A WORLD BANK COUNTRY STUDY

Ukraine

Restoring Growth with Equity:
A Participatory Country Economic Memorandum

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Manufactured in Ukraine

First printing October 1999

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ISBN: 0-8213-4382-3

ISSN: 0253-2123

Library of Congress Cataloging-in-Publication Data has been applied for.

ACKNOWLEDGMENTS

This participatory economic study is based on the findings of a joint team of the World Bank and Ukrainian experts co-lead by John Hansen (Economic Advisor, World Bank Office in Ukraine), Ihor Shumylo (Deputy Minister of Economy of Ukraine) and Vira Nanivska (Director of International Center for Policy Studies). The participatory process in Ukraine benefited from the guidance of a CEM Advisory Board composed of Mr. Vasyl Rohovy, Minister of Economy and Chair of the CEM Advisory Board, Prof. Anatoliy Halchinskiy, Advisor on Macroeconomy to the President of Ukraine, and the three co-leaders of the CEM process. Most of the preparatory and review work was done between June 1998 and June 1999.

The analysis in this report draws on a series of policy studies that were prepared by Ukrainian teams of experts, including the following: ***Agrarian Policy:*** Mr. Sablouk (Director, Agrarian Policy Institute) and Mr. Fesina (Leading Research Fellow, Agrarian Policy Institute); ***Energy Policy:*** Mr. Vrublevsky (Deputy Minister of Economy), Mr. Kiriniachenko (Head of Department, Ministry of Economy), and Mr. Skarshevsky (Expert, Prime Minister Service); ***Education Policy:*** Mr. Vitrenko (Head of Department, Ministry of Economy); ***Health Care Policy:*** Mr. Vitrenko (Head of Department, Ministry of Economy), and Ms.Nagorna (Deputy Director, Ukrainian Institute of Public Health Care); ***Fiscal Policy:*** Mr. Chechetov (Deputy Minister of Economy), Mr. Skarshevsky (Expert, Prime Minister Service), Mr. Lomynoha (Head of Department, State Treasury of Ukraine), and Mr. Soldatenko (Head of Sector, State Tax Administration), ***Industrial and Foreign Trade Policy***: Mr. Vrublevsky (Deputy Minister of Economy), Mr. Tryneev (Head of the Main Department, Ministry of Economy), and Mr. Yakubovsky (Deputy Director, Research Institute of Ministry of Economy); ***Shadow Economy Policy:*** Mr. Borodiuk (Doctor of Economics, Accounting Chamber of Ukraine), and Mr. Turchinov (Member of Parliament, Budget Committee, Verkhovna Rada); on ***Social Protection Policies:*** Mr. Yaremenko (Deputy Minister of Economy), Mr. Soldatenko (Head of the Main Department, Ministry of Economy), and Ms. Zinkevych (Deputy Head of the Main Department, Ministry of Economy).

World Bank and other experts who assisted and complemented the work of the Ukrainian teams included: ***Foreign Trade and Commercial Policies***: Michael Michaely with Veronika Movchan; ***Intergovernmental Fiscal Relations:*** Deborah Wetzel, Thomas Cochran, Mark Davis, Sean O'Connel, Leonid Polishchuk and Lucan Way; ***Public Expenditures on Education and Health:*** Frederick Golladay, Galina Sotirova, Kate Schecter and Ghanaraj Chellaraj: ***Legal Threats to Fiscal Sustainability:*** Joachim Lippott (Legal Advisor, TACIS/UEPLAC); ***Agriculture:*** Csaba Csaki, Mark Lundell and Ian Shuker; ***Banking Reform:*** Angela Prigozhina and Alan Roe; ***Coal Sector Policy:*** Heinz Hendriks: ***Shadow Economy:*** Maxim Ljubinsky; ***District Heating Policy:*** Carolyn Gochenour: ***Electricity Market Reform:*** Laszlo Lovei, Istvan Dobozi and Sergey Milenky, ***Environment:*** Alexi Slenzak; ***Education Finance:*** Katerina Petrina; ***Fiscal Reform:*** Mark Davis; ***Gas Sector Policy:*** Laszlo Lovei and Konstantin Skorik; ***Housing and Water Sectors:*** Ihor Korablev; ***International Trade***: Veronica Movchan; ***Labor Market:*** Arvo Kuddo; ***Pension Reform:*** Larisa Leshchenko and Katerina Petrina; ***Private Sector Development:*** Gregory Jedrzejczak and Vladimir Kreacic; ***Prospects For Economic Reform*** and ***Debt Sustainability:*** Andriy Storozhuk; ***Social Assistance:*** Galina Sotirova; and ***Transport Sector:*** Pedro Taborga.

Special credit goes to the International Center for Policy Studies, a leading NGO think-tank in Kyiv, for their support in this collaborative effort. A CEM facilitation team within ICPS comprising Sergiy Loboyko, Volodymyr Hnat, Andriy Bega, Vasyl Lashchivsky, Nazar Mahera, Larisa Romanenko and Christina Lashchenko handled the complex process of coordinating the work of the research teams, thereby making the participatory approach possible. A second team at ICPS headed by Hlib Vyshlinsky and Yevhenyia Yehorova handled publication of all reports produced by the CEM process. Special thanks are also due to Nadezhda Troyan and Tatiana Anderson for their dedicated work on document preparation, and to Victor Lukyanenko, Victoria Antoshchuk, Maria Korchynska and Oksana Burakovska for interpretation and translation.

This report was prepared under the guidance of Paul Siegelbaum (Country Director), Pradeep Mitra (PREM Director), Hafez Ghanem (Sector Leader), and Gregory Jedrzejczak (Resident Representative). The peer reviewers were William Easterly (PRDMG), Alex Sundakov (Economic Research Institute, New Zealand) and Marek Dabrowski (CASE, Poland).

The report draws significantly on the macroeconomic analysis and data prepared by the IMF, TACIS/UEPLAC, HIID, KPMG Barents Group and other donors.

In June 1999 the draft report was discussed in a joint Bank/Government conference in Kyiv attended by representatives of the Government of Ukraine, the World Bank, and a wide range of representatives from the academic, donor, NGO, domestic enterprise, and foreign investment communities in Ukraine. Special thanks are due to all of the key ministers and ministries of the Ukrainian Government for their excellent comments on the draft and for the opportunity to discuss in detail the findings and policy recommendations of the report. The current document reflects the many valuable comments that were received during the review process.

The views expressed here do not necessarily reflect those of the reviewers or of the organizations for which the authors work. The authors remain solely responsible for any errors that may remain in this paper.

ABSTRACT

Since independence, Ukraine has suffered one of the most severe economic declines of any country in this century. A decade of negative growth has left it with less than half of Soviet output levels. The decline in living standards has been less than the officially-reported GDP decline—a large share of output is in the shadow economy, and much of the Soviet-era output contributed little to the quality of life. But the sharply increased poverty now facing a major share of Ukrainians is clear from indicators of physical poverty such as falling life expectancy, rising infant mortality, and increased sickness.

The origins of this economic decline are much the same as in other transition countries—the twin shocks of collapsed trading relations and sharply higher energy prices following the breakup of the Soviet Union. As most Soviet-era products were not competitive on world markets, Ukraine's ability to shift exports to the West was limited. As the economy was heavily energy dependent, rising energy prices made it even harder to compete on world markets.

What has distinguished Ukraine from the other transition countries in the region that have more successfully replaced their old command economies with market economies has been the degree to which Ukraine tried to protect the loss-making enterprises from closure to preserve employment and income levels. To do this, the government lived far beyond its means, allowing subsidies and other privileges to push expenditures well beyond available resources. The difference was financed through hyperinflationary credit expansion during the early years of independence, then by heavy foreign and domestic borrowing.

The costs of these polices are now obvious. Today the Ukrainian government struggles to pay its bills on time and to meet its debt service obligations. Short of resources and faced with a large backlog of arrears in wage and social payments, the Government has put heavy pressure on profitable enterprises to pay taxes, leaving many with little for investment and growth. The combination of burdensome taxes and intrusive regulatory intervention has encouraged widespread tax evasion—putting even more pressure on firms remaining in the formal sector. Perhaps half of all economic activity now hides in the shadow economy, making it even harder for the Government to obtain the resources it needs to operate efficiently, to create a good business climate that attracts investment and growth, and to provide a good social system that develops and protects the people. The Government's high levels of domestic borrowing to cover its deficits and debt service costs has crowded out the enterprise sector from the capital market—with real interest rates exceeding 50 percent, few legitimate enterprises can afford to borrow.

Escaping the downward economic spiral requires a radical change in Government's role in the economy. Leading industrial enterprises from Soviet days are still owned by government, and at the local level government interference both with the sale and movement of agricultural products and with the operation of industrial enterprises causes serious economic problems. Although direct subsidies have been cut dramatically, the indirect cost of support to loss-making agricultural and industrial enterprises in terms of tax privileges and exemptions, preferential procurement, and politically directed lending from the commercial banks is not sustainable. This is widely known in Ukraine, but strong vested interests in the status quo, which provides widespread opportunities for corruption, have effectively blocked change.

Growth can be restored to Ukraine and poverty can be reduced only if the government moves quickly to a more market-oriented role. High priority actions include rapid privatization of virtually all large industrial enterprises including those in energy and telecommunications; a sharp and measurable decrease in the government's regulation of business; and fundamental changes in governmental organizational structures to encourage a shift from control to facilitation.

These changes could lay the foundations for Ukraine to raise living standards for all of its people based on internationally competitive production. It has abundant natural resources, highly trained human capital, strong industrial work ethic, and an excellent physical and geopolitical position. All it needs now is the necessary policies and institutions. This report outlines how Ukraine can accomplish this task.

UKRAINE: SELECTED INDICATORS TABLE

Indicators	1995	1996	1997	1998	1999F
GDP					
UAH billions (nominal)	54.5	81.5	93.4	103.9	130.6
Real GDP growth	-12.2%	-10.0%	-3.0%	-1.7%	-1.0%
US$ billions (PPP terms)	124.2	113.1	110.0	108.1	107.0
US$ billions (at market exchange rate)	37.0	44.6	50.2	42.7	31.9
GDP per capita based on market exchange rate (US$)	718	872	989	849	637
Atlas GNP per capita ($)	1,350	1,210	1,040	850	800
Gross domestic savings (% of GDP at market prices)	23%	20%	19%	18%	19%
Gross domestic investment (% of GDP at market prices)	27%	23%	21%	21%	20%
Agriculture and forestry (% of GDP at factor cost)	15%	14%	14%	14%	15%
Industry and construction (% of GDP at factor cost)	42%	38%	34%	36%	38%
Services (% of GDP at factor cost)	42%	48%	51%	50%	47%
MONETARY STATISTICS					
Monetary base growth	132%	38%	45%	22%	28%
Money supply (M3) growth	113%	35%	34%	25%	36%
Monetization ratio (M3/GDP)	13%	11%	13%	15%	16%
Exchange rate (UAH/US$, year end)	1.79	1.89	1.90	3.43	4.6
Inflation (CPI change, December on December)	181.7%	39.7%	10.1%	20.0%	17.0%
PUBLIC FINANCES (% GDP) [1]					
Consolidated budget revenues (including Pension Fund)	38%	37%	38%	36%	36%
Consolidated budget expenditures (including Pension Fund)	43%	40%	44%	38%	38%
Cash budget deficit	4.9%	3.2%	5.6%	2.7%	1.9%
Domestic financing[2]	3.9%	2.5%	5.3%	0.9%	0.6%
External financing	1.0%	0.7%	0.3%	1.8%	0.7%
Accrual budget deficit[3]	8.2%	8.4%	5.2%	3.0%	-0.6%
Total public debt (US$ billion)	8.2	10.1	14.2	15.2	15.0
Domestic	0	1.2	4.6	3.7	2.2
External	8.2	8.8	9.6	11.5	12.8

(continued on the next page)

UKRAINE: SELECTED INDICATORS TABLE (continued)

Indicators	1995	1996	1997	1998	1999F
BALANCE OF PAYMENTS (US$ billions)					
GNFS Exports [4]	17.1	20.3	20.4	17.6	15.8
Merchandise exports	14.2	15.5	15.4	13.7	12.3
% of GDP	46%	46%	41%	41%	50%
GNFS Imports [4]	18.3	21.5	21.9	18.8	16.1
Merchandise imports	16.9	19.8	19.6	16.3	13.6
Energy	7.8	8.9	8.3	6.2	5.9
Merchandise trade balance	-2.7	-4.3	-4.2	-2.6	-1.3
Current account balance	-1.2	-1.2	-1.3	-1.3	-0.5
% of GDP	-3.1%	-2.7%	-2.7%	-3.0%	-1.6%
Direct foreign investments [5]	0.27	0.52	0.62	0.74	0.45
Net international reserves (year end)	-0.4	-0.3	0	-2.0	-1.7
Gross foreign exchange reserves, excluding gold (year end)	1.1	2.0	2.3	1.0	1.6
weeks of GNFS imports	3.0	4.7	5.6	2.9	5.2
INTERNATIONAL DEBT (US$ billion)					
Total external debt (DOD)	8.4	9.1	10.0	12.2	13.6
Public	8.2	8.8	9.6	11.5	12.8
Private	0.2	0.3	0.5	0.7	0.8
% of GDP (Mod = 30%)	23%	20%	20%	29%	43%
Total external public debt service	1.5	1.2	1.2	1.8	2.0
% of GNFS Exports (Mod = 18%)	9%	6%	6%	10%	13%
ARREARS (UAH billion)					
Total wage arrears	0.6	3.7	4.9	6.5	5.5
Budget sphere	0	1.0	0.7	1.0	0.5
Pensions arrears	0.1	1.1	1.3	2.0	1.7
IBRD DEBT (US$ billion)					
IBRD DOD	0.5	0.9	1.2	1.6	2.1
IBRD debt service	0.01	0.03	0.06	0.06	0.10
IBRD debt service/External public debt service	0.5%	2.6%	4.7%	3.5%	5.2%
IBRD debt service/GNFS exports	0.0%	0.2%	0.3%	0.4%	0.7%
Share of IBRD portfolio	0.4%	0.8%	1.1%	1.4%	1.7%

[1] IMF GFS methodology
[2] Including privatization proceeds
[3] Negative—surplus
[4] GNFS—Goods & Non-Factor Services
[5] BOP definition

List of Acronyms and Abbreviations

CEE	Central and Eastern Europe
CIS	Commonwealth of Independent States
EBRD	European Bank for Reconstruction and Development
FSU	Former Soviet Union
UNDP	United Nations Development Programme
OECD	Organization for Economic Co-operation and Development
IBRD	International Bank for Reconstruction and Development
IFC	International Finance Corporation
MIGA	Multilateral Investment Guarantee Association
IDA	International Development Association
IMF	International Monetary Fund
EFF	Extended Fund Facility
NGO	Non Governmental Organization
NBU	National Bank of Ukraine
HDI	Human Development Index
VAT	value added tax
FDI	foreign direct investment
GDP	Gross Domestic Product
GNP	Gross National Product
PPP	Purchasing Power Parity
NAS	National Accounts System
GFS	Government Finance Statistics
GNFS	Goods & Non-Factor Services
NPV	Net present value
OVDP	State domestic bonds
FX, forex	Foreign Exchange

Monetary Units

UAH = Ukrainian Hrivnya
USD = U.S. Dollar
USD 1.00 = UAH 4.50
(October 1999)

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EXECUTIVE SUMMARY

This country economic memorandum—one of three reports produced jointly by the World Bank, the Ministry of Economy, and the International Center for Policy Studies through a highly participatory CEM process—defines a shared vision for a strategy that will allow Ukraine to halt its economic decline and move toward a more prosperous future.[1]

ECONOMIC DECLINE—AND GROWING POVERTY

Officially reported GDP is now less than 40 percent of its 1989 level—a decline twice as severe as that in the United States during the Great Depression, and worse than that in many other Central and Eastern European countries (figure 1). Many factors including initial conditions and external shocks, subsidies to failing enterprises, monetary expansion, and heavy borrowing have contributed to Ukraine's economic decline and growing poverty.

Initial conditions and external shocks

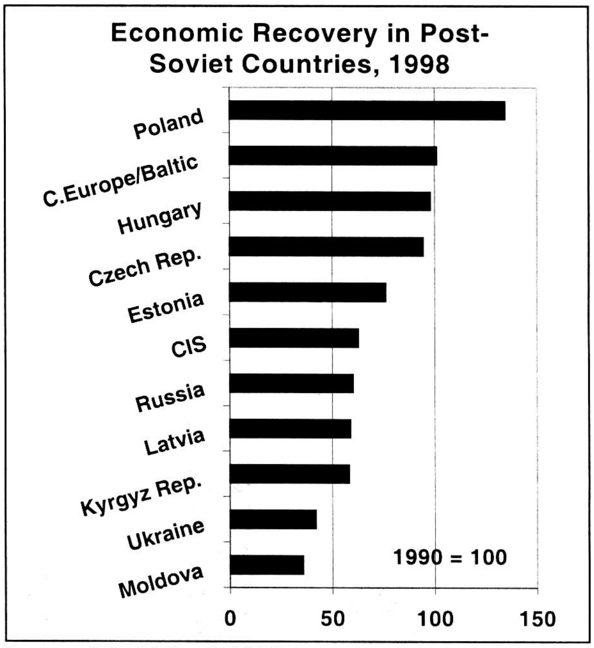
The most important initial conditions and external shocks have been:

- The breakdown in trade and payment relations that came with the collapse of the Soviet Union.
- The higher energy prices introduced by Russia after the collapse.
- The large scale of Ukraine's agricultural and industrial enterprises.
- A reluctance to impose hard budget constraints.

Trade and payments shock. Even during the Soviet era, Ukraine's economy was highly oriented to external trade, depending heavily on the markets of other republics in the former Soviet Union (FSU) and other communist bloc (COMECON) countries. This outward orientation was partly a reflection of real comparative advantage and partly the result of Soviet policies to foster the dispersion of economic activity throughout the FSU. When trade and payments relationships collapsed with the breakup of the Soviet Union, Ukraine lost markets that were vital to its enterprises, and after years of isolation from Western markets, its products could not compete in Western markets.

Energy price shock. As energy was available at negligible costs during the Soviet era, Ukrainian farms and factories were highly energy intensive. When Russia increased its energy prices by more than 10 times, many Ukrainian products became uncompetitive in cost as well as design.

Figure 1 Economic recovery in other former Soviet states outpaces that in Ukraine



Source: World Bank 1998.

[1] John Hansen and Vira Nanivska (eds). 1999. *Economic Growth with Equity: Ukrainian Perspectives* (World Bank Discussion Paper No. 407). World Bank, Kiev and Washington, D.C.; and John Hansen and Diana Cook 1999. *Economic Growth with Equity: Which Strategy for Ukraine? (World Bank Discussion Paper No. 408).* World Bank, Kyiv and Washington, D.C.

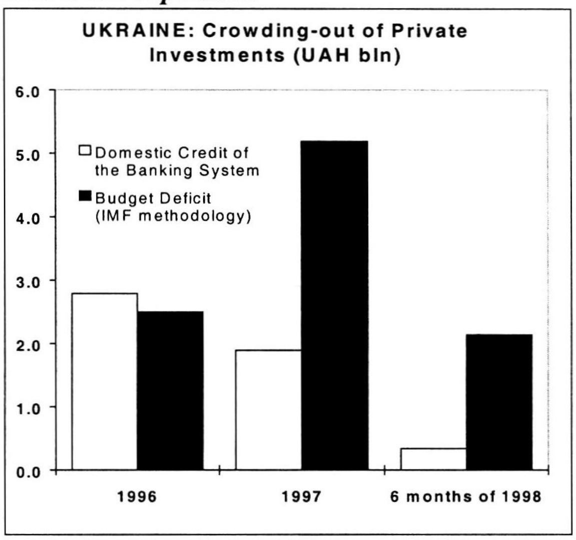
Diseconomies of large scale. The exceptionally large scale of the farms and factories inherited from the Soviet era has made it difficult to restructure them. These "giants" created a politically and socially important concentration of people who could lobby effectively for subsidies that would delay real reforms.

Soft budgets. The Government's willingness to support failing enterprises with subsidies created a "soft budget" culture that helped put the Ukrainian economy onto its precipitous downward course.

Subsidies, money, and hyperinflation

Largely as a result of subsidizing enterprises and individuals, total deficits including directed credits exceeded 20 percent of GDP in 1992-93, and money supply expansion peaked at more than 1,000 percent in 1993. This, together with the monetary overhang from the Soviet era, lead to hyperinflation. Between the end of 1992 and the end of 1994, prices increased by almost 500 times. The public lost confidence in the domestic currency, producing sharp declines in real money balances. Today Ukraine has one of the smallest banking and monetary systems in the world relative to GDP, and much of the available credit has been absorbed by the government, crowding out the enterprises and making it hard for them to borrow the money they need for payments, investments, and growth (figure 2).

Figure 2 Government deficits exceeded total credit expansion



Source: World Bank staff estimates.

Indirect subsidies, deficits, and debt

Although government sharply reduced budgetary subsidies to enterprises, it now offers financially failing farms and factories tax privileges. Such largess has failed to revitalize these enterprises, and it has drained resources from other potentially viable firms. The full negative impact of these tax privileges has not yet become obvious in terms of overall tax revenues for three reasons.

First, to compensate for the loss of tax revenues, the government has increased the tax pressure on profitable firms through high rates and intensive inspections. This drives once-profitable enterprises into financial distress—and into the shadow economy. The combination of tax privileges for loss-making enterprises and tax pressure for profitable enterprises gradually reduces tax revenues, increases budget deficits, raises the burden of debt payments, and creates a need to put even more tax pressure on the remaining profitable enterprises.

Second, many enterprises do not receive tax privileges. This reduces the negative fiscal impact—but creates an uneven playing field, distorting the competitive conditions for enterprises. Since attaining privileges can be more profitable than improving production and marketing performance, managers allocate their time and resources accordingly, and corruption increases.

Third, a major share of taxes are being collected not in cash but as "mutual settlements." Although tax revenues were reported to be around 35 percent of GDP, actual tax collections in cash were less than 20 percent of GDP in 1998-99. By allowing failing enterprises to remain in operation and "pay" their taxes with barter—if they pay at all—the government has helped create a large virtual economy.

The illusion of stability

With the exception of the aftermath of the Russian crisis in late 1998, domestic price levels and the exchange rate have been relatively stable since 1995. This stability was supposed to provide the foundations for growth—but the economy continues to decline, albeit at a slower pace than before. The problem is that Ukraine's stability is based on the weak foundation of tight monetary policy and an artificially stable exchange rate rather than on deep structural reforms.

The debt crisis

After the August crisis in Russia, Ukraine found it difficult to roll over its billions of hryvnias of t-bill debt, much of which had been sold to foreign investors who became wary of all emerging markets in the aftermath of problems in Asia and Russia. Once the t-bill debt could no longer be rolled over, even at real annual yields exceeding 70 percent, Ukraine was forced to restructure this debt, making it almost impossible to borrow new money on private international capital markets.

The impact on growth

Ukraine's soft budget culture and the resulting high budget deficits have hurt economic growth in several ways. First, enterprises have remained inefficient. If the government instead had enforced bankruptcy, growth-supporting structural reforms would have taken place far more rapidly. Second, as noted above, budget deficits have crowded enterprises out of the capital market (figure 2). At barely 2 percent of GDP in 1998, Ukraine had the lowest ratio of bank credit to the private sector of any transition country other than the Kyrgyz Republic (the ratio for transition economies in general is about 40 percent). Third, commercial bank credit to enterprises is among the most expensive in the world, with real interest rates on commercial bank loans peaking at 100 percent in September 1998 and was still running at 30-40 percent in the fall of 1999.

The lack of structural reforms, a central theme of this report, has led both to continued economic decline and to high budget deficits, propelling the vicious circular relationship between them. If Ukraine had more quickly implemented fundamental structural reforms in enterprise ownership, market relations, the legal and juridical structure, and the role of government, the economy would not have collapsed as far as it has. And if the structural reforms had been put into place more quickly, the budget would have been supported by a larger tax base, lowering the deficits.

The impact on social conditions

Human suffering has been the greatest cost of Ukraine's slow structural reforms. Family incomes have dropped sharply. Health standards have deteriorated. And adult literacy and school enrollments have declined. Between 1991 and 1995 the UNDP human development index (HDI)[2] plummeted, moving Ukraine from 32^{nd} to 95^{th} among 175 countries (figure 3).

Figure 3 Economic decline has brought a sharp drop in Ukrainian living standards

Source: UNDP 1998.

TRANSFORMING THE ROLE OF GOVERNMENT

The government deficits that have played such a prominent role in Ukraine's continued economic decline reflect in large measure the fact that government has been slow to relinquish the role it played during the Soviet era.

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[2] The Human Development Index is heavily influenced by per capita incomes and thus by official GDP. Since around 50 percent of total production in Ukraine may be in shadow economy and because much of this activity escapes the official measurements of GDP, the real decline in living standards may be considerably less than indicated by the dramatic decline in official data on per capita incomes. However, the physical indicators of the quality of life, particularly those related to health, indicate a sharp increase in the number of people living in real poverty.

Moving from a Soviet to a market role

Ukraine faced a major challenge when it attained independence in 1991—to replace its system of government that was designed to implement Moscow's directives with one that could design and implement the country's own market-oriented policies.

The government also had to undergo a fundamental change—from being responsible for the ownership, management, and control of essentially all economic activity to being responsible for facilitating economic activity in privately owned enterprises. This change has been difficult. As a result, many old administrative structures—such as the super-ministerial layer of the *apparat* between the ministers and the Prime Minister, and sector representatives in the Ministry of Economy and Ministry of Finance—are still in place.

High priority should be given to measures that will (a) reform the "Apparat" of the Cabinet of Ministers so that it focuses on policy coordination and support rather than on policy making; (b) consolidate the Cabinet so that it becomes a small collegial body focused on strategic policy making; (c) reform the civil service, clearly delimitating political and non-political posts, implementing pay reform, training of senior civil servants, and introducing merit-based promotion principles; and (d) reduce the number of business inspections and sharply limit the number of routine inspections by the State Tax Administration.

Mobilizing and using resources efficiently

With the total tax burden including pension fund contributions running at about 35 percent of GDP, Ukrainian enterprises and people are shouldering a burden comparable to that in countries with considerably higher levels of per capita income. Worse still, about half of all economic activity is hidden in the shadows and at least half of taxpaying enterprises are losing money. The full tax burden is effectively borne by only a small part of the country's economically active population.

By changing its role in the economy and in society, the government will be able to limit its resource requirements to only the highest-priority activities. At the same time, it needs to find ways to increase its efficiency of resource use. For example, investments need to be made to increase the energy efficiency of hospitals. Also, better diagnostic equipment would allow shorter hospital stays, allowing Ukraine to consolidate unneeded facilities.

Moving shadow activity to the formal sector. The shadow economy—defined here as production that does not pay taxes—accounts for about half of all economic output in Ukraine. As a result, shadow economic activity is vitally important to a major share of the Ukrainian people, providing badly-needed jobs, goods, and services. As in other countries, the shadow economy is largely created by government policies—high taxes and a heavy regulatory burden. Barter also contributes to shadow activity by making it hard to monitor and tax financial flows. The very existence of the shadow economy leads to its expansion. A legitimate firm that pays its taxes has little hope of competing against enterprises in the same business that do not pay their taxes. The only choice is to cease production or move to the shadow economy.

Small firms remain small to avoid detection, stunting their growth. Large firms spend money on bribes so that they can continue avoiding taxes. Firms that thrive are often not the most efficient ones, but those with the best political connections. Since much of the economic activity in Ukraine goes untaxed, the government must tax even more heavily the firms in the formal economy, frequently leaving these firms with no choice but to cease production or join other enterprises in the shadow economy. As the resources available to government shrink, its ability to provide services to firms and their employees shrinks, making it even less attractive for the firms to remain in the formal sector. The downward spiral of revenues becomes self-perpetuating.

Given the economic and social importance of the shadow sector, the objective cannot be to suppress or control it. The objective must be to implement policies that will encourage this activity to move into the formal, tax-paying economy where it can grow openly with full protection of the law. Ukraine needs to move swiftly to reverse the shift of economic activity into the shadows. Otherwise the tax base will be eroded—leading to higher deficits, weaker government services, and the risk of financial and social strife (see chapter 2).

Fighting corruption. Tightly linked to Ukraine's large shadow economy is widespread corruption. In addition to corrupt enterprises that hide in the shadow economy to avoid taxation and to profit from non-transparent barter deals, an unfortunate number of government officials and functionaries at all levels seem to be corrupt, basing their decisions less on what is best for economic growth and the people's welfare, and more on what will be personally profitable. This shrinks the efficiency of government, dampening prospects for restoring real economic growth

Managing government debt

Ukraine's inability to move forward with structural reforms has limited its access to resources from the World Bank, the International Monetary Fund (IMF), and the European Bank for Reconstruction and Development. Faced with relatively large fiscal deficits of recent years, ranging from 3-6% of GDP, Ukraine has borrowed funds commercially at high interest rates and with short maturities. Although the ratio of debt to GDP in Ukraine has risen sharply in recent years and now stands at about 40 percent, the real problem is the terms on which the debt was contracted.

The key to reducing the debt service burden to more manageable levels is to implement the structural reforms needed to restore access to borrowing from international financial institutions. Such resources are available at much lower interest rates and for much longer maturities. The structural reforms needed to gain access to such funds will reduce deficits and the need for borrowing. They will also increase growth and thus the resources needed to repay old debts. Finally, accelerated reforms will rebuild the confidence of investors in Ukraine, gradually restoring access to private capital flows.

The Urgency of Structural Reforms

Since independence Ukraine has made significant structural reforms in a number of areas. All small enterprises and about 80 percent of medium-size and large enterprises have been privatized. Although only about 15 percent of agricultural land is actually titled and held privately, most agricultural land is held collectively by private cooperatives. Nearly all export quotas and tariffs have been eliminated. Normal trading relations have been established with all major trading partners, including a partnership and cooperation agreement between Ukraine and the European Union. Ukraine has also signed a friendship treaty with Russia.

But some of the most crucial structural reforms have yet to be implemented. The lack of true structural reforms in large enterprises is the most serious problem facing Ukraine. The policy of protecting enterprises needs to be abandoned and replaced as quickly as possible by a policy of hard budget constraints. Faced with hard budget constraints and the threat of closure if they do not become self-financing, enterprises will seek out new investors (both domestic and foreign), new markets, new production technologies, and new management methods. They will also lease or sell underused space and equipment, paving the way for the creation of new enterprises that can employ the people who will be laid off when overstaffed state enterprises release redundant employees.

Although the design and implementation of improved bankruptcy procedures is absolutely essential if Ukraine is to break the heavy chain of non-payments that drags the economy down, bankruptcy must be implemented with care. In a normally functioning economy, only a small percentage of enterprises go bankrupt in any given year—but the threat that they might is enough to assure that most will do everything possible to avoid bankruptcy. In Ukraine, however, so many companies are already bankrupt *de facto* that rapid implementation of bankruptcy proceedings that forced all of these companies into immediate *de jure* bankruptcy could have a cataclysmic impact on the economy and on people. Many viable transactions would be frozen or delayed by the collapse of many banks and by bottlenecks in the nascent bankruptcy court system.

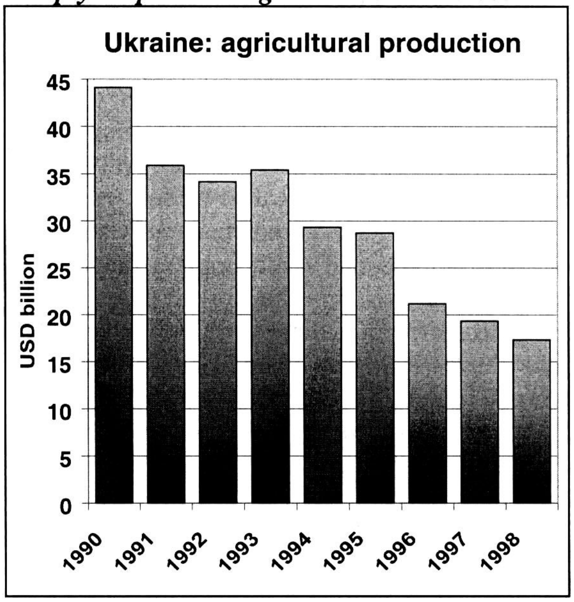
Major efforts will therefore be required to put in place an effective bankruptcy system that provides urgently needed incentives for payment discipline without creating an economic and social crisis. As demonstrated by Hungary and other formerly planned economies, this can be done.

The state also needs to create a business climate that is attractive to business development—one that stimulates investment, production, and growth by providing a level playing field where all competitors face clear, predictable, and equitable rules of the game. Such an environment would facilitate the structural transformation of old enterprises and would also stimulate the creation of new enterprises, the most important component in any program of structural reform.

Reviving agriculture

The situation in the agricultural sector today is calamitous. Ukraine, a country with a temperate climate and perhaps the world's best endowment of rich black soil, has seen its agricultural output fall year after year (figure 4). Equipment is worn out. Incomes are dropping. And the government is under constant pressure to provide tax privileges and write-offs of unpaid taxes and credits. The most pressing issues in the sector in terms of structural reforms are the lack of effective private owners and the lack of efficient markets for agricultural inputs and outputs.

Figure 4 Agricultural output continues to drop sharply despite rich agricultural resources



Source: TACIS/UEPLAC. *Ukrainian Economic Trends.*

Although most agricultural land is technically no longer held by the state, the collectives that control all but about 15 percent of the land are little more than a cosmetic reincarnation of the old state controls. Collective members generally operate as employees rather than as farmers—often under the control of directors from the Soviet era. Land ownership based on titles that can be mortgaged is essential so that farmers have collateral that can be used to secure loans for the investments needed to renew the equipment fleet and to provide working capital.

Access to banking system credit would help resolve the other big problem in agriculture—the continued state control of inputs and outputs through a system of commodity credits (credits of inputs like seeds and fertilizer that must be repaid with physical products like wheat). Cash credit would break the *de facto* state control over agricultural production and would introduce badly needed transparency in a shadowy environment dominated by physical transactions.

Reorienting manufacturing

Large-scale manufacturing is urgently in need of profound structural reforms. None of the industrial "giants"—enterprises with more than 750 million hryvnias in assets—have been privatized in a way that gives effective private ownership control. Many of these enterprises enjoy extensive tax privileges, making them a major source of budget deficits. State guarantees for loans to enterprises, in some cases involving millions of dollars, also create a burden when the enterprises, unable to repay the loans, leave the debts for the state to repay.

The key to structural reforms in manufacturing is hard budget constraints, reinforced by effective bankruptcy laws. Rapid privatization of enterprises of all sizes is also needed in all but a few exceptional areas. Such privatization should be done in a way that vests ownership control firmly in the hands of private investors without any blocking or "golden" shares held by the state. Privatization should be done in accordance with international standards, including a transparent, competitive process that advertises worldwide to find all potential, serious investors, especially those with good track records in the specific line of business.

Adjusting energy

Ukraine is one of the world's most energy-intensive countries. During the Soviet era, when energy was available at 5-10 percent of world prices, the wasted energy was mainly an environmental issue. Today energy intensity is a major economic issue. Energy accounts for nearly half of Ukraine's imports, creating a major drain on the balance of payments and diverting resources that could better be used to import the capital equipment needed to increase productivity, enhance international competitiveness, and provide new jobs.

Inefficiency is a constraint to economic growth and fiscal stability throughout the energy sector. In the coal sector, mines that have long been depleted continue to be operated for social reasons, creating a serious drain on the budget and raising the cost of coal to domestic energy users. District heating facilities waste massive amounts of energy in conversion to heat, in distribution, and in utilization. To correct this, extensive investments are needed in new boilers, distribution lines, heat meters, and building insulation. Here, as with gas and electricity, physical inefficiency is exacerbated by low cost recovery rates, low cash collection rates, and the lack of hard budget constraints.

As a result, all energy sectors are in bad financial shape, not even able to pay for inputs on time, much less make badly needed investments in improved efficiency. The lack of appropriate prices and payment discipline compounds the problem by failing to provide incentives for more efficient energy use by customers.

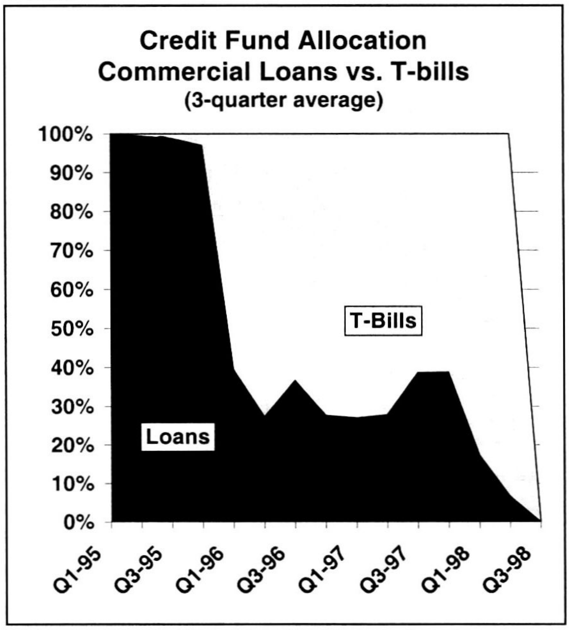
Bolstering banks

Ukraine's commercial banking system has suffered greatly because of the government's loose fiscal policy described above. As deficits increased, more and more of banking system capital was absorbed by the government (figure 5). Unable to appraise normal commercial risks and unwilling to buy more t-bills following the restructuring that took place in late 1998, banks began to place excess reserves in the central bank, creating an illusion of excess liquidity even though the money supply was extraordinarily small relative to GDP. The excess reserves deposits were a reflection not of excess liquidity but of the profound institutional weaknesses of a commercial banking system that had grown content with arbitraging interest rates internationally, taking advantage of the implicit exchange rate guarantee of the stable hryvnia, and lending at extraordinarily high real interest rates to the government. The central bank is now working actively with the IMF and the World Bank to strengthen the commercial banking system so that it can begin to play the role that it should in providing credit on a normal commercial basis to Ukrainian enterprises.

ASSURING GROWTH WITH EQUITY

Under the Soviet system, income differences were minimized. In contrast, significant income differences are normal in a market-based system, providing essential incentives. Increased income disparities are therefore a common part of the transition process. At the same time, basic social justice—a key objective for the Government of Ukraine and for the World Bank—calls for reducing or eliminating absolute poverty. This can be done by ensuring jobs-oriented growth, providing access to human development services, and supplying a social safety net.

Figure 5 T-bill sales quickly absorbed all new credit



Source: Harvard Institute for International Development.

Jobs-oriented growth

The best way to ensure adequate incomes for all citizens is a jobs-oriented growth strategy—one that stimulates the creation of productive employment in profitable enterprises. Developing sound macroeconomic policies and a good investment climate are essential to this objective because this would allow Ukraine to exploit one of its strongest areas of comparative advantage—a low-cost, well-educated labor force with extensive industrial work experience. High payroll taxes, an artificially appreciated exchange rate, excessive minimum wages, barriers to labor mobility, and widespread unionization have all tended to increase the cost of labor, discouraging investments in labor-intensive activities. Such distortions also increase the demand for capital-intensive investments, resulting in higher-cost production that is less competitive, contributes less to economic growth, and generates fewer jobs.

A jobs-focused growth strategy does not mean that the government should require enterprises to hire or retain a certain number of workers. Nor does a jobs-focused strategy mean that the government should subsidize employment. Instead, a jobs-oriented strategy means that the government should introduce policies that stimulate the development of small and medium-size enterprises. Throughout the world, such enterprises are the leading source of employment. In the United States, for example, firms with fewer than 500 workers account for 80 percent of employment. In addition to providing incomes to hundreds of thousands of families, the job opportunities created by fostering the development of small and medium-size enterprises would make it much easier to undertake the urgently needed restructuring of state enterprises.

Supporting human development

Access to quality health and education services in Ukraine today is often severely limited because the government lacks the necessary financial resources. As Ukraine moves forward, all people will need affordable access to good health and education, regardless of their income. Steps need to be taken to assure the necessary financing. Health and education efficiency should be improved by cutting the energy costs of schools and medical institutions, reducing under-used space, lowering excessive staff costs, improving the pay and professional preparation of those who remain in these sectors, and providing better equipment and supplies. Government spending should focus on the highest-priority needs in both sectors—particularly public health, and primary and secondary education. And user fees and other cost recovery mechanisms should be implemented more widely so that those who can afford services can openly contribute to the cost of their provision.

A social safety net

Much of the resistance to market reforms in Ukraine seems to come from the fear that introducing a market-oriented system will cause people to lose their jobs. As most Ukrainians are already poor by international standards, and many Soviet-era enterprises are heavily overstaffed, this fear is quite valid. An adequate social safety net must therefore be put into place if market reforms are to enjoy general support.

BARRIERS TO CHANGE

The participatory CEM process revealed a high degree of consensus on the policy recommendations summarized above. Given this consensus, we must ask why so much still remains to be done. Why has the reform process been so slow and incomplete? The main reasons appear to be inertia, vested interests in the status quo, and lack of institutional capacity.

Inertia

All political systems must deal with inertia when trying to bring about change, but the challenge has been particularly great in Ukraine. Ukraine was under the dominion of the Soviet Union much longer than, for example, the Baltic States—and was under the sway of the Russian tsars for centuries before that. The long tradition of following orders from Moscow has been hard to break.

The lack of a sharp economic and social crisis has also contributed to inertia. Countries with no way to avoid cold and hunger but through dramatic change will take the necessary actions. During the first bitter winter after independence, for example, Estonia was cut off