether the government can secure new tranches from the IMF. Because the government has so little space for maneuver without fresh injections of IMF loans and because so much is at stake if the government fails to secure the loans (the experience of Turkey paints a vivid picture of what will happen), it would be truly tragic if the government shoots itself in the foot. And yet it is not impossible for this worst-case scenario to happen. If this scenario realizes, the National Bank of Ukraine will have to use all its arsenal to protect banks, the hryvnia, and the economy.

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*Restricted bank financing is often mentioned as an impediment for business development and economic growth in Ukraine. Less frequently mentioned is underdeveloped financial market. Adjustments to the pension system could provide a boost for financial markets and an opportunity for firms to obtain «long» funding. However, as explained in the next section, this is not an immediate perspective.*



# Pension system





Pension system in Ukraine is by over 99% pay-as-you-go (PAYG) system administered by the Pension Fund of Ukraine (PFU). There are 64 private pension funds which form the third level of the system (voluntary accumulative pillar), which has low coverage and plays only a minor role in pension provision. Compulsory accumulative pillar has not been introduced yet. The pension reform law<sup>5</sup> adopted in October 2017 foresees the launch of the second pillar (compulsory personalized savings) in early 2019, however, there is no clear vision of the model design for this pillar, and crucial prerequisites for it are still missing.

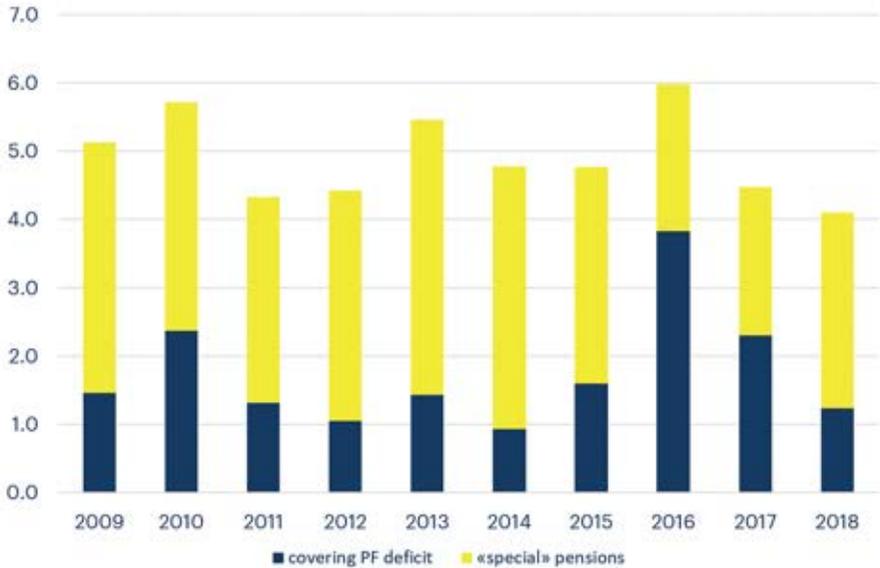
Overall low levels of trust to the government, high political and economic volatility result in both employees and employers preferring salaries «in envelopes» (and sometimes in foreign currency). Employers pay lower taxes, employees receive slightly higher salaries. As a result, Pension Fund has been running deficits since 2009 (and occasionally prior to that) – Figure 1. Cutting the rate of Social Security Contribution from 43-47% to 22% in 2016 did not bring expected deshadowing of salaries – instead, it widened the Pension Fund deficit. Doubling of the minimal salary since 2017 was helpful in increasing PFU revenues but may have had an adverse effect on employment (to the best of our knowledge, no research on the issue is available at the moment).

The main goal of the pension reform was strengthening the link between tenure during which a person made contributions to the Pension Fund and his/her old age pension. The minimum tenure to be eligible for an old age pension increased from 15 to 25 years in 2018 and will gradually rise to 35 years by 2028.

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<sup>5</sup> Verkhovna Rada of Ukraine (VRU). 2017. The Law on Amendments to Certain Legislative Acts of Ukraine on Pensions Increase. 2148-VIII of October 3, 2017. <http://zakon.rada.gov.ua/laws/show/2148-19>

Figure 1. Transfers to the Pension Fund from the State Budget, per cent of GDP



Data source: State Statistics Service, State Treasury

Although formally the retirement age remains at 60 for both sexes, those with lower tenure will retire later – at 63 or 65 depending on the duration of their employment. Thus, it is expected that people willing to receive a PAYG pension will be more motivated to find a formal employment. However, to fully realize this expectation, a major revision of the labour legislation is needed. In particular, simplification of procedures for official hiring and firing would reduce incentives for employers to offer insecure (informal) arrangements to their employees.<sup>6</sup>

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<sup>6</sup> The draft of the new Labour Code (#1658) is in the parliament since September 2014 and has been adopted in the first reading in November 2015. Since then, it has been discussed within the parliament: [http://w1.c1.rada.gov.ua/pls/zweb2/webproc4\\_1?pf3511=53221](http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=53221)

The last-year law made pension system more equal by eliminating «special» (privileged) pensions, except for the military. Previously granted special pensions (to state officials, MPs, prosecutors, journalists, scientists and some other) remain but they will not be adjusted for inflation anymore. Therefore, the fiscal burden of these higher pensions will fade out gradually.

Apart from that, the law implied revision of current pensions based on the average wage over 2014-2016 and eliminated discrimination<sup>7</sup> of people who retired earlier. Further revision of pensions should be performed automatically every year: average salary used for calculation of pensions will be increased by 50% of three-year average wage growth plus 50% of the previous-year inflation (CPI).

The full effect of the reform can be assessed only in the long run although the government expects PFU to reach zero deficit in 2024.

In addition to PAYG system reform, the law foresees introduction of the second pillar of the pension system based on compulsory personalized contributions. According to the law, accumulation of contributions should start in January 2019, although there is no agreement on the exact mechanism for implementation of this clause.

There are two main ideas for this mechanism.

The first idea, the so-called decentralized model, is laid out in

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<sup>7</sup> A formula for calculation of a pension includes coefficient based on person's duration of employment, ratio of her salary to average wage in the economy during respective time, and average wage in the country. But average wage used for calculation of pensions was not adjusted automatically – for example, before the increase in 2017, 2007 average wage was used. Thus people who retired earlier, other things being equal, had lower pensions.

a draft law<sup>8</sup> registered in the parliament by 59 MPs. According to this draft law, compulsory personalized contributions — starting from 2% of the wage in 2019 and gradually rising to 7% in 2024 — should accumulate in private pension funds. At the point of retirement money thus accumulated will be used to buy the annuity life insurance. An alternative idea<sup>9</sup> (a centralized model) is offered by the National Securities and Stock Market Commission. They suggest pooling all compulsory contributions into a single Savings Fund which will be managed by a competitively selected asset management company or several companies.

Since these ideas are radically different and neither has made it into the law yet, we think that probability of introducing the second pillar of the pension system in 2019 is extremely small. In any case, a necessary prerequisite for that would be much tighter and sophisticated oversight of asset managers, including private pension funds and insurance companies.

Unlike the banking system, private pension funds and asset management companies did not undergo a major cleanup — so probably there are quite a few "lemons" among them. Under the first model, the responsibility to choose a proper pension fund and trace its financial performance lies with an individual. The regulator, which is currently State Commission for Regulation of Financial Services Markets of Ukraine (SCRFSM), is weak. Reform of the regulator started in 2015 and essentially stopped at the draft laws stage which remain in the parliament despite multiple promises to adopt them. The most

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<sup>8</sup> Verkhovna Rada of Ukraine (VRU). 2018. Draft Law on Amendments to Certain Legislative Acts of Ukraine on Accumulative System of Compulsory State Pension Insurance. 6677 of July 10, 2017. [http://w1.c1.rada.gov.ua/pls/zweb2/webproc4\\_1?pf3511=62218](http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=62218)

<sup>9</sup> National Securities and Stock Market Commission (2018) Draft Law on the Accumulative System of Compulsory State Pension Insurance (not registered) of June 26, 2018. <https://www.nssmc.gov.ua/projects-of-regular/proekt-zakonu-ukrani-pro-zagalynoobovnyazkove-nako-pitchuvalyne-pensyne-zabezpetchennya/>

important part of the reform is elimination of current regulator and split<sup>10</sup> of its functions between the National Bank of Ukraine (oversight of insurance and leasing companies, credit unions, credit bureaus and other non-bank lenders, pawnshops and other financial companies) and National Securities and Stock Market Commission (NSSMC will deal with private pension funds, issuers of mortgage certificates, funds for construction financing, and real estate funds) in order to consolidate control over the financial markets.

Another part of the reform aims at strengthening NSSMC<sup>11</sup> independence and aligning the stock market regulation with IOSCO Principles with a view for Ukraine to become a signatory of IOSCO Multilateral Memorandum of Understanding. The draft law which introduces these provisions is criticized by market participants. They point at an excessive increase of the commission powers and respective corruption risks.

The major obstacles to the pension reform — macroeconomic and political risks — are still in place and likely to remain. Given the history of wrong macroeconomic policies (e.g. exchange rate fixing) and poor property rights protection, financial instruments suitable for long-term investment are still missing. The sector of voluntary pension savings emerged in 2005 but bitterly suffered from economic crises in 2008-2009 and 2014-2015. Today its total assets amount to UAH 2,47 billion (~USD 88 million or 0.08% of GDP) and only about 841 thousand people participate in it.

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<sup>10</sup> Verkhovna Rada of Ukraine (VRU). 2018. Draft Law on Amendments to Certain Legislative Acts of Ukraine on the consolidation of the functions of state regulation of financial services markets. 2413a of July 20, 2015. [http://w1.c1.rada.gov.ua/pls/zweb2/webproc4\\_1?pf3511=56124](http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=56124)

<sup>11</sup> Verkhovna Rada of Ukraine (VRU). 2018. Draft Law on Amendments to Certain Legislative Acts of Ukraine to Protect Investors against Abuse in the Capital Markets. 6303-д of July 4, 2018. [http://w1.c1.rada.gov.ua/pls/zweb2/webproc4\\_1?pf3511=64343](http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=64343)

Overall, we see three crucial conditions for the introduction of full-scale accumulative pillar of the pension system:

- 1) sound macroeconomic policies that make the future more predictable. These are mostly being implemented (inflation targeting is an example).
- 2) successful judiciary and law enforcement reform to guarantee property rights protection. This reform is ongoing and its result is uncertain at this point.
- 3) wise oversight of financial markets to lower the risks of long-term savings.

Successful implementation of the second pillar highly depends on the broader context of reforms, while introduction of compulsory savings without necessary prerequisites may force a larger part of salaries to the envelopes and may require future government spending to bail out private pension funds and insurance companies.

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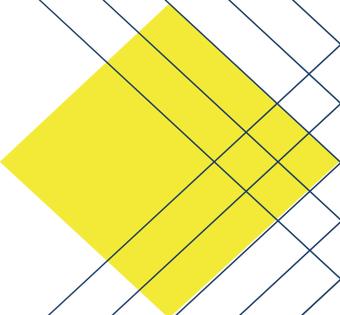
*Falling share of working-age population is a problem practically in all developed and in some emerging market countries. While setting the pension system right certainly helps, the only long-term response to this trend that would allow sustain growth is raising labour productivity and labour force participation rate through better quality education and healthcare systems. Reforms in these sectors are discussed next.*

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<sup>12</sup> State Commission for Regulation of Financial Services Markets of Ukraine (SCRFMSU). 2018. Results of the development of the system of non-state pension provision as of 31.12.2017 (in Ukrainian). [https://www.nfp.gov.ua/files/17\\_Dep\\_Repetska/NPF\\_IV\\_kv%202017.pdf](https://www.nfp.gov.ua/files/17_Dep_Repetska/NPF_IV_kv%202017.pdf)



# Education





## *Prior to September 2017...*

Education reforms started with adoption of the law «On higher education» in 2014. The law introduced more competition and fairness into the system. In 2015, the new law «On science» was adopted which opened up opportunities for young Ukrainian scientists, although positions of the «old guard» remained intact. In 2017, the National Science Council was created for coordination of policies towards science and innovation. In September 2017 the new law «On education» was adopted, which has laid the ground for launching the 'New Ukrainian School'<sup>13</sup> reform plan in Ukraine. This plan is perhaps the most important part of education reform since secondary education is the basic public service aimed at leveling the opportunities for children with different backgrounds – and thus should be of equally high quality across the country. Yet, full-scale school reform would require adoption of another law — «On secondary education» — which is being developed by the Ministry of Education and Science of Ukraine.

## *...and recently*

### **Schools**

Since adoption of the law «On education», large amount of public funds has been spent on the program «New Ukrainian School»,<sup>14</sup> namely on the primary education: development of the new curricula, retraining of teachers, writing new textbooks. Teachers' salaries in 2018 increased by more than 60% compared to 2017. Local governments that received more freedom in spending as a result of decentralization reform are renovating schools and providing new equipment for them.

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<sup>13</sup> <http://nus.org.ua/>

<sup>14</sup> Over UAH 2 billion is allocated to this program in 2018.

The reform faced its first difficulties because due to low institutional capacity many local authorities were unable to use up all the funding available for schools.

### *New system of primary school admissions*

Admission to the primary school remained a grey zone for a long period. According to the legislation parents had to send their kids to their (nearest) local schools, but the reality was much more complicated. Parents would pay bribes to get their kids to better schools, which led to even stronger leeway of less prestigious schools. In spring 2018 the Ministry of Education changed the approach and strengthened the regulations which directly link kids to their local schools. This induced a strong opposition from many parents who were planning to send their kids to more «elite» schools. Many parental groups reported that the system of bribes has just changed its form — the parents now had to bribe not the schoolmasters but officials who would change their official address, thus giving them access to «better» schools. Yet despite these problems the government remains committed to the idea that children have to study at their local schools.

### *Remaining problems*

Despite the start of the comprehensive reform, many problems remain. One of the biggest issues is highly inefficient school network. There are a few hundred of miniscule schools with less than 5 pupils in class. This leads to a very high cost per individual student (as these schools still need a basic set of teachers for different courses, administrative staff etc.), yet the learning outcomes of such students are very poor. Generally, children from rural schools on average have lower test results. The school network needs to be adjusted to the demographic

changes. The decision to close down schools is made by the local authorities<sup>15</sup> and is never a popular one. Hence, there is a need for clearer policy regarding this problem since this is a major impediment for the success of the «New Ukrainian School».

Educational inequality remains a major problem too, particularly in city schools. Better-off parents still rely heavily on private tutors to prepare their children for the university admission exams.

The next steps of the reform include the new curriculum for secondary schools, launch of the certification system for teachers, further retraining of teachers and modernization of study programs of pedagogical universities.

## Higher Education and Research

Recently the National Science Council developed a draft of a new Ministry of Education procedure according to which in order to get a candidate of sciences and doctor of sciences degree an applicant must have publications in journals listed in Web of Science or Scopus, international databases of reliable peer-reviewed journals. Similar requirements were enacted in 2015 for docent and professor academic titles. Yet, this time the idea caused much ado among the scientific community, with representatives of sciences mostly supporting it and many representatives of humanities and social sciences opposing it. As of now, the issue is undecided.<sup>16</sup>

In July 2018 the Ministry of Education approved the operational

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<sup>15</sup> Children in this case should be bused to the nearest available or a «district» school.

<sup>16</sup> For a comprehensive discussion of the problem see R.Cherniga «Ukraine without science» <https://voxukraine.org/uk/ukrayina-bez-nauki-abo-yak-provalili-sprobu-naukovogo-komitetu-zupiniti-val-fejkovich-disertatsij/>

procedures for the National Repository of academic texts. The repository will be a useful instrument for uncovering plagiarism.<sup>17</sup>

Some minor changes have taken place with respect to university admissions. Ministry of Health succeeded in tightening admission requirements for applicants to medical schools. Up until 2017 medical schools would admit any applicant as long as she/he was willing to pay the tuition, which surely drove down the overall quality of students and thus resulted in poor average quality of medical training. The Ministry of Education announced that admission requirements would be tightened in a similar way for law schools starting 2019.

To reduce corruption within universities, external testing for entering the MA level was introduced for law, humanities, social sciences, journalism, and international relations. Gradually, post-BA external testing will be extended to other specialties. Simultaneously, the Ministry of Education is reviewing the list of specialties and respective curricula offered by universities with the aim of providing more universal education to students.

### *Risks ahead*

There is always a risk of the roll-back of reforms. Yet, in case of secondary education the major challenge is engraining the reform. A full-scale reform requires adoption of the law «On secondary education»<sup>18</sup> which would elaborate many of the

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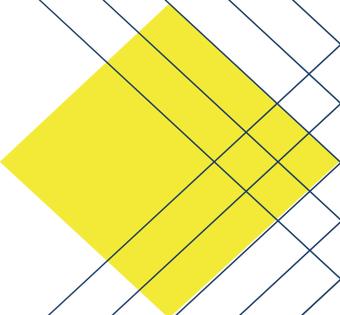
<sup>17</sup> However, as some cases show, even proven plagiarism does not always lead to professional consequences for a person. The idea of academic integrity is not well implanted into Ukrainian science and education yet.

<sup>18</sup> A draft is available on the MoE web-site: <https://mon.gov.ua/ua/news/mon-proponuye-dly-a-gromadskogo-o-govorenniya-proekt-zakonu-ukrayini-pro-povnu-zagalnu-serednyu-osvitu>

ideas that are now being discussed. Yet its adoption in the election year is rather unlikely, and if passed it may be largely a result of a compromise and thus might leave many things unchanged.

Concentration on the secondary school reform leaves things hanging for vocational colleges and universities. The higher education reform launched in 2014 is being torn by political impasses and thus the future of universities is vague.

# Healthcare





## *Prior to September 2017...*

The healthcare reform was perhaps the hardest to pass through. Nevertheless, the main reformist legislation is already in place. The law «On state guarantees in healthcare»<sup>19</sup> was passed by the parliament in October 2017 and signed by the president in December 2017. The law foresees gradual introduction of «money follows the patient» principle. Prior to that, in April 2017, the law on autonomization of healthcare facilities was adopted. In 2015, facility-level financing from the State Budget was replaced by medical subvention making local governments free to decide on the distribution of funds between facilities in their regions.

The main ideas of the healthcare reform are as follows:

- There is no free healthcare (despite what Ukrainian Constitution says). Since public funds in Ukraine are limited, the focus is shifted from hospital care (which now consumes over 60% of total healthcare budget and is extremely inefficient) to cheaper and more efficient solutions — prevention and early treatment or control of chronic diseases.
- Setting the incentives right. A well-known drawback of tax-financed healthcare, especially when «payment per service» mechanism is applied, is an incentive for both patients and doctors to overuse the system — i.e. doctors prescribe unnecessary procedures or drugs and patients refer themselves to specialists or hospitals or call emergency brigades without the actual need to do so. No country has yet found a comprehensive solution to this problem. However, a menu of partial solutions exists: payment per treated case that relies on medical protocols and Diagnostically-Related Groups

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<sup>19</sup> <http://zakon5.rada.gov.ua/laws/show/2168-19>

(currently being introduced in Ukraine), mandatory referrals from family doctors to specialists and hospitals (introduced), co-payments of patients or small fees per visit (not adopted by the Parliament).

The market for pharmaceuticals used to be one of the biggest sources of rent for healthcare officials and doctors. In 2015, centralized public drug procurement was transferred from the Ministry of Health to international organizations. Since the process took several months, there were delays in drug supplies to facilities in 2015-2016. However, this decision allowed to use the money more effectively and thus to provide more patients with necessary treatment. Still, this was a temporary measure. Since 2019 procurement of drugs should be transferred from international organizations back to the Ukrainian government, and a special agency is now being created to perform this function.

To prevent doctors from prescribing dubious drugs, the National List of Essential Medicines was aligned with the WHO Model List of Essential Medicines. The hospitals are obliged first to buy drugs from the List and then all other drugs. Likewise, the government reimburses only those drugs which are on the List.

The Accessible Drugs program now covers 239 drugs. The Ministry of Health (MoH) reports that during the year since the launch of the program the government reimbursed about 20 million recipes for almost UAH 1 billion under this program. The program effect is too early to assess but according to MoH, during the first year of the program there were 4.2% less emergency calls related to heart diseases and 5.7% less emergency calls related to asthma, compared to the previous year. Also, 7% more patients with type II diabetes had their level of blood sugar normalized.

*...and recently*

At the moment, the «money follows the patient» principle introduced by the reform is being implemented at the primary level. As of September 10th, over 17 million Ukrainians have signed declarations with their family doctors.<sup>20</sup> These declarations are included into the E-health system which:

- links doctors and patients and keeps track of visits and provided services;
- allows National Healthcare Service pay doctors and facilities according to the actual number of their patients;
- in the future will provide enough data to analyze efficiency of particular treatment schemes or policy interventions.

Primary care doctors and facilities are getting a fixed sum per patient<sup>21</sup> (Table 1). They also have limits on the number of patients they can «take on» — from 900 for pediatricians to 2000 for general physicians (in rural areas these limits can be exceeded).

Thus, if a family doctor serves 2000 patients aged 18-39, (s)he will get about UAH 62 thousand per month. Even taking into account taxes and incurred cost, this is a considerable salary increase.<sup>22</sup>

In August 2018, the newly created National Health Service (the centralized procurement agency for healthcare services) has already paid over UAH 250 million for providing primary care

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<sup>20</sup> E-health data

<sup>21</sup> They are not paid per service to provide incentives for them to keep their patients healthy.

<sup>22</sup> According to the Ukrstat, average salary in healthcare in the first half of 2018 was UAH 5645.

Table 1. Payments to primary care facilities or family doctors

Age of patients	Coefficient	Payment per patient in 2018, UAH
0-5	4	1480
6-17	2.2	814
18-39	1	370
40-64	1.2	444
65+	2	740
Additional coefficient for mountainous areas = 1.25 Payment to healthcare facilities for patients who did not sign the declaration = UAH 240		

Source: Ministry of Health

to patients to 154 public and private facilities that signed contracts with it.<sup>23</sup>

Reforming of secondary and tertiary healthcare levels is planned for the next 3-5 years. This reform is much more complicated than for the primary level since at these levels payments per service have to be introduced. For this, cost of service needs to be calculated, which is not a trivial task. Cost of service includes many components — salary of a doctor and support staff, drugs and materials, communal and

<sup>23</sup> MoH press-release: <http://moz.gov.ua/article/reform-plan/medichni-zakladi-vdruge-otrima-li-oplati-vid-naclsuzhbi-zdorov'ja>

administrative services etc., and linking parts of fixed cost to a specific service can be tricky. At the moment, several technical assistance projects in Ukraine are working on the issue.

If hospitals are paid per service, some of them (or some departments of them) that do not provide sufficient quantity of services will become redundant. This will bring forward the politically sensitive issue of restructuring hospital network via creation of hospital districts. Hospital districts should be created<sup>24</sup> by local governments taking into account the quantity of population, available infrastructure (transportation of a patient to the emergency room should not take more than 60 minutes) and quality of existing facilities. In a district, all advanced healthcare services will be concentrated in one or two «main» hospitals. A primary level main district facility would need to serve at least 120 thousand patients per year, and a secondary level hospital — at least 200 thousand patients (less in scarcely populated or mountainous areas). Hospitals that do not have enough patients will be converted into polyclinics or diagnostic centres, hospices, rehabilitation centres etc.<sup>25</sup>

Another direction of reform pursued by the Ministry of Health is raising the quality of doctors. It starts with medical students — thus, minimum score for after-school universal exam for admission to medical universities was set at 150 out of 200. Besides, international exams for students of medical institutions are being introduced, which has led to conflicts with heads of those institutions (the most prominent is the case of Bohomolets medical university, where the litigation between its rector and MoH lasts for over 1.5 years).

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<sup>24</sup> Cabinet of Ministers Decree #932 of November 30, 2016. <https://www.kmu.gov.ua/ua/npas/249582611>

<sup>25</sup> Closing down healthcare facilities is prohibited by the Constitution.

Quality of acting doctors will be compared to the WHO standards — licenses of facilities or departments in which doctors do not perform a minimum number of procedures recommended by WHO will not be renewed.

### *Risks ahead*

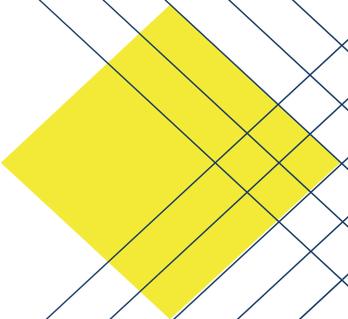
Acting Minister of Health and her team are constantly attacked by incumbents — starting from medical facility managers and rectors of medical institutions to MPs. This should not come as a surprise since the volume of shadow and semi-official cash flows in healthcare is roughly equal to its public financing. So the main risk for the healthcare reform is political — the current parliament does not have enough votes to appoint Ms Suprun a minister, and the next parliament would probably be even less likely to do that. Her replacement with someone supported by incumbents would probably lead to the reversal of the reform and further deterioration of the healthcare system.

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*The simplest economic models tell us that markets are efficient. More complicated models say that this is not always the case and propose instruments to correct market failures. Absence of markets though is viewed as an inferior outcome compared to both free and regulated markets. The markets (or absence of those) for two essential commodities — energy and land – are discussed next.*



# Energy





Before 2015 Ukraine suffered from chronic distortions in the energy market, which largely caused the public finance crisis in the early in 2014 amid the armed conflict in Eastern Ukraine and the annexation of Crimea.

The problems included cross-subsidization (low tariffs for households and high for industrial consumers), monopolization of the sector in view of a weak regulator, absence of metering devices (except for electricity) in the majority of households, meager infrastructure investment (substantial energy losses on the way from producer to consumer), and subsidies to the «chronically» loss-making coal industry, to name just a few.

The highest losses stemmed from distortions in the gas market described in detail in the last year White Book. They resulted in Naftogas deficit of 5.3% of GDP at the end of 2014, higher than the State Budget deficit at that time.

In 2015 the new law «On the natural gas market»<sup>26</sup> was adopted. The law liberalizes the market in line with the requirements of the European Energy Community and prescribes separation of gas networks and fuel suppliers. Sellers can now compete for customers, who in turn received the right to freely choose a supplier. This allowed to replace administrative regulation with market prices. Still, the reform is implemented only for industrial consumers and public entities. Extension of the new law to the sector of natural gas consumption by households and district heating companies has been postponed by the government decision<sup>27</sup> (which expires in October 2018) to artificially reduce gas prices for households, which are now almost twice lower than market prices.

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<sup>26</sup> #329-VIII of April 9th 2015, <http://zakon.rada.gov.ua/laws/show/329-19>

<sup>27</sup> Decree #187 of March 22nd 2017, extended by Decree #669 of August 29th 2018.

At the same time, the prices for industry and public institutions are now set on the basis of supply and demand, and this case is probably the most successful reform in the energy sector over the past four years. Thus according to the calculations of Kyiv School of Economics based on the data of the national procurement system Prozorro<sup>28</sup>, from 2016 (when the new law was enacted) to 2018 the number of natural gas sellers working with public institutions has increased from 160 to 450 companies. Moreover, our last year calculations<sup>29</sup> showed that prices at which gas was procured through auctions were 3% lower than prices under the negotiation procedure (when buyers were willing or forced not to use the opportunities provided by the new law). In 2018, this difference increased: the average price of natural gas at an auction was 13% lower than under the negotiation procedure (UAH 9 vs UAH 10.4 for one cubic meter).

Ceasing to regulate prices for households and district heating companies as well as leveling them off with the market prices will have long-term positive effects<sup>30</sup> for both suppliers and consumers, conditional on monetization of subsidies to those groups of consumers who currently cannot afford to pay market prices for the natural gas. At the same time, it is one of the most politically sensitive issues for the authorities, especially in view of the presidential and parliamentary elections. However, this is also one of the crucial conditions for securing the financial support from the IMF. Although until recently the government refused to discuss the liberalization of gas prices for households, the latest statement by the Prime

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<sup>28</sup> <http://bi.prozorro.org>

<sup>29</sup> The research paper «Three sources of losses for the economy at the natural gas market», April 2017 <http://cep.kse.org.ua/article/3-Problems-of-Gas-Procurement/index.html>

<sup>30</sup> See Tymofiy Mylovanov, Ilona Sologoub, «The economics of the market gas price», KSE Voice article of 03.09.208, <https://www.epravda.com.ua/publications/2018/09/3/640149/>

Minister Volodymyr Groysman<sup>31</sup> reveals understanding of inevitability of this step. The only remaining question is the specific implementation scheme for this decision.

The blueprints of the gas market reform will be applied to the electricity market since 2019, according to the law «On the electricity market»<sup>32</sup> adopted in 2017. During 2018 the national energy market regulator (National Energy and Utilities Regulatory Commission — NEURC) approved the codes of transmission system, of electricity distribution and commercial measurement systems as well as the draft of market regulations, draft rules for the day-ahead market, the daily market and the electricity retail market and other. The new rules for the electricity market aim at abandoning administrative pricing and demonopolization of the market. This means that customers will be able to freely choose a supplier, and owners of the resource will set tariffs so as to attract consumers. Currently the main risk for introduction of this reform is the same as for the household gas market, i.e. a large gap between household prices and market prices. Today, Ukraine is probably the only country in Europe where industry tariffs are higher than household tariffs, i.e. there is a cross-subsidization (Figure 2).

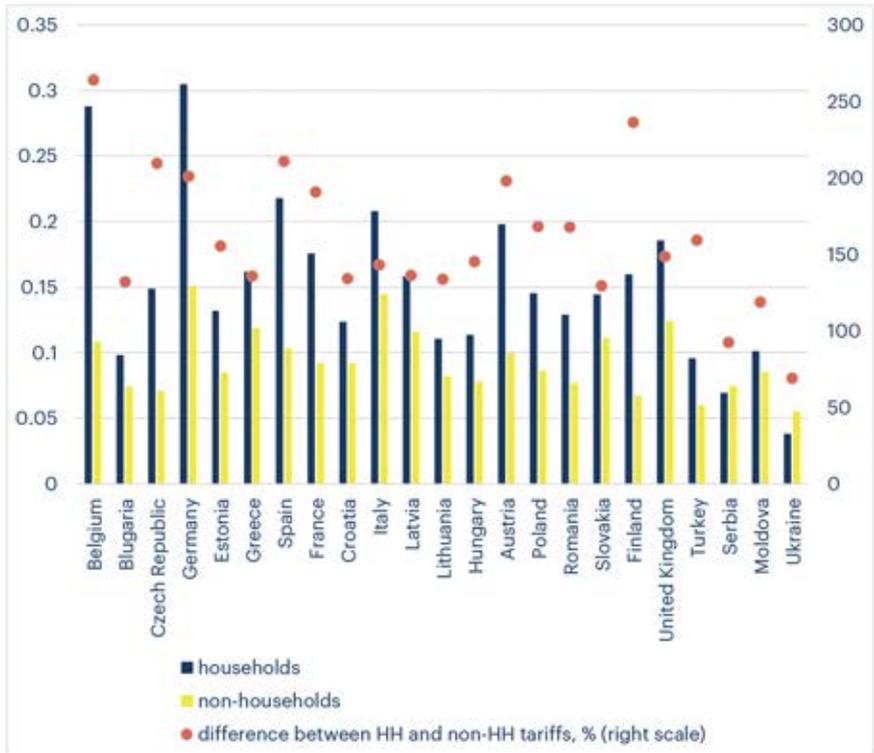
The situation with the liberalization of household gas and electricity prices clearly demonstrates the main problem of the energy market: there is a consensus on the need for reforms but there is no common vision (of the government, industry regulators, members of parliament) of specific mechanisms for their implementation. That is why the projects on RAB-regulation in the electricity distribution market and auctions for the «green tariff» (which is now the highest in

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<sup>31</sup> The news of 04.09.2018, <https://www.epravda.com.ua/news/2018/09/4/640176/>

<sup>32</sup> #2109-VIII of 17.04.2017, <http://zakon.rada.gov.ua/laws/show/2019-19>

Figure 2. Electricity tariffs for household and non-household consumers in selected European countries, second half of 2017



Data source: Eurostat

Europe) are not implemented; there is still no universal natural gas metering, energy subsidies are not monetized, there is no payment for usage of gas networks, promises to start auctioning rights for extraction of natural resources (namely oil and gas) remain just promises, there has been no reform of highly subsidized coal mining, there is no daily gas balancing etc.

Consider the example of RAB tariffs. All stakeholders agree that this is a progressive regulation which will increase investment attractiveness of electricity networks and will provide incentives for renovation of worn-out grids. But the formula proposed by the regulator (12.5% of revenues for both old and new assets) was sharply criticized by the government. Thus, currently it is effective only for Ukrenergo and not for all distribution companies.

The main legislative acts on energy reform have already been adopted. Now they need to be implemented. Implementation is mostly the responsibility of the national regulator (NEURC). In 2016 Verkhovna Rada adopted the law «On the National Energy and Utilities Regulatory Commission»<sup>33</sup> which strengthened independence of the Commission and introduced a competitive procedure for appointment of its members (whereas previously they were appointed by the President of Ukraine). The newly elected NEURC members<sup>34</sup> took the office in 2018. They will be responsible for solving many complicated problems of reform implementation in specific energy markets.

### *Risks ahead*

Russia has been working on the idea of excluding Ukraine from its European gas supply chain for over a decade. Now it has come very close to realization of this idea. From the technical point of view — it needs only to construct the second<sup>33</sup> line of the «North Stream» pipeline via Baltic Sea and complete the «Turkish stream» pipeline in the Black Sea, which is quite a feasible task for the next 2-3 years. The main obstacles to these projects are political. Some EU countries (former USSR and

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<sup>33</sup> #1540-VIII of 22.09.2016, <http://zakon2.rada.gov.ua/laws/show/1540-19>

<sup>34</sup> <http://www.nerc.gov.ua/?id=11810>

Eastern Europe) raise their voice against increased presence of Gazprom in Europe. Some countries, notably Germany, support construction of the North Stream-II, in particular arguing that the project is just business and implemented by private companies — so that EU governments cannot restrict its implementation.

The US does not support construction of the pipeline citing security reasons (namely, possible intensification of Russian military presence in the Baltic Sea). But at the same time it pursues economic interest — widening the market for its liquefied natural gas in Europe. In principle, the US can apply sanctions to companies that participate in the project (e.g. supply pipes or perform construction works) to prevent construction of the pipeline. However, the US readiness to use this instrument is unknown.

The European Commission hopes, if the North Stream-II is completed, to force Gazprom to comply with the EU Third Energy Package. This implies that other natural gas suppliers such as Rosneft or Novatek will be able to sign direct contracts with European consumers and use Gazprom transit network under non-discriminatory conditions.<sup>35</sup> However, it's unclear whether Gazprom will comply with this regulation even if it signs on to it.

According to the Naftogas reform Strategy, its gas transportation division should become an independent company, and this company should attract a large European operator to jointly manage the Ukrainian gas transit system. Last year, Naftogas signed Memorandums of Understanding with a few companies interested in this opportunity.

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<sup>35</sup> Currently, Gazprom monopsonically buys all the gas extracted by independent producers and sells it to Europe at a profit.

However, since late 2017 finding a foreign partner for this enterprise is the task of a special working group within the government. At the beginning of 2018 this working group announced that 10 European companies were interested in cooperation with «Long-distance Ukrainian Pipelines».<sup>36</sup> However, the competition to define a partner company has not been announced yet.

Transit contract of Naftogas with the Gazprom expires on December 31st 2019. However, Gazprom CEO Alexey Miller announced that they were willing to terminate the contract in March 2018, after they lost the case to Naftogas. Today, Naftogaz is suing Gazprom for this decision. Given all the circumstances, signing a new contract for gas transit through Ukraine is unlikely (at least it requires a strong united position of the EU and the US).

Thus, Ukraine must get ready for consequences of termination of gas transit through its territory. These are:

- 1) loss of up to \$3 billion of transit fees (currently about 2.6 per cent of GDP);
- 2) possible reduction of gas imports from Europe (if Gazprom refuses to supply to Eastern European countries the necessary volumes of gas for Ukraine);
- 3) possible escalation of military conflict in Donbas.

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<sup>36</sup> Government announcement of 22.03.2018

In view of these challenges, Ukraine needs to develop domestic energy production, strengthen its army and promote economic growth. More specifically,

1) to complete the energy market reforms, including leveling off the prices for all consumers. Simultaneously, a single database of recipients of social support should be completed. This database will allow for more efficient provision of subsidies;

2) to start auctioning rights for extraction of natural resources; to increase natural gas extraction by state-owned «UkrGasbydobyvannya» company;

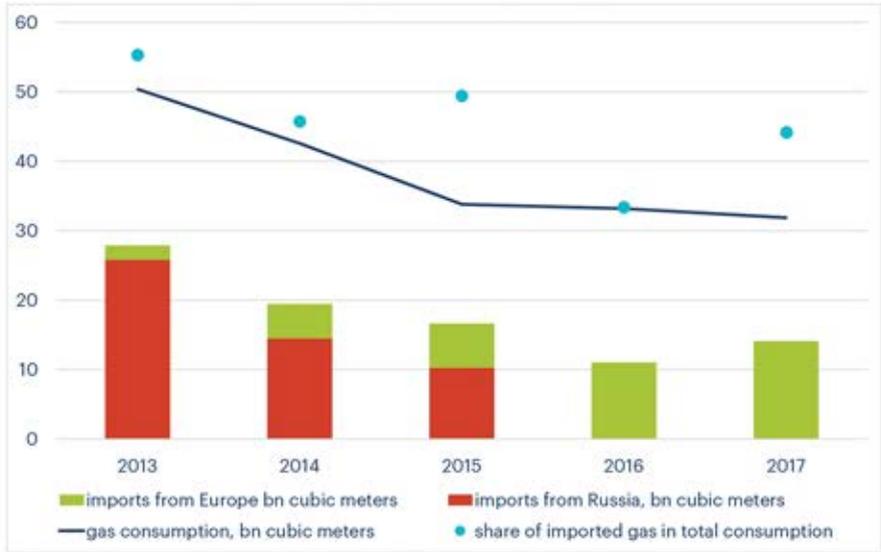
3) to single out the distribution fee from the gas tariff and liquidate unnecessary intermediaries on the gas distribution market;

4) to develop energy efficiency, primarily in the communal sphere;

5) continue strengthening the army;

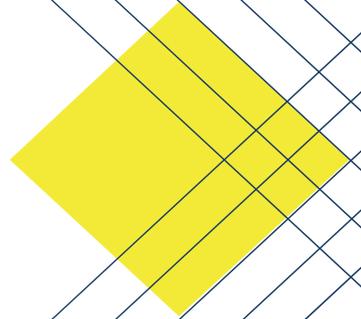
6) continue other growth-promoting reforms (some of them are discussed in this White Book).

Figure 3. Ukraine's dependence on imported natural gas



Data source: Naftogas

# Agriculture and Land Market





Ukraine's agriculture continues to grow along a low trajectory. Its agricultural and agri-food exports are growing but are largely dominated by such low value-added products as grains, oilseeds and vegetable oils. As a result, Ukraine's agricultural productivity remains just a fraction of that in the developed countries. For example, Ukraine's value added per hectare of arable land is USD 413, compared to USD 1,135 in the US and USD 2,445 in France,<sup>37</sup> and this is despite the fact that a third of the most productive soils in the world (black soils) is located in Ukraine. Moratorium for farmland sales is the first and foremost among the reasons for this result. Another highly debatable issue in agriculture is agricultural state support.

## **Agricultural land market**

Moratorium on land sale has been in place since 2001. It undermines producers' incentives to invest in productivity-enhancing technologies (e.g. irrigation) and grow higher value-added crops (e.g. fruits). Inability to purchase the farmland creates uncertainty with respect to its usage over the long term. Small farmers that cultivate mainly their own land are especially undermined by moratorium, for they cannot use their land as a collateral in attracting loans for their development. If the moratorium is lifted, a potential volume of farmland secured loans could be as high as USD 10 billion<sup>38</sup>.

In general, the scale of the moratorium really impresses. Out of more than 42 mln ha of agricultural land (or 70% of Ukraine's territory), about 41 mln ha or 96% of it is affected by the moratorium. Of this land, 68% (27 mln ha) are land plots of some 2-5 ha that during 1990s were distributed to 6.9 mln of former collective farm workers (or 16.2% of Ukraine's

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<sup>37</sup> Calculated using the World Bank World Development indicators

<sup>38</sup> <http://agroportal.ua/views/blogs/investitsii-kotorykh-net-izza-moratoriya-na-selkhozemlyu>

population) who cannot freely dispose their private property. The majority of these owners live in rural areas and are rather senior.<sup>39</sup>

Individual owners of land plots are the biggest losers from the current situation. The majority of them do not cultivate the land themselves but rent it to enterprises – approximately 60% of cultivated agricultural land is leased by private businesses from plot holders. Inability to freely sell their land weakens the bargaining power of landowners. Thus rental incomes are too low compared to the margins generated by agricultural producers. If land moratorium is lifted, the average land rental price as well as its value could increase 2-3 times from the current 50 USD/ha.<sup>40</sup> Overall, if the moratorium is lifted, Ukraine's GDP growth could accelerate by at least 1 p.p. annually.<sup>41</sup>

Now the moratorium is set to expire on January 1st 2019, conditional on adoption of the law «On agricultural land circulation».<sup>42</sup> According to the law that extended the moratorium for the 9th time in 2017, the draft law defining land market rules was to be developed by the Government of Ukraine and submitted to the Parliament by the end of May 2018. That never happened. Further perspectives towards the draft law development and eventual adoption are very vague and much complicated by approaching presidential and parliamentary elections in 2019. The dangers of opening the land market is a traditional scarecrow used by politicians to

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<sup>39</sup> <https://voxukraine.org/uk/moratoriy-na-zemli-ua/>

<sup>40</sup> Low rental price of land which results from the ban on its sales is a shadow subsidy to agricultural companies – at the expense of land owners; <https://voxukraine.org/uk/land-prices-and-size-of-the-market-what-to-expect-for-ukraine-ua/>

<sup>41</sup> <http://www.worldbank.org/en/news/opinion/2017/10/02/ukraine-can-boost-annual-output-us15-billion-with-land-reform>; <http://www.easybusiness.i.ua/moratorium-on-farmland-sales/>

<sup>42</sup> Draft Law #5535: [http://w1.c1.rada.gov.ua/pls/zweb2/webproc4\\_1?pf3511=60724](http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=60724)

inflate their ratings, so there is a high probability that land moratorium will be prolonged again until after the elections.

The draft law «On agricultural land circulation» is to design the rules of the farmland market, and the most debatable issues in its design so far are **ownership restrictions** (maximum size of a land plot that can be owned by one entity; the right of legal entities and foreigners to buy land) and **timeline of land market opening** (either gradually — region by region — or in a single move). Restrictions of the maximum plot size, exclusion of foreigners and/or legal entities as well as staged implementation of land market are all proposed as safeguards against large scale buying up of land by large agricultural companies.

Despite failing to open the land sales and purchase market itself, the Parliament and the Government make some efforts to reform land governance in Ukraine, albeit in a very chaotic way. There is a clear need for a land reform strategy to make the entire process more coherent and uncontroversial. The last vivid example of controversy in the land reform process is the recently adopted law that solved the problem with the legal status of formerly collective land (e.g. land under the field roads, woodland belts etc). At the same time the law introduced a tool for a «forced» consolidation of land usage rights. Users that rent at least 75% of the tract of land (e.g. a field) have the right to rent another 25% of the tract either through lease agreements from land owners or sublease agreement from other land users. The official purpose of this norm is consolidation of land usage rights. In reality, however, this can lead to monopolization of rental market at the expense of small and less powerful farmers.

In the previous White Book on Reforms we provided the following list of actions that should precede the opening of the farmland sales market:<sup>43</sup>

1) mandatory use of an e-auction platform for transfers of state or communal land;

2) mandatory registration and publication of land prices (publication of prices for land rental at the moment of registration is already mandated by law though currently not practiced);<sup>44</sup>

3) establishing and regularly publishing systematic data on Land Governance Monitoring;<sup>45</sup>

4) enhancing access to justice and recourse in case of rights violations;

5) completing registration of state and communal land (now only about 25% of state and communal agricultural land has been registered in the Cadaster, and registered lease contracts exist only for about 2.5 million ha);

6) defining the legal status of the formerly collective land;

7) operationalizing deferred payment schemes for acquiring

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<sup>43</sup> [voxukraine.org/2017/05/31/beyond-lifting-the-moratorium-preconditions-for-success](http://voxukraine.org/2017/05/31/beyond-lifting-the-moratorium-preconditions-for-success)

<sup>44</sup> According to the Law of Ukraine «On state registration of rights on immovable property» and Article 22 of the Order for administration of the State Register for Rights for Immovable Property

<sup>45</sup> The concept of the Land Governance Monitoring was developed and tested in 2015 by the Project «Capacity Development for Evidence-Based Land & Agricultural Policy Making in Ukraine» (<http://land.kse.org.ua>) jointly with an inter-agency government Working Group. Recently, the Ministry of Agricultural Policy and Food and the State Geocadastre have submitted a proposal of a Resolution on the Land Governance Monitoring (<http://www.minagro.gov.ua/uk/node/23860>) to the Cabinet of Ministers of Ukraine that would establish the normative base for the monitoring.

state or communal land (such schemes can be a powerful tool to allow key groups such as the youth or veterans of antiterrorist operation to access land. While the legal basis is set,<sup>46</sup> it lacks clear eligibility criteria);

8) allowing banks to own foreclosed land for a limited time and mandate e-auctions for its disposal.

Only the sixth entry of this list was fulfilled during the last year, as described above.

## State Support for Agriculture

Agricultural state support system has been constantly evolving over the last 5 years in Ukraine. Before 2017 its instruments were mainly tax benefits that made up more than 90% of the total agricultural support. Tax benefits accrued from a so-called single tax (or Fixed Agricultural Tax before 2015 — FAT) and a special value-added tax regime in agriculture — AgVAT<sup>47</sup>. In 2015, due to significant increase of the normative value of land, FAT liabilities increased to roughly \$9/ha, which is still very low compared to what the farmers would have paid on the general tax system. In 2015, the benefits from the AgVAT were estimated at UAH 28 bn.<sup>48</sup> Both beneficial tax regimes were heavily criticized and were found to be very cost-ineffective and undermining efficiency and productivity improvement in agriculture.<sup>49</sup> In 2016 and 2017

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<sup>46</sup> The Land Code and Cabinet resolution #381 of 22 April 2009 (signed by Yulia Tymoshenko) provide all necessary normative base for using this instrument after the moratorium is lifted.

<sup>47</sup> World Bank (2013). Ukraine: Agricultural Policy Review. Report No 83763, 2013

<sup>48</sup> <https://www.epravda.com.ua/columns/2016/03/22/586322/>

<sup>49</sup> <http://agroportal.ua/views/blogs/ob-ekonomicheskoi-tselesoobraznosti-spetsrezhima-nds-i-edinogo-naloga-v-selskom-khozyaistve/>;  
[https://www.researchgate.net/publication/320518841\\_Impact\\_of\\_tax\\_exemptions\\_on\\_agricultural\\_productivity\\_growth\\_in\\_Ukraine](https://www.researchgate.net/publication/320518841_Impact_of_tax_exemptions_on_agricultural_productivity_growth_in_Ukraine)

In 2016 and 2017 the AgVAT system was gradually eliminated under the pressure of the IMF and other international donors.<sup>50</sup> The FAT or profit exemption is still in place and is expected to stay put.

In 2017 the AgVAT tax benefit system was replaced by so-called «quasi accumulation VAT» regime, whereby agricultural producers (mainly livestock and horticulture producers) were entitled to receive budget subsidies proportionally to the VAT transferred to the state budget. The total volume of the program was UAH 4 billion. The program was, though, heavily criticized as such that favored primarily large agriholdings.<sup>51</sup>

In 2018 the volume of budget subsidies to agriculture increased to UAH 6.3 billion. Eligibility and allocation criteria also changed significantly. UAH 1 billion out of 6.3 billion was allocated specifically for small farmers (up to 500 ha of farm size).

Current agricultural subsidies can generally be described as input subsidies, i.e. subsidies that decrease input cost for farmers. The main problem is that the new support programs were designed and implemented without an open evidence-based discussion of their goals and instruments. Thus there is no way to evaluate the efficiency of allocating taxpayers money to these programs.

Moreover, chaotically evolving agricultural support programs are unlikely to help farmers, except probably for a few mighty and well connected agricultural enterprises. Support

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<sup>50</sup> <http://www.imf.org/External/NP/LOI/2015/UKR/072115.pdf>

<sup>51</sup> <https://biz.nv.ua/ukr/publications/miljardi-dlja-tsariv-poliv-khto-otrimuje-shchedri-dotatsiji-vid-urjadu-2489425.html>

programs need to be stable and in place for a significant time span (at least 3-5 years) so that farmers could plan their activities taking state support into account.

Even if such programs were designed and implemented properly and sustainably, farmers turn out to be the smallest beneficiaries of input subsidies. The main beneficiaries of such programs are input suppliers who will receive more than 80% of UAH 6.3 billion allocated for state support of agriculture in 2018. 5% to 6% of the program budget is wasted in the form of dead weight losses, and farmers and rural workers share the rest of the subsidy.<sup>52</sup> This result makes the case for a major revision or abandoning of the current support programs and for designing better thought-through agricultural support policies based on cost-benefit analysis.

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*In the previous White book, we focused on anti-corruption reforms since these are the most visible and discussed in the society. However, corruption is not a problem per se – rather, it is a symptom of malfunctioning institutions – first of all institutions that should protect rights and freedoms of people and enforce laws and contracts. Thus, in this paper we take a broader view on the issue and review the developments in law enforcement and judiciary since 2014.*

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<sup>52</sup> Nivievskyi and Neyter (2018). The new agricultural support system in Ukraine: who does in fact benefit? Forthcoming at VoxUkraine



# Judicial and law enforcement system



Very generally, the functions of the law enforcement system and the corresponding institutions are threefold:

- Uncovering/registering and investigating violations (police);
- Presenting cases in courts (prosecution);
- Deciding on the proofs of violations and respective punishment (courts).

Certainly, there can be other law enforcement bodies which essentially implement the same three functions, albeit on a narrower scale (e.g. with respect to specific violations or categories of people). We discuss these three functions in their turn but first we make a quick digression into the progress of anti-corruption reforms since September 2017.

### **Anti-corruption reforms update**

Since corruption in Ukraine is ubiquitous, it would be naive to expect a part of the state (namely, law enforcement) to be clean while the rest of the institutions are corrupt.

The specific problem with law enforcement is that when it is not working properly, no policy solution can be implemented to the full extent — it is either sabotaged, circumvented or turned into someone's source of rent. Another peculiarity of the law enforcement is that it is one of the few functions of the state that should be implemented top-down and cannot be outsourced to the civil society (in fact, if bottom-up law enforcement becomes not exceptional, the state is in trouble).

Since law enforcement bodies are strictly hierarchical and rather closed systems, they can be relatively easily reformed «from above» if there is a political will. However, the

temptation to use law enforcement as an instrument to contain or destroy political opponents is hard to resist. When bootstrapping is impossible, a parallel system of institutions which would implement the above-listed three functions with respect to high-level officials has to be created. In Ukraine, this system includes National Anti-Corruption Bureau (NABU), Special Anti-Corruption Prosecution Office (SAP) and Specialized Anti-Corruption Court (ACC). A few other bodies — Corruption Prevention Agency and Asset-Management Agency — support the activities of this anti-corruption vertical. Although creation of these institutions was planned or started already in 2015, were it not for joint effort of civil activists and Ukraine's international donors, we would probably still did not have them.

Among the above-listed entities, only the National Anti-Corruption Bureau can be called a success. It is currently 86% staffed, investigates 683 cases (which caused estimated total losses of about UAH 200 billion), and has sent 143 cases to courts.<sup>53</sup> So far, as a result of NABU investigations, UAH 360 million have been recovered (NABU budget is about UAH 500 million per year). However, politicians try to tie up the NABU hands. Thus, NABU still does not have the right for independent wiretapping,<sup>54</sup> full access to the registry of e-declarations, and there were multiple attempts to appoint politically non-neutral persons to the NABU audit committee.<sup>55</sup>

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<sup>53</sup> According to NABU report for the first half of 2018: <https://nabu.gov.ua/report/zvit-pershe-pivrichchya-2018-roku>.

<sup>54</sup> NABU can wiretap people only through the State Security Service (SBU), and the latter often leaks information to suspects. Also, in December 2017 SBU uncovered some of the NABU undercover agents. SBU reform, specifically, depriving it the right to investigate economic matters, has long been advocated by civil society and international organizations but so far only cosmetic measures have been implemented — such as the famous law «masks-show stop».

<sup>55</sup> After two years of political bargaining the NABU auditors are Pavlo Zhebrivskiy, former head of Donetsk oblast administration, Mykhailo Buromenskiy, former at hoc judge of the European Human Rights Court, and Volodymyr Vasylenko, former judge of UN Human Rights court and Ukraine's representative at the UN Human Rights Council.

Recent conflicts between NABU and prosecution, including SAP,<sup>56</sup> clearly illustrate how the establishment reacts when an institution created «to please» foreign partners turns out operational rather than ornamental.

Adoption of legislation on the Anti-Corruption Court has been more than a year late and one of the reasons for putting on hold the IMF program with Ukraine. After multiple tensions, the AC court was finally launched in mid-2018.<sup>57</sup> However, simultaneously a reputational scandal around the head of the anti-corruption prosecution office unleashed (allegedly, he leaked details of NABU investigations to suspects). Thus, although the competition for positions of ACC judges is ongoing, it seems that another element of the anti-corruption vertical has been knocked out.<sup>58</sup>

Corruption Prevention Agency has been muddling through during the last two years. First, the number of e-declarations seems to be too high and exceeding the capacity of the Agency to process them, let alone take actions towards violators.<sup>59</sup> Second, the software for automatic check-up of declarations has been supplied to the agency only last month. It is expected to become operational on September 25th 2018. Third, there were doubts about the independence of the Agency from the president.<sup>60</sup>

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<sup>56</sup> The most prominent case was closing of the case against the son of the Minister of Interior investigated by NABU — there was evidence that a firm related to him supplied to the Ministry of Interior low-quality backpacks at a high price (the loss to the state is estimated at about \$500 thousand).

<sup>57</sup> Two laws: <http://zakon5.rada.gov.ua/laws/show/2447-viii> and <http://zakon3.rada.gov.ua/laws/show/2509-viii>

<sup>58</sup> Currently AC prosecutor is on vacation leave after a rebuke – although the most ethical step for him would be to resign.

<sup>59</sup> About 1 million declarations are uploaded to the system annually, while as of June 2018 NCPA has fully checked just 331 of them, according to Reanimation Package of Reform experts: <https://rpr.org.ua/news/z-takymy-tempamy-nazk-pereviryt-vsi-deklaratsiji-ne-ranishe-nizh-cherez-3600-rokiv-eksperty/>

<sup>60</sup> According to the statements of a whistleblower from the agency staff. The accused Agency director has been replaced since that time.

Meanwhile, two notorious clauses — on the need for those involved into anti-corruption activities to fill in e-declarations and on the need for members (and candidates) of supervisory boards of state and communal enterprises to do the same thing — remain in the legislation, despite multiple promises to exclude them. The first one puts all the NGO heads and supervisory board members in a Schrödinger cat position — guilty and innocent at the same time, depending on the (electoral) needs of those currently in power.<sup>61</sup> More importantly though the second clause threatens the entire reform of state-owned enterprises making it next to impossible to attract foreign professionals to their supervisory boards.

National Agency for Recovery and Management of Illegally Obtained Assets has only started working in 2017 and now is 55% staffed.<sup>62</sup> As of end-2017 it had 125 property objects and some UAH 2.5 million under its management.<sup>63</sup> Agency both searches for assets linked to cases of corruption in Ukraine around the world and manages these assets from the moment they are frozen until a court decision on them is implemented. The efficiency of its work remains to be seen.

## Police

Police reform started in summer 2015 when the new law «On the national police»<sup>64</sup> was passed. The first units of the new patrol police took the oath on July 4th 2015, upon selection and a few months training financed by international donors who also provided material supplies (e.g. cars and uniform) for

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<sup>61</sup> The law rather vaguely defines what an «anticorruption» activity is and people who can be defined as implementing this activity.

<sup>62</sup> 72 of 130 staff positions have been filled, according to the Agency report for 2017, <https://arma.gov.ua/files/general/2018/06/06/20180606134642-24.pdf>

<sup>63</sup> *ibid*

<sup>64</sup> <http://zakon.rada.gov.ua/laws/show/580-19>

the new police. By mid-2016 patrol police was active in 33 cities, and now it replaced the Road Police in the entire Ukraine.

Initially, the government intended to replicate the success of Georgian police reform. Thus it invited to Ukraine people who implemented this reform in Georgia — Khatia Dekanoidze became the head of the National Police (former militia) and Eka Zguladze — the head of the new Patrol Police.

Simultaneously with development of the new patrol police (to which 12 thousand «outsiders» were hired) over 70 thousand of former militia employees were evaluated by a special commission. Of them, only 5257 were dismissed (7.3%), and about a half of those later were renewed in their positions by courts (and they were also paid UAH 55 million of compensation for forced absence at the workplace).<sup>65</sup> Thus, a comprehensive police reform was substituted by introduction of the new patrol police, which is similar to putting a fresh layer of paint on a cracked wall. The main idea of the reform – political independence of the police — was never implemented. No wonder that both invited reformers resigned — Zguladze in May 2016 and Dekanoidze in December of the same year.

Although the patrol police has been constantly proclaimed one of the most successful reforms, it faces serious problems which can undermine all the earlier progress:

— Unreformed other police departments make it practically impossible to build a career at the National Police — so people who entered the patrol police in 2015 on the wave of the initial enthusiasm are resigning;

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<sup>65</sup> As of January 1st 2018, the National Police had 140 thousand positions of which 116 thousand were filled. <https://www.npu.gov.ua/about/struktura/shtat-ta-chiselnist.html>

— About 50% of regular salary of a policeman is a «bonus» which a person can lose on discretion of his/her supervisor. Likewise, disciplinary measures towards policemen are mostly decided by supervisors rather defined by the rules. This reduces incentives for policemen to take initiative and make creative decisions in non-standard situations;

— Detailed rules regarding algorithms of actions, rights and duties of patrol policemen in different situations exist only for administrative violations. With regard to other violations policemen actually do not know the boundaries of their power — and thus can be either rewarded or prosecuted for the same actions. This is especially dangerous in case of mass protests;<sup>66</sup>

— Current Code of Administrative Violations (adopted in 1984) makes it rather hard for policemen to defend their cases in courts, which discourages them.

The attempts to reform the rest of the police linger on. Thus, with the help of the EU, departments staffed with detectives who combine functions of agents and investigators have been created in all oblasts. However, the lack of political will for a genuine police reform is clearly evident not only for experts but for the society in general. Thus, at the end of 2017, balance of trust to the new patrol police turned negative (Figure 4) and balance of trust to police in general, although improved a bit compared to 2014, remains negative, albeit slightly higher than trust to prosecution and courts (Figure 5).<sup>67</sup>

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<sup>66</sup> Speaking of mass protests — one of the requirements of the law «On the national police» is clear identification of policemen (namely, their personal numbers should be written on their helmets and waistcoats). This very simple change was never implemented thus simplifying potential use of force by police against protesters.

<sup>67</sup> Since end-2017 the efficiency of work of the police is evaluated based on the trust of people to it. This survey-based method replaced the old system which evaluated the quality of the police work by a share of investigated crimes, which gave rise to various human rights violations and data padding.

Since in Ukraine many officials are not only corrupt but generally try to place themselves above the law, a new agency — State Investigation Bureau (SIB)<sup>68</sup> — is being created to investigate crimes (except for those investigated by NABU) of high-level officials and employees of law enforcement bodies, including NABU and SAP. Currently this function belongs to the Prosecutor General Office (PGO). After SIB is created, PGO and the prosecution in general will only present cases in courts, they will not perform investigations.

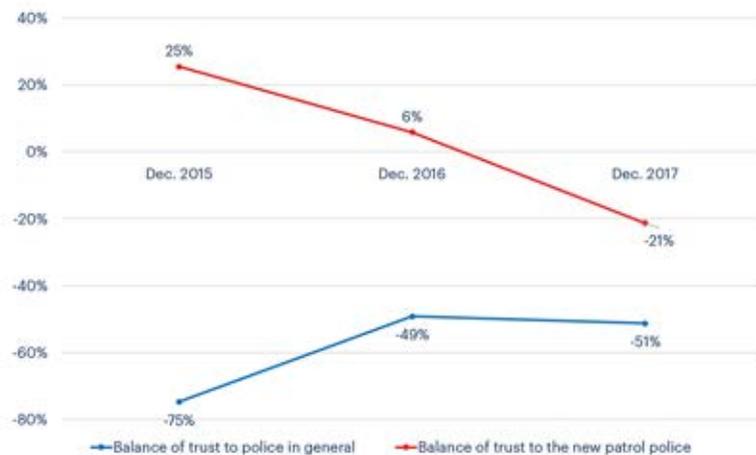
With 1500 staff (compared to 700 in NABU), SIB is going to be a very powerful institution. No wonder that the attempts to capture it started on the very same day as the staffing process began. With varying success, civil society is actively counteracting these attempts, which slows down the process. Thus, although the commission for selection of SIB head was created in spring-2016, SIB head and his deputy heads were selected and appointed only at the end of 2017. By now, the SIB head appointed 27 heads of regional departments, and the competition for over 700 investigators' positions is ongoing.<sup>69</sup>

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<sup>68</sup> As other anti-corruption bodies, the Bureau was created «on paper» at the end of 2015, and in May 2016 a competition for its head was announced. However, the competition was completed only at the end of 2017, and was accompanied by many scandals.

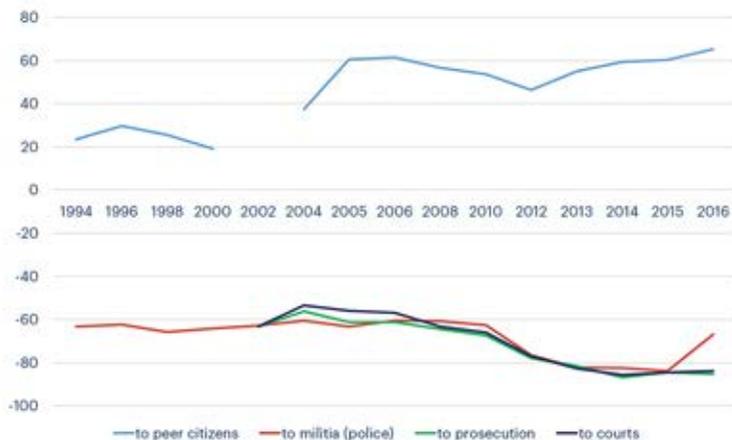
<sup>69</sup> SIB report: <https://www.kmu.gov.ua/storage/app/media/uploaded-files/pro-diyalnist-gruden-2017-berezen-2018.pdf>

**Figure 4. Balance of trust to the police**



Data source: Democratic Initiatives Foundations surveys

**Figure 5. Balance of trust to different entities**



Data source: Institute of Sociology «Monitoring of Ukrainian Society» surveys

Balance of trust is calculated as the difference between shares of those who «trust» or «mostly trust» and «don't trust» or «mostly don't trust» normalized by the share of people who have a defined opinion on the issue.

## Prosecution

Prior to 2015 prosecution had practically unconstrained powers since one of its functions was general oversight of law compliance. The new law on prosecution<sup>70</sup> enacted in mid-2015 deprived prosecution of this function, and later this change was supported by the constitutional reform of mid-2016 which also introduced major changes into the judiciary system (see below). The new law foresees that the prosecution only:

- Represents citizens and the state in courts and
- Ensures law compliance by law-enforcement agencies and during implementation of court decisions

The new law foresaw reduction of the number of prosecutors from 15 thousand to 10 thousand since January 1st 2018, with respective salary increases for remaining ones. At the end of 2017, the parliament cancelled this clause. Also, the demands for would-be prosecutors were softened to allow «outsiders» enter the system.

Nevertheless, although reformed on paper, the prosecution remains a non-transparent «do-whatever-I-want» institution.<sup>71</sup> Rather useful for those currently in power but dangerous for the society.

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<sup>70</sup> <http://zakon.rada.gov.ua/laws/show/1697-18>

<sup>71</sup> And replacement of Shokin by Lutsenko in exchange for \$1 billion US loan guarantee didn't help. See, for example, <https://www.bloomberg.com/view/articles/2018-01-25/how-uk-raine-s-president-fooled-joe-biden>

## Other law enforcement bodies

Other entities infamous for their overuse of power are the Security Service of Ukraine<sup>72</sup> (SSU) and the Tax Police. The need to reform those — namely, liquidate the economic department of SSU and the entire Tax Police and instead organize Financial Police (alternative suggestion — the National Bureau of Financial Investigation) — the agency that will investigate financial crimes, including tax evasion, has been discussed for over a decade. The first draft law on financial police was developed in 2012. In 2016, a group of MPs submitted another draft law<sup>73</sup> on the matter. In spring 2018 three alternative draft laws<sup>74</sup> were submitted to the parliament. Although they are rather similar, the important conflicting issues are:

- Subordination of the new agency (subordinate to the Ministry of Finance or an independent institution accountable to the parliament) — and consequently procedures for selection, appointment and dismissal of the agency head;
- The spectrum of violations it can investigate (ideally, that should not overlap with NABU and other law-enforcement agencies), and respectively the number of people in it (suggestions vary from 1500 to 3000).

The new Deputy Minister of Finance thinks<sup>75</sup> that by the end of 2018 the Ministry and the Parliament will reach a consensus and develop a compromise draft law. Whether this is too optimistic will soon become evident.

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<sup>72</sup> The famous "masks-show stop" law which somewhat constrained this SSS ability was rather a cosmetic change.

<sup>73</sup> #4228 [http://w1.c1.rada.gov.ua/pls/zweb2/webproc4\\_1?pf3511=58400](http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=58400)

<sup>74</sup> #8157, #8157-1 and #8157-2

<sup>75</sup> In his interview to Ukrainska Pravda of September 6th, 2018, <https://www.epravda.com.ua/publications/2018/09/6/640249/>

## Court system

Judiciary has had a permanent membership at the top-5 obstacles to investment in Ukraine<sup>76</sup> — along with corruption.

Police outrage and absurd sentences to Euromaidan activists during the Revolution of Dignity highlighted the extent to which law enforcement and judiciary system were rotten. Thus, no wonder that one of the first laws adopted after the formation of the new government in 2014 was the law «On renewal of trust to the judiciary».<sup>77</sup>

According to this law, heads of all courts had been dismissed. However, 80% of them very soon were re-elected to the same positions.<sup>78</sup> The Supreme Council of Justice and the Supreme Qualification Commission for Judges were disbanded by the same law and re-elected in about a year after. They are responsible for evaluation of integrity of current judges and would-be judges respectively.

Also, a Temporary Special Commission that had to make decisions regarding «Euromaidan Judges» was created. According to its latest report of August 2015, this Special Commission checked 66 judges of 331 it was asked to consider.<sup>79</sup> Later its functions were transferred to the newly elected Supreme Council of Justice, which by now dismissed just 48 of over 350 «Euromaidan judges».<sup>80</sup>

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<sup>76</sup> See, for example, surveys of EBA members at [www.eba.com.ua](http://www.eba.com.ua)

<sup>77</sup> April 8th 2014, <http://zakon3.rada.gov.ua/laws/show/1188-18>

<sup>78</sup> As of early 2015, according to the research by Maria Popova, McGill University. Summary and presentation video here: <https://archive.voxukraine.org/day-2-the-judiciary-after-euro-maidan-the-judicial-lustration-process/>

<sup>79</sup> <http://www.vru.gov.ua/statistics/47>

<sup>80</sup> <https://www.radiosvoboda.org/a/news/29048703.html>

The judicial sector reform was given a fresh start in mid-2016 with the adoption of changes to the Constitution<sup>81</sup> and an accompanying law on judicial system.<sup>82</sup>

The main changes introduced by these two laws are:

- More independence and self-governance for judges. Specifically, the power to implement all disciplinary actions towards judges as well as to propose judges to be appointed by the President goes to the Supreme Council of Justice;<sup>83</sup>
- A better pool of potential judges. Increased minimum age (from 25 to 30) and prior legal experience (from 3 to 5 years) for newly appointed judges; elimination of the requirement for a judge to live in Ukraine for at least 10 years before appointment;
- Provision of the right to an individual to file a case to the Constitutional Court if he/she thinks that the law applied to prosecute him/her violates the Constitution;
- Stripping the prosecution off the universal oversight function;
- Three instead of four levels of courts — local courts, appeal courts and the Supreme Court (in addition, two specialized courts — Anti-Corruption and Intellectual Property are to be created). About 150 small raion courts will be closed down and their responsibilities transferred to district courts;

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<sup>81</sup> <http://zakon3.rada.gov.ua/laws/show/1401-viii>

<sup>82</sup> <http://imorevox.org/news.php?id=1043>

<sup>83</sup> An additional law on Supreme Council of Justice was adopted at the end-2016: <http://zakon3.rada.gov.ua/laws/show/1798-viii>

- Creation of the Civil Integrity Council that will advise to the Supreme Qualification Commission for Judges during the process of selection of judges (all the judges will have to go through the selection/attestation procedure during which «outsiders» may also apply for positions of judges);
- Significantly increased salaries of (re)appointed judges (from 10-13 to 30-75 minimal wages).

During 2017, judges for the Supreme Court were selected. Among 120 of its appointed judges there are 30 for whom Civil Integrity Council provided negative conclusions<sup>84</sup> because they either did not declare all their assets or had assets which could not be explained by their income or had participated in unlawful cases against Euromaidan activists. In August 2018, two more dubious judges were appointed to the Supreme Court by the President. One of them (Slynko) had participated in the trial of Yuriy Lutsenko, current prosecutor general, which the European Human Rights Court recognized as politically motivated. The second one (Simonenko) allegedly obtained a Russian tax ID number after 2014 and provided incomplete list of her family assets in the e-declaration.

Since fall-2017 the process of attestation of candidates for all positions of judges in Ukraine has started. Supreme Qualification Commission for Judges (SQCJ) expects to complete the selection by mid-2019. Taking into account that there are some 7000 positions of judges in Ukraine, this task is quite overwhelming. During April-December 2018, the Commission plans to interview 5300 judges who have completed a professional test. According to representatives of the Civil Integrity Council, during the first month of the

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<sup>84</sup> A complete list can be found on Chesno NGO web-site: <https://chesnosud.org/analytics/nedobrochesna-30-ka-kozhen-chetvertij-majbutnij-suddya-verhovnogo-sudu-otrymav-neg-atyvnyj-vysnovok-grd/>

process one interview lasted about 3-6 minutes (to draw attention to the dubious procedure, the Integrity Council even announced its withdrawal from the selection process). Recently, the pace of interviewing slowed down — e.g. during June-July 2018, 517 judges were interviewed. The head of the SQCJ reports that as of July 30, 1385 judges completed the assessment procedure, and 83% of them — successfully.

Naturally, during the course of reform Ukraine is experiencing a shortage of judges which is probably going to last for the next 3-5 years. First, several hundreds of judges resigned in 2016 in order not to fill in e-declarations. Second, not all judges will pass the assessment procedure, and the pool of potential candidates who have adequate qualifications is rather limited. Third, some judges and court staff are resigning because of largely increased workload on them in this transition period. Shortage of judges leads to prolonged consideration of cases in courts. However, this is an unavoidable cost of better judiciary.

The judicial reform implies two hard choices — between the speed of reform (and the length of painful transition period) and thoroughness of cleaning up the system and then between the extent of cleaning up and independence of the judiciary. Since two years available for this reform were lost, the choice of speed over thoroughness is logical. And perhaps the choice of independence of the judiciary over the depth of its «cleaning» can be justified. The risk of such choices is also obvious — keeping a large part of the «old guard» in the system, ending up with more politically independent but still malfunctioning judiciary.

More independent judiciary implies that the Supreme Council of Justice whose powers have been substantially extended, will clean the system of judges with doubtful reputation, although this will probably take years. There is also hope that some 2000 vacancies in the judiciary will be filled by «outsiders» — people ready to bring the new spirit and values into the system. In this case, overall quality of the court system will improve — perhaps even to the point when business downgrades it to some 10th place among constraints for investment.

# Decentralization

The background features a series of concentric, nested blue lines forming a large, downward-pointing chevron shape. Three solid yellow diamonds are scattered on the right side of the page: one large one overlapping the word 'Decentralization', and two smaller ones below it.



*Prior to September 2017...*

Decentralization started in 2014 in order to bring government closer to people, to deconcentrate power and increase responsibility at the local level. In the long run, this should result in emergence of «organic» political leaders (i.e. those who first gained experience at community level, then at the oblast or city level etc.) and parties.

In 2015 and in the subsequent years fiscal decentralization was implemented — namely, local governments were provided more freedom in budget spending and more responsibilities for provision of public services (healthcare, education, infrastructure, administrative services).

In 2017, the share of local taxes in local governments' own revenues reached 27% compared to 0.7% in 2017. The main revenue source of local budgets is personal income tax. Real estate and land taxes are not very actively used by local governments, although in other countries they form a considerable share of local budgets (because they are «tied» to a territory and relatively easy to administer).

Decentralization enjoys higher popular support than other reforms. Thus, according to the «Democratic Initiatives» survey, 43% of people support decentralization and 22% — do not support it,<sup>85</sup> while, for example, healthcare and education reforms are supported by 19% and 25% and not supported — by 39% and 27%<sup>86</sup> respectively.

Amalhamated territorial communities (ATC) are gradually

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<sup>85</sup> <https://www.ukrinform.ua/rubric-presshall/2532249-rik-decentralizacii-dosagnenna-zminita-nastupni-kroki-rezultati-opituvanna.html>

<sup>86</sup> <https://dif.org.ua/article/reformi-v-ukraini-gromadska-dumka-naselennya-traven-2018>.

formed. These are lowest-level administrative units which, however, can raise enough revenues to supply quality public services.

An attempt to embed decentralization into the Constitution failed. Though it may seem that this is not an urgent issue, without solving it the decentralization reform will not be complete.

*...and recently*

As of August 10th 2018, 803 ATCs existed in Ukraine compared to 616 a year ago. Leaders of this process are Zaporizka, Zhytomyrska, Khmelnytska, Chernihivska and Dnipropetrovska oblasts where ATCs cover over 50% of total area. In addition, 1206 perspective plans for ATC formation have been approved.

During the last year, two positive and two negative decisions concerning decentralization were made.

*Positive decisions:*

- **ATCs are allowed to merge with cities of oblast significance.**<sup>87</sup> This decision simplifies solution of the problem of financing common infrastructure (transport, medical and educational services) — thus, ATC citizens will receive higher quality services. On the other hand, city business receives opportunities for development on the ATC territory.
- ATC can obtain state-owned agricultural land outside of its

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<sup>87</sup> Внесення змін до Закону України "Про добровільне об'єднання територіальних громад"  
[http://w1.c1.rada.gov.ua/pls/zweb2/webproc4\\_1?pf3511=61814](http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=61814)

• **ATC can obtain state-owned agricultural land outside of its settlements into its communal property.**<sup>88</sup> According to the government decision, State Geocadastre has to transfer state-owned land outside of ATC settlements to the ATC communal property by the end of 2018. If completed, this initiative will positively impact the communities since they will obtain another source of revenue. In addition, the procedure of land transferring includes inventory counting of ATC land which will contribute to the higher efficiency of its use.

*Negative decisions:*

• **Heads of local administrations and their deputy heads are deprived of the status of state officials.**<sup>89</sup> Depriving heads of local administrations of this status, the parliament made it possible (again!) to appoint people to these positions based on political considerations rather than on merit (state officials are appointed based on results of competition, and there is a defined list of reasons for dismissing them). We think that this decision was aimed at making local governments more «obedient» in view of the upcoming elections.

• **To put on hold organization of local elections in newly created amalgamated communities.** On August 9th the Central Electoral Committee announced that there was some legal collision with the law on referendum and thus local elections are postponed until the Parliamentary Committee on Legislation and Justice provides clarification for this legal issue.<sup>90</sup> Thus, 98 newly created communities cannot elect their government and become fully operational.

<sup>88</sup> Розпорядження уряду від 01.01.2018 <http://land.gov.ua/info/rozporiadzhennia-kabine-tu-ministriv-ukrainy-vid-31-sichnia-2018-r-60-r-pytannia-peredachi-zemelnykh-dilianok-silsko-hospodarskoho-pryznachennia-derzhavnoi-vlasnosti-u-komunalnu-vlasnist-ob/>

<sup>89</sup> Changes to laws on state services ([http://w1.c1.rada.gov.ua/pls/zweb2/webproc4\\_1?pf3511=62569](http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=62569)) and on local administrations (<http://zakon.rada.gov.ua/laws/show/586-14>)

<sup>90</sup> <http://www.cvk.gov.ua/pls/acts/ShowCard?id=43878&what=0>.

*Problems to solve:*

- **Raion level of government.** The more ATCs are formed — the less needed this raion level becomes because communities take on its functions and budget. Some raion heads thus sabotage formation of ATCs. Thus, there is a need for a plan of “peaceful” liquidation of the raion level, including the issues of financing of raion education and healthcare facilities.
- **Mandatory formation of communities.** Today ATCs are formed voluntarily — with the help of «carrots» provided to them by the State budget. However, at some point the potential for voluntary amalhamation, as well as budgetary «carrots» will be exhausted. Then, the rest of the ATCs will have to be created by a central government decision. Thus, the mechanism for taking and implementing this decision is needed.
- **Constitutional reform.** It is needed not only to complete decentralization but also to eliminate the dualism of executive power branch — because there should be just one center of decision-making and a responsible person — either the president (then he should be the head of the government) or the prime-minister (then the president would have only representative functions).





# Public procurement



*Prior to September 2017...*

In 2013, over over 70% of public procurement (which totaled 16% of GDP<sup>91</sup>) were performed via uncompetitive procedures<sup>92</sup> — below-the-threshold or «negotiations with one buyer». This was possible because the previous legislation made 43 types of public contracts exempt from competitive tendering. This resulted in high levels of corruption and nepotism in procurement. The situation radically changed with implementation of the electronic public procurement<sup>93</sup> system ProZorro.<sup>94</sup>

ProZorro project began in spring 2014 as a volunteer startup: it relied on technical ingenuity and was not financed by the state. The majority of project participants were not previously employed in public sector and had a background in financial markets, electronic services, data analysis, software development etc.

In contrast to politicians, the level of trust to volunteers after the Euromaidan was extremely high.<sup>95</sup> This high level of trust allowed them to initiate productive discussions between business and officials, as well as between Parliament and the Ministry of Economic Development and Trade (MoEDT). In August 2014 the group of volunteers in cooperation with the Department of Public Procurement Regulation, experts from

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<sup>91</sup> Ukrstat

<sup>92</sup> EBRD Are you ready for eProcurement? Guide to Electronic Procurement Reform 2015. p.77, <http://www.ebrd.com/documents/legal-reform/guide-to-eprocurement-reform.pdf>

<sup>93</sup> Meaning transparent in Ukrainian, the name also hints at Zorro, a fictional defender of common people against the tyranny of evil men.

<sup>94</sup> For example, according to the survey performed at the end of 2014, volunteers were in the first place with 7.3 points out of 10: [https://dt.ua/UKRAINE/naybilshe-ukrayinci-doviryayut-volonteram-ta-dobrovolcyam-naymenshe-sudam-i-gpu-160339\\_.html](https://dt.ua/UKRAINE/naybilshe-ukrayinci-doviryayut-volonteram-ta-dobrovolcyam-naymenshe-sudam-i-gpu-160339_.html) Today the level of trust to volunteers, although lowered a bit, remains rather high.

<sup>95</sup> Project Harmonisation of the Public Procurement System of Ukraine with EU Standards.

the EU<sup>96</sup> and Georgia developed the Concept of the Reform of Public Procurement System in Ukraine which guided the next steps of the reform. The concept envisioned implementation of a pilot project<sup>97</sup> for below-the-threshold procurements. These procurements were not regulated by law, so public companies and institutions could voluntarily participate in the pilot project. At first, the development of the pilot project was financed by private companies that seized the opportunity to enter the emerging e-market.

The pilot project became functional in February 2015. During 2015, the Prozorro team was integrated into the MoEDT, and thanks to their exceptional effort the Parliament adopted the new version of the procurement law in December 2015.<sup>98</sup> This law prescribed that since April 1st 2016 all central executive bodies and state-owned natural monopolies had to conduct procurements exclusively through ProZorro. Since August 1st 2016 all public procurements are carried out only through ProZorro.

As a result of the ProZorro implementation, a huge portion of previously hidden data was revealed. For instance, in the period from December to September 2017 more than 500 thousand «below the threshold» procedures with the reserve value of USD 2.5 billion were registered in the system. ProZorro also greatly increased information available on «above the threshold», especially competitive, procurements. This wealth of data can be used by public procurers to assess the quality of their procurement function, by the prospective suppliers to find business partners as well as by controlling

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<sup>96</sup> Project Harmonisation of the Public Procurement System of Ukraine with EU Standards

<sup>97</sup> voluntary participation by the public companies and institutions in the pilot project was made possible by Government Decree 501-2015-p: <http://zakon3.rada.gov.ua/laws/show/501-2015-%D1%80>

<sup>98</sup> <http://zakon3.rada.gov.ua/laws/show/922-viii>

authorities and whistle-blowers to monitor public procurements.

Due to new rules, the share of competitive procurements (both under- and above-the-threshold) increased from 26% of total volume of procurement in 2015<sup>99</sup> to 78% in 2017. Thus, more trustworthy procurement procedure attracted new companies to join the procurement market. The section «Impact of Reforms» below illustrates this for the markets of pharmaceuticals and natural gas.

But the most important is that more efficient and competitive procurement mechanism generated additional savings of public funds.

*...and recently*

Further development of public procurement includes three directions — centralization, professionalization and technical progress. We consider each of them in turn.

**Centralization.** Centralization implies that procurement of standard goods or goods common for several entities should be performed by central procurement bodies (CPB) or electronically from a public e-shop, thus allowing the government and public procurers working under the Public Procurement Law to increase efficiency of public spending.

Centralized mechanisms could take away or simplify 54%<sup>100</sup> of total public procurement spending thus sparing time of public buyers for more complex tenders of sophisticated capex procurement such as equipment, construction, and services.

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<sup>99</sup> both above and below threshold

<sup>100</sup> According to the estimates of Kyiv School of Economics

In 2017-2018 the Ministry of Economic Development and Trade has been piloting a project of centralized purchasing via a specialized state enterprise «Profesiyni zakupivli» (professional procurement) to test the mechanism of centralized procurement and to lay the ground for a full-scale launch of a Central Purchasing Body (CPB). The Ministry drafted necessary legislation to launch the first national CPB, yet the documents are awaiting approval.

The CPB will operate as a state-owned enterprise and act as an intermediary between public buyers and suppliers. It will serve as an operator of centralized purchasing tools and manager of the e-shop, as well as a consultant providing advice and conducting procurement procedures on behalf of public buyers. The CPB services can be used by public buyers at their discretion and are to be remunerated — depending on the type of service — by contracting authorities or suppliers. Central and local governments will be able to establish their own CPBs if there is evidence of benefits of such decision.

Along with the CPB design, the Ministry of Economic Development and Trade approved the legal framework for centralized purchases (framework agreements) and drafted the legal framework necessary for the e-shop development. Along with it, the Ministry of Health drafted the reform strategy for procurement of pharmaceuticals and medical equipment.

**Professionalization.** Kyiv School of Economics is providing mid-term professionalization program for procurement managers of large purchasers and short-term wide-scale programs on legal and technical aspects of public procurement for tender committees. Along with it, a number of local firms and consultants are providing short-term trainings on the commercial basis and using technical

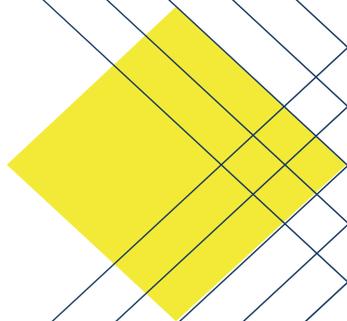
assistance. ProZorro Center maintains a network of regional agents and administers InforBox and on-line courses about ProZorro.

**Technical advancement.** Digitalization and simplification of procedures and their control is one of the paramount strategic directions of the reform. During the last year, ProZorro system administrator, SOE «ProZorro» integrated the Registry of Medications with the system (now, if someone wants to procure a drug, he/she will be able to select it from the pre-composed list rather than type into the system). Besides, the MoEDT and the SOE «Prozorro» developed regulations and implemented into the system so-called ESCO contracts that allow procurement of the energy saving technologies.

The Prozorro system itself was under threat for some time because it was not certified by the State Service for Special Telecommunications and Information Protection. It took more than a year to obtain certification and transfer the system from a cloud to a server in Ukraine.

In early 2018, electronic cabinet of the State Audit Service controllers was embedded into the ProZorro system, accompanied by legislative changes that introduce the notion of risk-based monitoring into the system.

# Impact of reforms





What is the effect of reforms on competition in the Ukrainian markets? In this section, we provide some descriptive evidence that competition has increased. We look at two markers – pharma and gas (CPV codes: 336 and 09123000-7 respectively) and use ProZorro data to evaluate the number of suppliers and the degree of competition among them in 2015-2018. Please see sections on Healthcare and Energy for discussion of the reforms introduced in these markets.

The analysis shows that the market structure has changed. The number of suppliers increased and on average they began to supply to more buyers. Furthermore, the density of the markets has decreased.

Figures 6 and 7 visualize the transactions in pharma and gas sectors for 2015-2018 respectively. Figure 6 plots four graphs of suppliers and contractors in the gas market during 2015-2018. Figure 7 has the same design and shows four years of the pharmacy market.

## Change of numbers of participants

Table 2. Gas, number of auction participants per year

	Number of participants	Of them those that did not participate in the previous year
2015	8	
2016	94	5%
2017	324	20%
2018 (Jan-Sep)	255	55%

Source: ProZorro data, own calculations

**Table 3. Pharmaceuticals, number of auction participants per year**

	Number of participants	Of them those that did not participate in the previous year
2015	237	
2016	1,268	15%
2017	2,468	34%
2018 (Jan-Sep)	1,939	67%

*Source: ProZorro data, own calculations*

Tables 2 and 3 show that the numbers of participants in the (ProZorro) markets increase over time. In addition, the data show an inflow of new participants. There are 67 percent of the new pharmacy suppliers in 2018 who did not participate in auctions in 2017. This number was 55 percent for the Gaz market. This is in strong contrast to 15 percent and 5 percent in 2016 respectively. The data suggest that auctions encourage new players to participate on the market.

### **Change of shares on the market**

Our data show that the average number of auctions in which a supplier participates has increased (see Tables 4 and 5, average number of ties). The possible economic transactions are visualized as ties on graphs in Figures 6 and 7 (if a supplier participates in an auction of a buyer, there is a tie between them).

Our data show that the density of (the graph of ties in) both markets decreased with time.

The density is a measure that shows a proportion of all observed connections in a graph to all possible connections. In our case, connections represent auctions. Suppliers are connected to a contractor by participating in an auction. Some suppliers participated in many auctions and some in a few. Sometimes, different suppliers systematically

participated in the same auctions, and sometimes they were isolated from each other and their paths never crossed.

In our case, lower density could mean that the markets have become more structured. The number of ties increased but these ties are established between certain suppliers and contractors. There are fewer and fewer small stars on the periphery of the graphs. Instead, over time there are more suppliers that connect to certain buyers in a clustering matter. This suggests that certain market niches become more structured.

All in all, the ProZorro procurement data for the gas and pharmacy market show that the number of suppliers increased between 2015 and 2018, that the number of their auction participation increased as well, and that the market overall became more structured. These metrics are indicative of competitive markets.

**Table 4. Gas, shares on the market**

	Average number of ties	Density of the market
2015	1.6	0.05
2016	2.0	0.003
2017	2.3	0.0003
2018 (Jan-Sep)	2.2	0.0004

Source: ProZorro data, own calculations

**Table 5. Pharmacy, shares on the market**

	Average number of ties	Density of the market
2015	9.1	0.01
2016	25.0	0.004
2017	36.6	0.003
2018 (Jan-Sep)	43.9	0.004

Source: ProZorro data, own calculations

## Remarks about the data

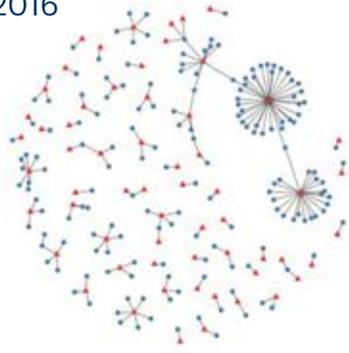
- We analyze procurement data for gas and pharmacy from the ProZorro system. The following CPV codes were employed. For gas - CPV 09123000-7 (Природный газ). For pharmacy, we analyzed all medicines that starts with three CPV digits 336.
- For all years we compare all participants of auctions, including winners and others. By doing this we are able to show the de-facto increase in businesses that actively participate on the market and compete with each other.
- For 2018, we analyze only the first three quarters of the year.

Figure 6. Change of the gas market structure

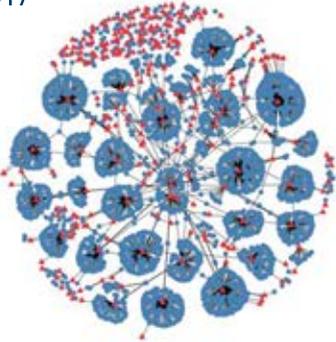
2015



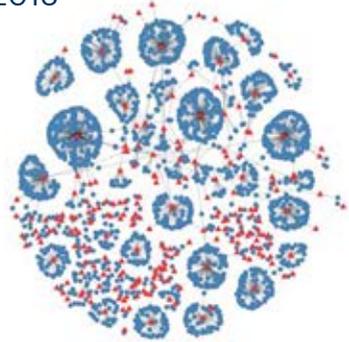
2016



2017



2018

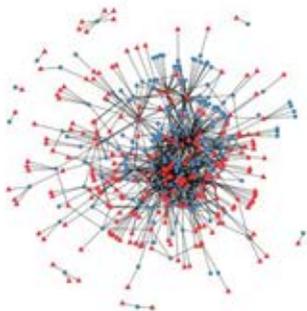


Supplier ●  
Contractor ▲

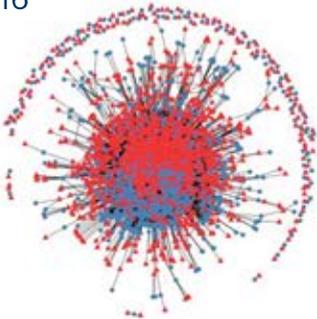
Source: ProZorro data, own calculations

Figure 7. Change of the pharmacy market structure

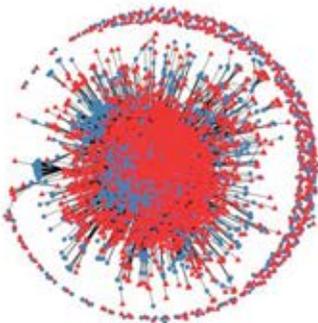
2015



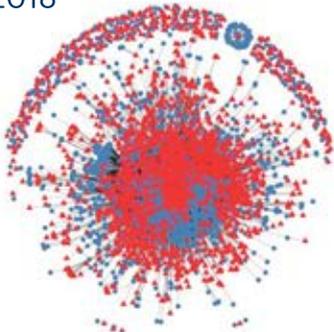
2016



2017



2018



Supplier ●  
Contractor ▲

Source: ProZorro data, own calculations



**Part II.**  
Risks,  
challenges and  
opportunities  
ahead



The international institutions forecast somewhat slower growth of the world economy for the next 3-5 years, a rise in inflation and further «normalization» of monetary policy (raising key rates) both in EU and the US. For Ukraine this means that bonanza of 2005-2006 with growing commodity prices and billions of foreign investment is not going to repeat itself. The «northeastern» source of funds is also closed.

Thus there is no alternative to structural reforms that protect property rights, improve quality of the labour force, make policies predictable and long-term planning possible. In its turn, this implies that institutionalization should be the most important task of all Ukrainian entities — as important as industrialization was for Soviet Union during 1930s. In the following table we review the main challenges that global economy and Ukraine are facing, and then we elaborate on the two of them.

Global challenge	Implications for Ukraine
<p>More inward-looking policies in the EU and the US.</p> <p>Lower enthusiasm to search for «win-win» solutions.</p> <p>One consequence may be a full-scale trade war or even a demise of the WTO.</p> <p>On the other hand, international institutions may emerge stronger from the current crisis</p>	<p>More cases of «realpolitik». Specifically, there is a high probability that Nord Stream II is completed.</p> <p>Loosening sanctions against Russia in the medium term cannot be ruled out.</p> <p><i>Consequences of a global trade war for Ukraine are described below.</i></p>
<p>Climate change: higher likelihood of extreme weather events and natural disasters</p>	<p>More breakdowns of infrastructure which is quite outdated.</p> <p>Falling yields of «traditional» crops.</p>
<p>Rising old-age dependency ratio.</p> <p>Rising expenditures on pensions and healthcare.</p> <p>Lower natural interest rates and thus growing savings. At the same time, political and technological uncertainties impede investment.</p>	<p>Now, Ukraine's old age dependency ratio is 23.* It is projected to reach 28-33 by 2030 and 31-52 by 2050.**</p> <p>Besides demography, labour force is shrinking because of labour migration and widening education-job mismatch.</p> <p><i>Ukraine's labour force shortage and its consequences are discussed below</i></p>

\* ratio of the number of people aged 65+ to the number of people aged 15-6\*\*

\*\* Institut of Deography NASU forecast

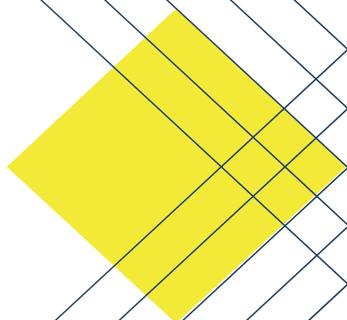
What the government can do	What the business can do
<p>Conduct transparent and rules-based privatization to attract foreign investors.</p> <p>Complete energy sector reform to reduce inefficiencies and increase domestic energy production</p>	<p>Invest into energy efficiency. Diversify suppliers and consumers.</p> <p>Raise the quality of products and services.</p>
<p>Invest in infrastructure both at central and local levels.</p> <p>Develop the system of early warning and minimization of consequences of natural disasters (floods, extreme winds etc.)</p>	<p>Run stress-tests «N days of infrastructure cutoff», develop action plans and train the staff.</p> <p>Control local government budgets and their spending, including infrastructure spending.</p>
<p>Continue healthcare and education reform (including adult education/retraining).</p> <p>Complete tax administration reform to minimize evasion.</p> <p>Complete law enforcement and financial market reform to facilitate long-term savings.</p> <p>Increase labour market flexibility to bring back people who are out of labour force (allow temporary, part-time contracts, simplify firing and hiring procedures etc).</p> <p>Develop childcare to support parental employment.</p>	<p>Invest into productivity-enhancing technologies.</p> <p>Educate workers and empower them. Viewing workers as partners and giving them voice increases flexibility of an organization, and in an uncertain environment flexible systems are more stable than rigid ones.</p> <p>Offer part-time contracts and flexible schedules.</p> <p>Develop and implement non-discrimination policies</p>

Global challenge	Implications for Ukraine
<p>Migration.</p> <p>While many studies show that economic benefits of migration outweigh its cost, if the extent of migration exceeded the capacity of host countries to absorb migrants, this may lead to the rise of anti-migrant sentiment and election of far-right or populist parties</p>	<p>At the moment Ukraine doesn't have large inflows of migrants. However as the situation improves, this may change (e.g. Poland is already having a considerable influx of workers from Asia). This may put strain on social infrastructure in some regions.</p>
<p>Increased capital mobility that makes tax evasion and profit shifting cheaper.</p>	<p>For a small open economy this implies larger currency fluctuations.</p> <p>For an economy with poor property rights protection this implies capital flight and smaller public revenues</p>
<p>Rising old-age dependency ratio.</p> <p>Rising expenditures on pensions and healthcare.</p> <p>Lower natural interest rates and thus growing savings. At the same time, political and technological uncertainties impede investment.</p>	<p>Unlike developed countries, Ukraine preserves some «old-style» monopolies which can abuse their market power and blackmail consumers and the government (examples – the situation with chlorine this year or with automobile gas in 2016)</p>
<p>Rising frequencies and scale of «digital wars» – from promoting fakes and throwing together social groups to major hacker attacks on the government and companies</p>	<p>Electoral support for pro-Russian politicians or populists.</p> <p>Rising tensions within the society. Infrastructure breakdowns.</p>

What the government can do	What the business can do
<p>Complete demographic registry and simplify the system of registration of people.</p> <p>Develop and implement a comprehensive policy for integration of migrants. Solutions for (re)integration of IDPs can be used for this policy.</p>	<p>Offer part-time contracts and flexible schedules.</p> <p>Develop and implement non-discrimination policies</p>
<p>Complete tax administration reform to widen tax base and minimize evasion. Relying more on indirect taxes is also a possibility.</p> <p>Regulate capital flows.</p> <p>Complete law-enforcement system reform.</p>	<p>Diversify asset holdings.</p> <p>Support law enforcement reform.</p>
<p>Enforce pro-competitive legislation.</p> <p>Define monopolies which can potentially abuse their power and take precautionary measures (e.g. simplify imports).</p> <p>Reduce red tape (barriers to entry).</p>	<p>Participate in regulatory policy discussions with the government and initiate discussions on regulatory policy changes.</p> <p>Constantly look for new market niches and ways to improve efficiency.</p>
<p>Conduct stress-tests and improve digital security of government agencies and crucial enterprises.</p> <p>Talk to people (explain you actions).</p>	<p>Conduct stress-tests and improve digital security.</p> <p>Raise your voice about socially important issues.</p>



**Probable  
challenge:  
A full-scale  
global trade  
war**





There are many things on which economists do not agree but there is at least one thing where economists are more likely to unite: free trade. For the majority of economists, free trade is always welfare improving, hence any barriers to trade flows are not only counterproductive for countries against which these barriers are imposed but they also levy additional costs on consumers of the country which imposed these barriers.

Even though there is a fear among economists and some policy makers about the recent rise of the protectionism in global trade, the data of the Global Trade Alert show decrease in application of new protectionist measures in 2017 and 2018 relative to 2016 following the increase in application of protectionist measures in the aftermath of the Global financial crisis.<sup>101</sup>

The fear of global rise in protectionism comes from the actions of the largest economy in the world, the United States, which currently is in four major battles with its trading partners, according to the Peterson Institute for International Economics.<sup>102</sup> The battles are over:

- (1) Solar panels and washing machines
- (2) Steel and aluminum products
- (3) Technology and intellectual property issues
- (4) Autos

Out of the four «battles», only one directly affects Ukraine, as iron and steel still account for the largest share in total Ukrainian exports of goods even though its importance has been fading (around 20% in 2017, as compared to average 31% before 2008). Over the last few years, Ukrainian producers

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<sup>101</sup> [https://www.globaltradealert.org/global\\_dynamics/day-to\\_0831](https://www.globaltradealert.org/global_dynamics/day-to_0831)

<sup>102</sup> <https://piie.com/blogs/trade-investment-policy-watch/trump-trade-war-china-date-guide>

benefited from higher prices of their products increasing the value of Ukrainian metal exports. The United States were the fifth largest export market for Ukrainian iron and steel producers.

In March 2018, Trump administration announced introduction of 25% tariff on steel and 10% tariff on aluminum (on average across code lines). These tariffs directly affect Ukraine as the biggest chunk of metal exports are in two categories which are subject to the new tariff (7207 — Semi-finished products of iron or non-alloy steel and 7208 — Flat-rolled products of iron or non-alloy steel, of a width  $\geq$  600 mm, hot-rolled, not clad).

Besides, Ukrainian steel and iron producers are subject to antidumping duties imposed on exports of hot rolled flat steel products from Ukraine (primarily category 7208) by the E.U. in 2017 and ranging between EUR 17.6 and EUR 96.5 per ton.

In addition to the direct effect from the U.S. measures, Ukraine is affected by the retaliation actions taken by the U.S. trading partners in response to the U.S. protectionist measures. Three largest exporters of iron and steel to the U.S. — the European Union, Canada and China — immediately announced their own tariffs on American exports, followed by Turkey and Mexico. According to the Peterson Institute, retaliation tariffs are expected to affect around 25 billion of US exports of steel, agricultural and food products, and some «iconic» consumer goods (motorcycles, blue jeans etc.). While tariffs on jeans and motorcycles are not really relevant for Ukrainian producers, the new barriers for U.S. agricultural and food producers can have indirect effect on Ukrainian economy. For example, in response to U.S. steel tariffs China imposed a 25% tariff on pork, which reduces the competitiveness of the U.S. producers (third largest to the Chinese pork market). Similar situation is observed in other markets affected by retaliation tariffs, e.g.

cereals. Ukraine can use this opportunity to expand its presence or enter the new markets where competitiveness of the American producers was hit by tariffs.

The biggest trade volumes are affected by the U.S. actions under umbrella of the unfair trade practices for technology, intellectual property investigation against China and retaliation measures taken by the latter. As of end-August 2018, two countries have imposed 25% tariffs on a total of \$50bn of one another's goods and further threats of subjecting new trade flows to tariffs<sup>103</sup> are aired. According to Petersen Institute, more than 85 percent of imports targeted by the American tariffs are in intermediate inputs and capital goods, thus increasing costs of production and hampering competitiveness of the American companies which use them in production. China on the other hand imposed tariffs mostly affecting vehicles, aircraft and vessels, and vegetable products such as soybeans. As in the case of retaliation tariffs discussed above, Ukrainian producers of agricultural products can try to improve their position in global markets dominated by American producers now hit by tariffs.

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<sup>103</sup> <https://www.bbc.com/news/business-45294162>



**Current  
challenge:  
Labour force  
shortage**



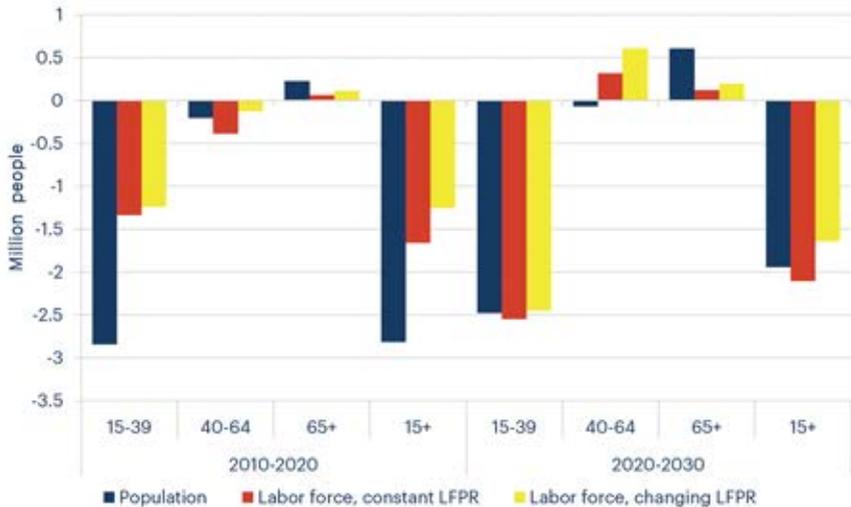
One of the main long-term challenges for Ukraine is declining and aging labor force due to a negative natural population growth (more deaths than births) and emigration of working-age population. Estimations based on the UN-2015 population projections in 5-year age- and gender-specific groups show a substantial decline of population aged 15 years and above, especially among the youngest (Figure 8). In order to assess the impacts of demographic trends for the future labor supply in Ukraine, we examine labor force projections using two scenarios — one assuming constant gender- and age-specific labor force participation rates at 2012 levels, and another one taking ILO (2013) projections of gender- and age-specific labor force participation rates. If labor force participation rates stay at the same levels as they were in 2012, Ukraine is expected to lose about 1.7 million workers aged 15 years and above between 2010 and 2020, and over 2 million workers between 2020 and 2030 (Figure 8). If age- and gender-specific participation rates slightly increase by 2030 as projected by the ILO, with the highest increase expected in older age groups, projected reduction in the labor force will be lower than in the first scenario but not substantially.

Projections of the labor force in 2010-2060 presented in Kupets (2016)<sup>104</sup> reveal that even under the most optimistic assumptions, where labor force participation rates would exceed 90 percent in all adult age groups (25 to 64 years) and 60 percent among the elderly (65+ years), Ukraine is not likely to counter a shrinking and aging labor force.

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<sup>104</sup> Kupets Olga (2016) «Chapter 8. Ukraine: Jobs for an Aging Society». In: Betcherman Gordon and Martin Rama (eds.), *Jobs For Development: Challenges and Solutions in Different Country Settings*, Oxford University Press, pp. 255-285.

Figure 8. Projected changes in population and labor force by age group, 2010-20 and 2020-30



Sources: Estimations based on the UN demographic age- and gender-specific projections until 2060 (UN 2015) and ILO projections of age- and gender-specific labor force participation rates in 2013–2030 (ILO 2013). Projections did not take into account changes in the population of Ukraine due to temporary occupation of Crimea and part of Donbas.

Notes: Basic scenario assumes constant gender- and age-specific labor force participation rates at 2012 levels. Scenario with changing participation rates takes ILO projections of age- and gender-specific labor force participation rates in 2013–2030.

An increase in immigration of young skilled workers to compensate for declines in the labor force, as it happens in developed countries, seems impossible in Ukraine. The main reasons that reduce the attractiveness of the country for immigrants compared to neighboring countries is the ongoing conflict in eastern Ukraine, low living standards, and serious problems related to employment and integration of immigrants (IOM, 2016).<sup>105</sup> The overwhelming majority of

<sup>105</sup> International Organization for Migration (2016) Migration in Ukraine: Facts And Figures, IOM, available at: [http://iom.org.ua/sites/default/files/ff\\_eng\\_10\\_10\\_press.pdf](http://iom.org.ua/sites/default/files/ff_eng_10_10_press.pdf).

immigrants that register in Ukraine are the citizens of post-Soviet states who obtain permanent residence permits on the basis of close family ties with the citizens of Ukraine.

On the other hand, temporary labor migration and more permanent emigration of working-age Ukrainians are expected to intensify in the future if the gaps in real income and quality of life between Ukraine and main destination countries are not reduced substantially (IOM, 2016). Given this, the only way to cushion the negative impact of aging and shrinking labor force on output and income of Ukrainians is to achieve pronounced labor productivity growth moving to capital- and/or skill-intensive technologies.<sup>106</sup>

One of the key factors limiting productivity growth in Ukraine is the inadequacy of workforce skills. Although Ukrainians have on average very high level of educational attainment compared to the majority of countries in the world, the formal education and training systems do not equip students with the skills employers need to achieve their business objectives, namely with practical job-specific skills, up-to-date knowledge and important soft skills (Del Carpio et al., 2017).<sup>107</sup> As a result, a lot of university graduates hold jobs that do not require tertiary education (about 40 percent of workers aged 15-29 years in 2013),<sup>108</sup> while employers experience substantial skills shortages and mismatches that limit companies' ability to hire,

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<sup>106</sup> In order to keep real GDP per capita constant (zero growth), labor productivity measured as real GDP per person in the labor force would need to grow on average by 0.3 percent annually during 2010-2060, with particularly pronounced growth needed in 2017-24 and 2041-48. If the goal is to reach a GDP per capita annual growth rate of 3 percent, the required productivity growth would be on average 3.3 percent per annum (Kupets, 2016).

<sup>107</sup> Del Carpio Ximena, Olga Kupets, Nomi Muller, and Anna Olefir (2017) Skills for a Modern Ukraine. Directions in Development, Washington, DC: World Bank.

<sup>108</sup> Kupets Olga (2016) «Education-job Mismatch in Ukraine: Too Many People with Tertiary Education or Too Many Jobs for Low-skilled?», Journal of Comparative Economics, Vol. 44(1), pp. 125-147.

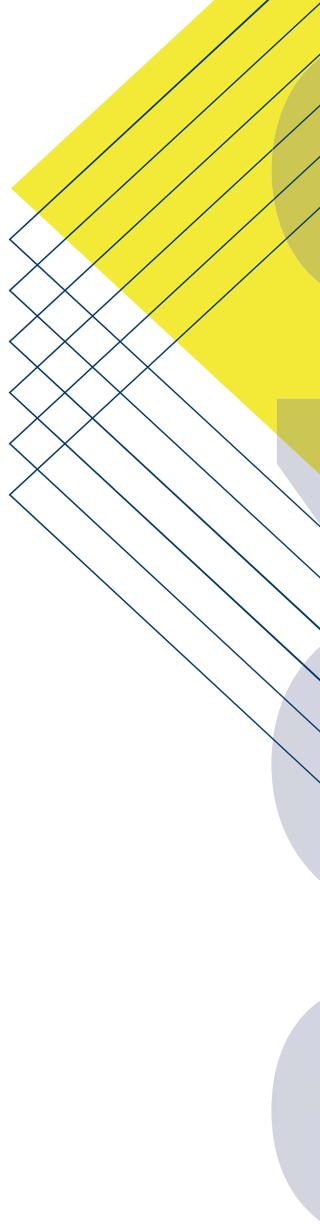
perform, and grow. Despite the obvious benefits of employer-provided training for alleviating skills shortages, increasing productivity of an ageing workforce and boosting innovation and competitiveness, relatively few employers in Ukraine provide regular training to their employees, especially if the firms are small and not oriented on innovations and international business contacts.<sup>109</sup>

To address these challenges, we suggest policy interventions aimed at promoting an effective use of the existing human capital and enhancing the development of skills for current and new workers. Along with policies improving the relevance of education and training programs, these interventions should also address the main constraints to employer-provided training such as a lack of (i) adequate and reliable information about training services providers and returns to various types of training, (ii) incentives to extend the coverage of training programs, and (iii) effective public-private partnerships in education and training of the workforce.

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<sup>109</sup> Kupets Olga (2018) «Employer-provided training, innovation and skills in post-Soviet countries», *Economics of Transition*, forthcoming.





# WHITE BOOK ON REFORMS

2<sup>nd</sup> issue

UKRAINE  
ECONOMY  
WEEK

Productivity

