Policy Contribution
Issue n°24 | September 2017

Ukraine's unfinished reform agenda

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Executive summary

COMPARED TO PREVIOUS attempts, especially those following the Orange Revolution in 2004, the current reform round in Ukraine (since 2014) has proved more successful. Some politically difficult decisions have been taken, such as the elimination of gas subsidies and the restructuring of the banking system. But reform remains incomplete in many important areas, such as local and regional self-government, public administration, the judiciary, law enforcement agencies, the energy sector and infrastructure, the pension system, privatisation and land ownership.

SINCE NEAR-DISASTER IN February 2015, Ukraine's macroeconomic situation has stabilised. The economy stopped declining in 2016. However, macroeconomic stability remains fragile and the recovery of 2016-17 looks rather weak given the scale of the previous decline.

THE WINDOW OF political opportunity created by regime change and the mobilisation against external aggression in 2014-15 has not been used effectively as a springboard for reforming the dysfunctional Ukrainian economy and state. The window of opportunity now seems to be closing as Ukraine approaches a new electoral cycle in 2018-19.

THE EXTERNAL PLAYERS, in particular, the International Monetary Fund, the European Union and the United States, have provided Ukraine with a substantial balance-of-payments and budgetary support, along with technical assistance. In addition, the EU opened its markets to Ukrainian exports and granted visa-free travel to Ukrainian citizens. However, the macroeconomic assumptions behind the IMF programmes have been too optimistic, and the IMF and the EU have not always set the right reform priorities.

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This Policy Contribution is based on a presentation at the conference 'Quo Vadis Ukraine? Taking Stock of a Quarter Century of Disappointment', organised by the Uppsala Centre for Russian and Eurasian Studies, Uppsala, 18-19 May 2017. The author is grateful to Dmytro Boyarchuk, Anders Aslund, Christopher Hartwell and Georg Zachmann for their comments.

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1 Introduction

Ukraine has been a focus of European and global political attention since 2013. The dramatic events of the Euromaidan in Kyiv (also called the 'Revolution of Dignity') resulted in the collapse of the regime of president Viktor Yanukovych in February 2014. This was followed by the Russian annexation of Crimea in March 2014 and military intervention in Donbas shortly after, events that have undermined post-Cold War geopolitical order in Europe and created a serious challenge to regional security. Despite the Minsk-1 and Minsk-2 ceasefire agreements (in September 2014 and February 2015 respectively), the conflict has continued with varying intensity, and multiplying human victims and material losses.

Less in the spotlight, however, the new Ukrainian leadership, which emerged after Euromaidan, has been engaged in a struggle to reform the dysfunctional Ukrainian state and its poorly performing economy. Sadly, the economic and political transition since 1991, when Ukraine became independent, cannot be considered a success story, despite several reform attempts (see Dabrowski, 2007 and 2014, for an historical overview).

However, the question arises of whether the dramatic events of 2013-17 have helped to consolidate Ukraine's society and political class to the extent that the modernisation of the country's economic and political systems could be enabled, laying the foundations for rapid economic growth and stable liberal democracy in future.

In our opinion, there is no unequivocal answer to this question. Compared to previous attempts, especially those following the Orange Revolution in 2004, the current reform round has proved more successful and some politically difficult decisions have been taken (for example, the elimination of gas subsidies). But reform remains incomplete in many important areas, such as local and regional self-government, the judiciary, law enforcement agencies, privatisation and land ownership. Worse, the window of political opportunity created by regime change and the mobilisation against external aggression in 2014-15 seems to be closing. Ukraine is approaching a new electoral cycle in 2018-19.

This Policy Contribution analyses the Ukrainian economic, institutional and political reforms of 2014-17 in terms of their sustainability and completeness, and evaluates what remains to be done (sections 2 and 3). We also discuss the political economy and politics of the reform process, including the role of external players such as the Bretton Woods institutions and the European Union (sections 4 and 5), before summarising the political lessons (section 6).

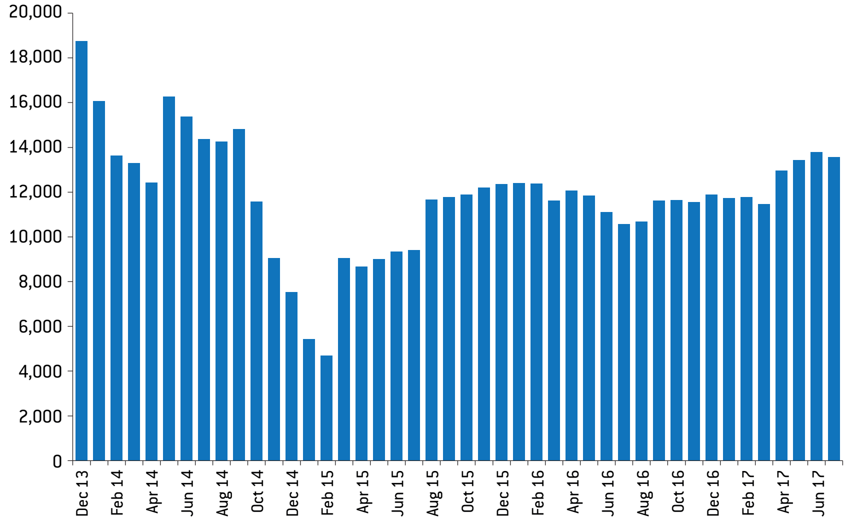
2 Economic policy and reforms

2.1 Macroeconomic challenges

In 2014-15, Ukraine's economy experienced a steep output decline and deep macroeconomic imbalances caused by a combination of populist policies and the hostile business climate of the Yanukovych's era, political uncertainty during and after the Euromaidan, Russian intervention and economic sanctions, and the decline in international metal prices in 2014. The first round of currency and financial crisis in spring 2014 was temporarily arrested with the help of the International Monetary Fund Stand-by Arrangement (SBA) (IMF, 2014). However, because of various shortcomings of the SBA (Dabrowski, 2014), slow movement on reform by the new Ukrainian authorities, the decline in commodity prices and, most importantly, the escalation of the conflict in Donbas, the key underlying cause of macroeconomic crisis – the fiscal imbalance – was not tackled. This has led to a new round of macroeconomic crises since October 2014. The situation became particularly dramatic in January and February 2015 (Dabrowski, 2015) when the international reserves of the

National Bank of Ukraine (NBU) were largely depleted and the hryvna's value against the dollar collapsed (Figures 1 and 2).

Figure 1: Ukraine: gross international reserves in $ billions, end-of-month, 2014-17



Source: http://www.bank.gov.ua/doccatalog/document?id=46950.

Since the near-disaster in February 2015, the macroeconomic situation has stabilised and the economy stopped declining in 2016. However, macroeconomic stability remains fragile and the recovery of 2016-17 looks rather weak given the scale of the previous decline (Table 1). There is little chance that two-digit inflation can be reduced to a low single-digit level soon. The economy continues to be heavily dollarised[1], reflecting limited public trust in the hryvna.

Table 1: Ukraine: basic macroeconomic indicators, 2012-2016

Indicator	2012	2013	2014	2015	2016
GDP, annual change in %	0.2	0.0	-6.6	-9.8	2.3
Inflation, %	-0.2	0.5	24.9	43.3	12.4
General govt. revenue, % of GDP	44.7	43.3	40.3	41.9	38.4
General govt. total expenditure, % of GDP	49.0	48.1	44.8	43.0	40.6
General govt. balance, % of GDP	-4.3	-4.8	-4.5	-1.2	-2.2
General govt. gross debt, % of GDP	37.5	40.5	70.3	79.3	81.2
Current account balance, % of GDP	-8.1	-9.2	-3.9	-0.3	-3.6

Note: numbers in red are IMF staff estimate. Source: IMF World Economic Outlook database, April 2017.

Macroeconomic and financial stability and the possibility of low inflation depend heavily on the hryvna's exchange rate (Figure 2), which, in turn, is determined by the size of fiscal and external imbalances. While in 2015-17, the fiscal deficit was reduced and the huge quasi-fiscal deficit practically eliminated[2] the public debt-to-GDP level more than doubled, reaching over 80 percent of GDP in 2016 (partly this was the effect of depreciation of the

1 In December 2016, 46.0 percent of total bank deposits and 49.3 percent of total loans in Ukraine were denominated in foreign currency (IMF, 2017b, Table 6, p. 38). In addition, much of the population and small businesses keep a large part of their financial assets in foreign currency (mainly US dollars).

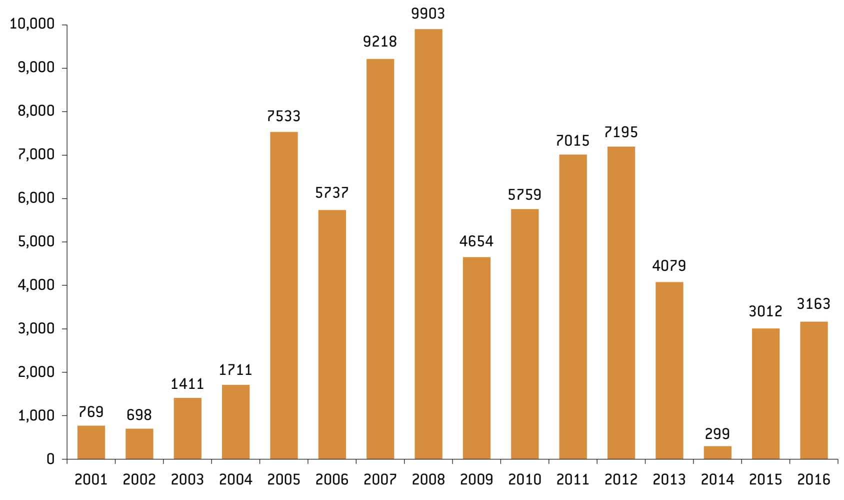
2 The quasi-fiscal deficit was generated mainly by the deficit of the national gas company Naftogaz, as a result of keeping natural gas tariffs for households well below cost-recovery level until spring 2016.

hryvna). With such heavy indebtedness, it will be difficult for Ukraine to return to private debt market financing at a reasonable price after 2018, as assumed in the IMF Extended Fund Facility (EFF) programme, accepted in March 2015 (IMF, 2015). Furthermore, the reduction and rescheduling of the government liabilities to private bondholders negotiated in 2015 as part of the conditionality of the EFF programme have made such a return even more problematic. Consequently, Ukraine's public debt sustainability will depend, most likely, on continuation of official external assistance for many years to come.

Figure 2: Exchange rate of hryvna (UAH/$100), 2014-17

Source: https://bank.gov.ua/control/en/curmetal/currency/search/form/period?startPeriod=31.12.2013&endPeriod=31.08.2017&char-Code=169&step=daily&outer=table.

Figure 3: Net inflows to Ukraine of foreign direct investment (inward minus outward investment), $ millions



Source: http://unctadstat.unctad.org/wds/TableViewer/tableView.aspx.

There are similar challenges in terms of balance of payments. Although the high current account deficit of the Yanukovych era was reduced to almost zero in 2015, it grew again in 2016 when the economy started to recover. In principle, a moderate current account deficit is a normal phenomenon in an emerging-market economy, on the basis that it can be financed by net capital inflows on a sustainable basis. Unfortunately, meeting this condition has proved problematic for Ukraine. Net inflows of foreign direct investment (FDI) remain modest (in 2015-16, they were largely targeted to bank recapitalisation), reflecting geopolitical and domestic political uncertainty and the ongoing poor business climate (Figure 3).

In the coming years, Ukraine's balance-of-payments sustainability might depend on the continuation of official external assistance, as in the case of fiscal accounts. The recorded increase in the NBU's gross international reserves (Figure 3) happened largely thanks to disbursement of the subsequent tranches of the IMF loans. In summer 2017, reserves were equal to 3.6 months of imports –three months is usually considered the minimum level for uninterrupted trade transactions. The NBU's net international reserves are much lower – about $5 billion.

The NBU only partly removed restrictions that were introduced at the end of 2013 on current account transactions. The restrictions proved most painful for small and medium sized enterprises. Large enterprises have various means of circumventing them.

2.2 Rehabilitation of the banking sector

In parallel with the balance-of-payments and currency crises, Ukraine has suffered from a systemic banking crisis. Many Ukrainian banks, state-owned and private, have faced the risk of insolvency as result of the devaluation of the hryvna, imprudent lending practices, including large-scale connected lending to enterprises owned by major shareholders (such as Privatbank – see below), losses arising from the annexation of Crimea and large parts of Donbas, and deep recession. Since the summer of 2014, the government of Ukraine and NBU, with the support of the IMF, the World Bank and the European Bank for Reconstruction and Development (EBRD) have engaged in a wholesale restructuring, rehabilitation and, in many cases, revoking of the licenses of those commercial banks that did not have sufficient capital adequacy ratios or conform with other prudential norms. Nationalisation of the largest Ukrainian bank – Privatbank, owned by the politically influential businessmen Ihor Kolomoysky and Gennady Bogolyubov – in December 2016 was the most spectacular step in this process (Olearchuk, 2017).

While measures taken in this field helped to head off the sudden collapse of the entire banking system and improved the prospects of a credit recovery in the future, substantial fiscal costs were involved: 2.3 percent of GDP in 2015, 5.4 percent of GDP in 2016, and a further 3.6 percent of GDP in 2017 (IMF, 2017, Table 2b, p. 7). This still might not be the entire bill: the situation in many banks remains fragile with high and increasing ratios of non-performing loans (NPLs) and continuous large open foreign-exchange positions.

Banking sector stability in Ukraine will depend, to a large degree, on the relative stability of the hryvna. Even if Ukrainian banks follow prudential practices in their foreign exchange operations by avoiding open foreign-exchange positions, their unhedged clients will remain vulnerable to any new round of deeper hryvna depreciation.

2.3 Reform of the natural gas sector

Reform of the gas sector represents a promising story mainly thanks to the courageous decision of the government of prime minister Volodymyr Groysman to accelerate adjustment of natural gas and district heating tariffs to the full cost-recovery level in May 2016 (it was originally planned to happen a year later). Furthermore, a half-yearly automatic tariff adjustment mechanism was introduced to prevent a return to natural gas subsidisation in the future. These moves facilitated fiscal consolidation in 2016-17, elimination of the major source of systemic corruption and the stopping of natural gas imports from Russia in 2016. Economic room was also created for the restructuring of Naftogaz, including the unbundling of transmission from production and distribution. Nonetheless, the sustainability of those reforms again depends on the stability of the hryvna exchange rate. In case of any abrupt hryvna depreciation, there would be the political temptation to prevent its pass-through to domestic gas tariffs and, therefore, to return to direct or indirect subsidisation of natural gas prices. Even without currency depreciation, there is political reluctance to allow the half-yearly tariff adjustment mechanism to work. For example, a natural gas tariff increase was scheduled for 1 October 2017 – by 18.8 percent because of higher import prices – but the Cabinet of Ministers rejected Naftogaz's proposal on this.

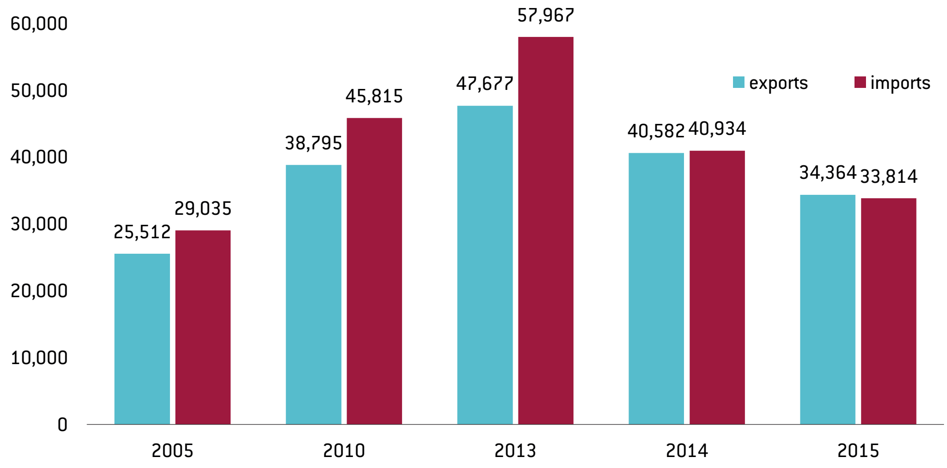
Furthermore, structural and institutional reforms in the gas sector are only in their initial stage and face continued risks of political reversal (Polityuk and Zinets, 2017).

2.4 Trade reorientation

Loss of political control over Crimea and part of the Donbas region, combined with Russian trade sanctions, were a heavy blow to Ukrainian trade. Figure 3 shows the dramatic decline in Ukraine's exports and imports after 2013.

Russian trade sanctions against Ukraine started already in 2013 when the then Ukrainian leaders (president Viktor Yanukovych and prime minister Mykola Azarov) considered signing the Association Agreement (AA) with the EU, which included the Deep and Comprehensive Free Trade Area (DCFTA) between the EU and Ukraine. Russian sanctions escalated during 2014 and 2015 leading to unilateral termination by Russia on 1 January 2016 of the bilateral Russia-Ukraine free-trade agreement within the Commonwealth of Independent States, in reaction to the entry into force of the EU-Ukraine DCFTA.

Figure 4: Ukraine: total exports and imports of goods, € millions, 2005-15



Source: Eurostat (2017), Tables 1 and 2.

These shocks led to a substantial reorientation of Ukraine's trade geography. The share of Ukraine's total exports going to Russia went down from 26.1 percent in 2010 to 12.7 percent in 2015 (Table 2) and to 9.9 percent in 2016[3]. Respectively, the share of total Ukrainian imports coming from Russia went down from 36.5 percent in 2010 to 20 percent in 2015 and 13.1 percent in 2016. At same time, the share Ukrainian exports going to the EU increased from 25.5 percent in 2010 to 34.1 percent in 2015 and 37.2 percent in 2016. The figures for imports were 31.5 percent in 2010, 40.9 percent in 2015 and 43.7 percent in 2016. The share of China in Ukrainian trade also increased though to a lesser extent (Table 2).

3 See http://trade.ec.europa.eu/doclib/html/113459.htm, accessed 20 September 2017.

Table 2: Ukraine: exports and imports of goods to/from selected partners, % of total exports and imports, 2010 and 2015

Indicator	EU28		Russia		China	
	2010	2015	2010	2015	2010	2015
Exports	25.5	34.1	26.1	12.7	2.6	6.3
Imports	31.5	40.9	36.5	20.0	7.7	10.1

Source: Eurostat (2017), Tables 9 and 10.

In the coming years, the share of the EU in Ukrainian trade could further increase as a result of the implementation of the EU-Ukraine DCFTA[4]. However, more time and domestic regulatory homework on the Ukrainian side is needed to fully grasp all the potential benefits of this agreement.

To have a complete picture, one should also mention the politically-motivated decisions of the Ukrainian authorities that damaged trade and economic relations with Russia and the Ukrainian territories beyond their control. An economic blockade of the occupied part of Donbas was initiated spontaneously in early 2017 by Ukrainian battalions of volunteers and eventually backed by the president and government. This serves as the best example of such a wrong policy (Kostanyan and Remizov, 2017).

Examples of similar decisions taken earlier included banning direct passenger flights between Russia and Ukraine in October 2015 (Rainfords, 2015), and the energy and transport blockade of Crimea in November 2015 (Olearchyk and Farchy, 2015).

2.5 Tax reform

Since 2016, the tax system has been simplified by replacing 67 different rates of social security contribution (SSC) with an average effective rate of 41 percent with a single rate of 22 percent, the introduction of proportional personal income tax of 18 percent (instead of previous two rates of 15 percent and 20 percent), and elimination of some other taxes of marginal fiscal importance (IMF, 2016a, Box 1, p. 11).

While tax simplification should be seen as a progressive step helping to improve the business and investment climate and reduce sources of corruption, it has unfortunately not been free from populist pressures in the Rada (the Ukrainian parliament) in favour of upfront reduction of the tax burden while disregarding fiscal constraints. As result, almost halving the SSC rate led to a revenue loss of 4 percentage points of GDP in 2016 (IMF, 2017a, Table 2b, p. 34). This loss was only partly compensated for by elimination of the special VAT regime in agriculture (a significant improvement in the overall VAT architecture), higher excise and property taxes, and higher marginal taxes under the simplified regime for small taxpayers.

In parallel, there has been a continuous effort to improve tax and custom administration by modernisation and reorganisation of the State Fiscal Service (SFS). The long-existing problem of the lack of automatic VAT refunds for exporters seems to have been solved.

2.6 Pension reform

The public pension system in Ukraine is among the most expensive and socially inefficient in the world. Public pension expenditure amounted to 17.2 percent of GDP in 2013. It went down to 13.4 percent of GDP in 2015 mainly as result of inflationary depreciation of pension benefits (IMF, 2017b, Table 3, p. 27) – hardly politically sustainable in the medium-to-long term. However, as result of the drastic reduction in the SSC rate (see section 2.5) the deficit of the Pension Fund of Ukraine increased to 6.3 percent of GDP in 2016. In 2017, there have been signs of increased Pension Fund revenues as a result of the doubling of the minimum wage and, therefore, reducing the shadow remuneration of labour.

Apart from unfavourable demographic trends, it is the low retirement age, numerous

4 See Dabrowski (2016) for an analysis of the content of the AA and DCFTA.

sectoral and occupational pension privileges, and underreporting of wages that are responsible for the high costs and the high deficit of the public pension system. Even after the pension reform of 2011, the statutory retirement age was 60 for men and 58 for women (it will increase gradually to 60 for women in 2021), with many groups of employees eligible for early retirement at the age of 55 or even 50, and many enjoying higher pensions than the standard rates (IMF, 2017b). Those privileges were only marginally corrected in 2015 (Dabrowski, 2015).

At the beginning of 2016, the number of pensioners in Ukraine exceeded 12 million, about 27 percent of the population (IMF, 2017b, Table 1, p. 22). In the coming years and decades, the dependency ratio will further deteriorate because of unfavourable demographic trends unless the effective retirement age is increased and various privileged schemes are terminated.

In June 2017, the Cabinet of Ministers submitted to the Rada a legislative proposal[5] under which there would be a one-off revaluation of pension benefits (depreciated by the effect of high inflation – see above) and the introduction of a permanent pension indexation mechanism (50 percent according to inflation and 50 percent according to the nominal increase in the average wage). The substantial fiscal costs of revaluation and future indexation would be compensated for by (i) use of a less generous formula in calculating new pension benefits; (ii) the elimination of professional pension privileges; and (iii) introduction of a minimum 25-year period for paying SSC as a condition of retirement at age 60[6]. This paying-in period will be gradually increased to 35 years in 2028.

The proposed law is expected to enter into force in late 2017. At time of writing, it is difficult to assess its full short- and long-term fiscal consequences and its impact on the labour market.

2.7 Stalled privatisation

There were no meaningful privatisation deals between 2014 and 2016, which slowed down restructuring in many sectors and private capital inflows, constrained public debt repayments and encouraged corruption and other predatory practices against state-owned (or partly state-owned) enterprises. In 2017, the State Property Fund started to sell state-owned utility companies, generating by the time of writing proceeds of about $100 million.

In October 2016, the Ukrainian parliament extended the moratorium on the sale of agricultural land for another year, until 1 January 2018. The lack of an open private market for agricultural land is delaying the modernisation of the Ukrainian agriculture sector (Aslund, 2017).

3 Institutional and political reforms

3.1 Constitutional order

Immediately after the collapse of the Yanukovych regime in February 2014, Ukraine revisited the 2004 constitutional amendments that reduced the power of the president in favour of the Rada, mainly by granting the latter the authority to appoint and control the government, which was previously subordinated to the president[7]. While such constitutional changes can be considered positive from the point of view of reducing the risk of authoritarianism, the concrete amendments adopted hastily during the 2004 Orange Revolution were not necessarily well designed and, therefore, proved dysfunctional in practice.

5 See http://w1.c1.rada.gov.ua/pls/zweb2/webproc34?id=&pf3511=62088&pf35401=427169.

6 The basic retirement age of 60 for both sexes is to remain unchanged.

7 In 2010, this amendment was nullified by the Constitutional Court of Ukraine in a controversial ruling, which allowed Viktor Yanukovych to return to the pre-2004 presidential prerogatives.

Forming a parliamentary majority and a government, which is appointed by this majority, has become a lengthy and politically fragile process. Furthermore, the division of constitutional prerogatives between the president and cabinet of ministers remains unclear, leading to frequent tensions. The collision of competences intensified in the situation of armed conflict, which naturally increased the power of the president as the supreme commander of the armed forces. The National Security and Defence Council of Ukraine, formally an advisory body to the President, often *de facto* assumes the role of cabinet. Overall, the tensions within the executive branch of government do not help in the country's governance and progress towards reform.

There is little chance to change the constitution in this and other aspects (for example, regional and local self-government – see section 3.3) because of the absence of a constitutional majority in the current term of the Rada (see sections 3.2 and 4).

3.2 Political parties and parliament

Political parties play a crucial role in all democracies. However, in Ukraine, similarly to many other post-communist countries, a stable system has not formed. After the Euromaidan, most of previous parties disappeared from the political scene[8] and were replaced by new ones. However, these look fragile and might not survive the election cycle of 2018-19.

Most current political parties were either formed or are supported by powerful business groups (oligarchs) and remain at least partly dependent on them. This is also the case for individual members of parliament (MPs) who are financially supported by business 'sponsors', or even paid for endorsing or rejecting legislation. The legislative process is thus extremely corrupt and an easy target for capture by powerful lobby groups. To make things more complicated, the largest parties are penetrated by several business groups, often with conflicting aims.

Ukraine's mixed electoral system in which half of the seats in parliament are distributed via a proportional representation system and half of MPs are elected in single-seat constituencies based on first-past-the-post voting, further weakens political parties, helps oligarchs and other interest groups to elect their representatives, and encourages political corruption. Because of the weakness of Ukraine's political parties, MPs from single-seat constituencies often owe greater allegiance to those who finance their campaigns than to their parties. Overall, in such circumstances, the cabinet of ministers, even if represents formally the parliamentary majority, cannot count on party discipline in parliamentary voting.

The frequent political stalemate in parliament is also enabled by the specific definition of 'majority' in the Ukrainian constitution. Unlike in many other countries, where a simple majority (with the quorum threshold of 50 percent of MPs taking part in the voting) is sufficient to endorse a law, in Ukraine a majority consists of more than 50 percent of the constitutional number of parliamentary seats, which is set at 450. Thus, at least 226 MPs must vote 'yes'. Constitutional changes require two thirds of MPs, or 301 votes, in favour. Any abstentions or non-votes by MPs (for example because of absence) are counted as 'no' votes.

Furthermore, at the time of writing, the Rada has 27 empty seats (that is, there are only 423 elected MPs) because it was not possible to conduct the 2014 parliamentary elections in Crimea and the occupied parts of Donbas. As a consequence, in practical terms, the majority rule requires 'yes' votes from 53.2 percent of the elected MPs for normal legislation, and 70.9 percent for constitutional changes.

Unfortunately, the current Rada is no less dependent on oligarchic interests than previous incarnations, and reform aimed at the elimination of existing deficiencies (for example, a return to the pre-2012 system of fully proportional representation based on open party lists) has been effectively blocked. One of the few innovations adopted in 2015 was the introduc-

8 The Fatherland (*Batkivschina*) party of twice-prime minister Yulia Timoshenko is the only one that survived the 2013-14 events.

tion of state financing of political parties (Kosmehl and Umland, 2016). However, to have a positive impact on fighting political corruption, such a law should be supplemented by other legislation on, for example, the conduct of the mass media (largely owned by oligarchs) during election campaigns and effective enforcement of the already existing rules on financing political parties from private sources.

3.3 Local and regional self-government

Since independence in 1991, the Ukrainian state has been excessively centralised with no genuine local and regional self-government. This was one of institutional legacies of the Soviet past when all key economic and administrative competencies were concentrated in Moscow. After the collapse of the USSR, these competencies were automatically taken over by the central institutions of the new Ukrainian state in Kyiv. Among others factors, political reluctance to devolve more powers to regional and local levels had its roots in the fear of the country's territorial disintegration, a threat that partly materialised anyway in 2014 as a result of the Russian intervention.

Since 2014, decentralisation has become the flagship policy goal of the new authorities but little has happened in practice. The draft constitutional changes of 2015 that were intended to open way for genuine local and regional self-government were halted in the Rada after the first reading, largely because of opposition to the special status of Eastern Donbas (currently outside the control of the Ukrainian authorities), which was part of the same legislative package. In the unchanged constitutional and legal environment, the 2015 local election made no difference in terms of forming local authorities more responsive to the population's needs.

Instead of wholesale reform, some incremental changes have been introduced, such as voluntary amalgamation of the lowest territorial units *hromadas* (most of them being too weak to benefit from serious devolution of power) and some degree of fiscal decentralisation, mainly related to education and healthcare (Jarabik and Yesmukhanova, 2017).

3.4 Public administration, the judiciary and law enforcement agencies

The notoriously poor business and investment climate in Ukraine (Dabrowski, 2014) has its deep institutional roots in the predatory behaviour of state apparatus, which has remained largely unreformed since the Soviet era. Unfortunately, reform progress in this field since 2014 has been patchy and the most serious steps still await implementation.

While there has been a serious effort to improve the professional quality of senior positions in government and the central administration, including attracting Ukrainian expats and foreign specialists on a long-term basis (unfortunately, many of them have already left), the structure of government, the number of ministries and various central agencies, and public official headcounts have changed very little. On the regional and local levels, change has been even more problematic because of the blocking of self-governance reform (see section 3.3). Public servants remain poorly paid, making them prone to corrupt practices and resulting in recruitment of low-quality candidates. On the other hand, unless the public administration is seriously restructured and the overall number of staff is cut, there will be no fiscal room for higher salaries (see IMF, 2017a, p. 15).

The various law-enforcement agencies have been another source of harassment of both the business community and ordinary citizens. Again, reforms in this sphere have been only partial so far. They have concentrated on formation of the new traffic police and reforming tax enforcement (which is still ongoing at time of writing) and the tax and customs administration (see section 2.5). Reform of other police formations is less advanced, even if the previous militia staff members have had to pass through verification processes and many have been replaced by new functionaries. The Security Service of Ukraine (*Sluzhba Bezpeki Ukrainy – SBU*) remains unreformed and uses its broad national security and investigation prerogatives to harass business. Reform of the General Prosecutor's Office is only just starting.

The annexation of Crimea and the conflict in Donbas has triggered a far-reaching reform of the Ukrainian army – a process that has to continue in the coming years to improve the country's external security.

In 2016, a package of constitutional and legislative changes initiated the reform of the judicial branch of government (Carnegie, 2017), with the ultimate goal of strengthening the rule of law and radically improving contract enforcement and protection of property rights. The structure of the Ukrainian court system was simplified (from four to three tiers) and merit-based recruitment of judges was initiated. However, as the experience of other transition and developing countries demonstrates, building a professional and impartial judiciary free from political interference, pressure of business interests and corruption, takes many years and involves the risk of derailment or even reversal. Ukraine is only at the beginning of this process and a lot of political determination will be required to continue it in the years to come.

3.5 Fighting corruption

Corruption is perceived as Ukraine's biggest social disease. It harms economic growth, undermines society's trust in public institutions and public services and, therefore, undermines the very foundations of the Ukrainian state and political system[9]. This perception is firmly backed by various international rankings, for example, the Transparency International Corruption Perception Index, which in 2016 put Ukraine in distant 131st position out of 176 countries ranked[10], a small improvement compared to 2013 when it occupied 144th position out of 175 countries ranked[11]. Hence, fighting corruption has become one of the key demands of both the Ukrainian public and external donors such as the EU, IMF, World Bank, EBRD, USAID and others.

Several specific institutional and policy steps have been taken since 2015 to satisfy these expectations. These include, for example, creating the National Anti-Corruption Bureau of Ukraine (NABU), the Specialised Anti-Corruption Prosecutor's Office (SAPO), staffing them via open and merit-based recruitment processes, introducing e-declarations of assets for public officials and an electronic public procurement system.

The main question concerns the balance between policies aimed at the elimination of the sources of corruption and fighting the symptoms of corruption. While some important steps towards eliminating systemic sources of corruption have been taken (such as elimination of natural gas subsidies, the new electronic public procurement system, budget financing of political parties, strengthening banking supervision and revoking banking licenses in cases of fraudulent banking practices) many others wait for implementation. These include introducing an open and transparent privatisation process, further reform of the energy sector, elimination of tax exemptions and foreign exchange restrictions, reform of the public administration, law enforcement agencies and judiciary, simplifying business regulations, enforcing rules on the private financing of political parties, reform of the electoral law, including the role of the private media in election campaigns, tightening procedures related to granting disability benefits, and many others.

One of the biggest challenges concerns the role of large business groups (oligarchs) in Ukraine's economy and politics. On one hand, their strength and the plurality of their economic and political interests helped to protect country from falling into full authoritarianism in the critical junctions of post-independence history (2004 and 2013-14). On the other hand, they have created serious obstacles to reform by trying to defend their interests.

Immediately after the Euromaidan, the political influence of some oligarchs further increased thanks to their role in stabilising the domestic political situation and fighting external aggression. The prominent example was Ihor Kolomoysky, who was nominated as the governor of the Dnipropetrovsk region in 2014 and played the leading role in organising and financing battalions of volunteers to defend the Donbas region.

9 For a deeper analysis, see for example IMF, 2017b, pp. 3-18; Carnegie, 2016.

10 See https://www.transparency.org/country/UKR.

11 See http://files.transparency.org/content/download/700/3007/file/2013_CPIBrochure_EN.pdf.

One may hope that if reforms aimed at creating an open and competitive economic and political system progress enough, they will undermine the monopolistic positions of the largest business empires and, thus, the sources of their political rents and influence.

4 The political economy and politics of Ukrainian reforms

The dramatic political developments of 2014-15 and the need to defend the country's independence and territorial integrity led to an unprecedented mobilisation of Ukrainian society. It was a unique window of political opportunity to overhaul both the political and economic systems. Regrettably, this opportunity has only been partly grasped. Almost all of 2014 was spent on two election campaigns (the presidential election in May 2014 and parliamentary elections in October 2014) and the lengthy process of formation of a governing coalition. The new government emerged only in December 2014.

Then, 2015 and the beginning of 2016 were marked by continuous political tensions and rivalry between president Petro Poroshenko and prime minister Arseniy Yatsenyuk. Fortunately, those tensions did not reach the point of those between president Viktor Yushchenko and prime minister Yulia Timoshenko in 2005, immediately after the Orange Revolution, but they were serious enough to slow down the process of reform. Ultimately, the cabinet of ministers resigned in March 2016 and a new government was formed under prime minister Volodymyr Groysman in May 2016, representing the same political party as the President.

The formation of Groysman's government diminished tensions within the executive branch of government but at the cost of losing majority support in the Rada. In fact, this majority (which constituted an unprecedented 80 percent of all MPs in December 2014) gradually disappeared over 2015 and early 2016. The Yatsenyuk's government also experienced growing difficulties in mobilising MPs votes in favour of its legislative initiatives. To a great degree, this was the result of penetration of political parties by special interest groups (see section 3.2) and the double loyalty of several MPs (to their party and business 'sponsors'). As the popularity of both the president and the two parties that form the government (the Block of Petro Poroshenko and the Popular Front) plummeted during 2017, most other political parties preferred to stay in opposition to their policies and gain popular support in preparation for the next election round. In practical terms, this means waiting for the outcome of the 2019 election, unless snap parliamentary elections are organised earlier, or a new majority coalition is formed in the Rada.

A comparison between the developments in Ukraine from 2014-17 and those in the successful reformers of central Europe or the Baltic region in the early 1990s, or even to the successful deregulation and anti-corruption reforms in Georgia after the 'Rose' revolution in December 2003, leads to rather pessimistic conclusions. As previously (in 1994, 2000 and 2005-06), Ukraine has experienced a deficit in reform leadership both in political and professional terms. Such a deficit cannot be made up by importing even the most experienced policymakers from abroad (as was tried in the last three years).

5 The role of external assistance

Confronted with the existential threat to Ukraine's existence, the international community offered it broad-based political, economic and security support. Limiting our further analysis to the economic field and international support for economic and institutional reforms, we focus on two key players: the IMF and the EU.

The IMF supported Ukraine with two programmes: the 24-month SBA in April 2014 of SDR10.976 billion (800 percent of Ukraine's quota in the IMF) replaced by the four-year EFF in March 2015 of SDR12.348 billion (900 percent of quota). This was substantial support offered quickly at the critical time of greatest market distress. However, questions could be raised about the programmes' macroeconomic assumptions (too optimistic, as indirectly confirmed in the internal *ex-post* evaluation of the SBA; see IMF, 2016b) and soft conditionality (see Dabrowski, 2014 and 2015, for details).

As result, neither IMF programme guaranteed the country's return to the private debt market, one of the key conditions of the so-called exceptional access to the Fund's resources, which justified the size of financial assistance and its fast-track disbursement.

Beyond these general shortcomings, there are questions about the programmes' priorities. This concerns, for example, the recommendation to adopt an inflation targeting framework in 2014-15, at the time of greatest macroeconomic and financial turbulence when the NBU did not enjoy full legal and political independence. Debt restructuring was another controversial measure because it absorbed the political and administrative energy of the Ministry of Finance for most of 2015 and prevented Ukraine's access to the private debt market. Contrary to its Articles of Agreement, the IMF did not effectively oppose continuous current account restrictions in Ukraine. In the area of anti-corruption policy, the focus has been fighting the symptoms of corruption rather than elimination of corruption's deep systemic causes. Instead of pushing for establishment of the special anti-corruption court, conditionality should encourage faster reform of criminal justice.

In 2014-15, the European Commission offered Ukraine three low-interest loans totalling €3.4 billion under the Macro-Financial Assistance (MFA) scheme, the highest ever amount for a non-member country[12]. The EU MFAs always provide supplementary financing to the IMF loans. The last tranche of MFA III, amounting to €600 million, waits at the time of writing for disbursement, along with the remaining tranches of the IMF EFF loan.

Of course, the EU's role has gone much further than the MFA and other aid programmes, including technical assistance. One should mention the signing and ratification (in July 2017 after more than a year of uncertainty created by the advisory referendum in the Netherlands) of the EU-Ukraine AA, including its DCFTA components. In July 2017, this was supplemented by EU unilateral trade preferences, such as additional tariff-free import quotas for agricultural products and full removal of import duties on several industrial products, granted to Ukraine for a three-year period (Council of the European Union, 2017).

Furthermore, since June 2017, holders of Ukrainian electronic passports can travel to the EU without visas, which increases support within Ukraine for EU-Ukraine cooperation, and is helpful in facilitating business contacts.

Nevertheless, not all EU policy initiatives and aid conditionality were optimally designed. For example, postponing until 1 January 2016 the entry into force of the DCFTA, in order to avoid Russian trade sanctions against Ukraine, did not achieve its goal, while delaying implementation of this agreement by Ukraine. Similarly to the IMF, the focus on fighting the symptoms of corruption rather than its causes, and pushing for spectacular high-profile anti-corruption cases, can produce undesirable political consequences – it might be tempting to use anti-corruption investigation against political adversaries, for example.

12 See https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/international-economic-relations/enlargement-and-neighbouring-countries/neighbouring-countries-eu/neighbourhood-countries/ukraine_en.

6 Policy lessons and the way ahead

Without any doubt the process of reforming the Ukrainian economy and state remains unfinished, even if the overall balance looks more optimistic in comparison with the situation in the period following the Orange Revolution of 2004. Unfortunately, several important policy areas, sectors and institutions have not been touched by reforms or have been reformed only partly. Because reforms are far from complete, the economic and political changes introduced so far face a sustainability risk arising from their incompleteness, diminishing domestic political support and the forthcoming 2018-19 election campaign. Internationally, there are some symptoms of 'Ukraine fatigue', resulting from a perception that reform and the eradication of corruption in this country go too slowly (see for example Ukrayinska Pravda, 2017). This might translate into diminishing political support and aid flows, especially from the major donors such as the US and EU.

Another question is whether reform to date has created the 'critical' mass to generate the rapid economic growth Ukraine so badly needs. Some experts remain optimistic (Aslund, 2017) but the IMF forecasts a rather modest recovery of 2 percent in 2017 and 3.2 percent in 2018. International metal prices have rebounded somewhat in 2017, and if this continues in longer term, it might help with faster growth and the relaxation of both fiscal and balance-of-payments constraints.

However, one cannot exclude a pessimistic scenario under which a combination of continuing conflict in Donbas, domestic political uncertainty and lack of substantial improvement in the business climate might lock Ukraine into a low growth/stagnation scenario for several years to come.

The main lesson from the post-Euromaidan reform experience is that time is the most precious political asset. Once the political window of opportunity for serious reform is open, as happened in Ukraine in 2014-15 when there was 'revolutionary' enthusiasm and a need to rally against an existential threat posed by external intervention, it should be used as intensively and effectively as possible. Whether this happens depends on the quality of the political and professional leadership of the reform process.

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