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Reforming the Ukrainian Economy and State: The Unfinished Business

KEY MESSAGES

- **Until 2013, Ukraine's record in reforming its economy and state was not impressive. The late start of reforms in the 1990s and their chaotic implementation led to macroeconomic and financial crises in 1993, 1998-99, 2008-09, and 2014-15, and the building of powerful oligarchic groups**
- **The Euromaidan protest movement in 2013-14 marked a turning point in Ukrainian history, which also opened a new window of political opportunity for reforming the Ukrainian state and economy**
- **Since 2014, reforms have accelerated, but their pace has been uneven. Several areas including the judicial system, law enforcement agencies, large share of state ownership in the economy have remained unreformed or underreformed**
- **The Russian invasion in February 2022 is causing severe material, economic, and human losses, which is increasing daily. Furthermore, martial law has meant the necessity to subordinate the entire economy and its management to military and security needs. International financial aid helps to partially close a sizeable fiscal gap resulting from the war**
- **Ukraine will need additional international aid to rebuild its economy and infrastructure when the war ends. A strict reform conditionality should accompany this aid. Incentives for reforms will also be created by the European Union's accession process**

Until 2013, Ukraine's record in reforming its economy and state was not impressive. As a result, the income per capita level in 2021 in purchasing power parity terms did not differ from that in 1992 when the Soviet Union collapsed (Figure 1).

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The late start of macroeconomic stabilization and liberalization (end of 1994) and slow and chaotic reforms in the 1990s and 2000s led to macroeconomic and financial crises in 1993, 1998-1999, 2008-2009, and 2014-2015 (Dabrowski 2007 and 2017a). The slow pace of reforms helped build powerful oligarchic groups that benefited from macroeconomic imbalances, structural distortions, and opaque legislation. They parasitized numerous state-owned enterprises (SOEs) and captured national and local politics.

The Orange Revolution in 2004 seemed to bring new opportunities and hopes for democratic and market transition. However, they were lost due to personal rivalries between the Revolution leaders and a lack of coherent and consequent reform vision of the subsequent governments. Eventually, the victory of Viktor Yanukovych in the presidential election in January 2010 led to the reversal of the post-Orange Revolution democratization gains. Government policy was captured by the oligarchic clan around the President and his family.

The Euromaidan protest movement, which started in November 2013 and culminated with the fall of President Yanukovych in February 2014, marked a turning point in contemporary Ukrainian history. It signified a shift towards a clear West-facing orientation of politics and the economy. Although it provoked Russian intervention, the annexation of Crimea, and the war in Donbas, it also opened a new window of political opportunity for reforming the Ukrainian state and economy.

Since 2014, Ukraine has had two presidents and four prime ministers. The activity of each government followed a typical political economy cycle: attempts at reforms at the beginning of their terms followed by their gradual deceleration, stagnation, and, sometimes, even partial reversal. As a result, the periods of the most intensive and comprehensive reforms fell for the periods 2014-15 (after the election of President Petro Poroshenko and the formation of the Cabinet of Ministers of Arseniy Yatsenyuk), 2016 (after the nomination of Volodymyr Groysman for the position of the Prime Minister), and mid-2019–early-2020 (after election victories of the President Volodymyr Zelensky and his "Servant of the Peoples" party when a short-lived Cabinet of Ministers of Oleksiy Honcharuk was in office). The reform effort concerned both the economic and political systems. The progress in both spheres was closely interrelated.

ECONOMIC REFORMS 2014-2021

In the economic sphere, the Yatsenyuk's government (2014-2016) and the new leadership of the National Bank of Ukraine (NBU) concentrated on macroeconomic stabilization that was seriously damaged between the end of 2013 and February 2015 and the banking sector restructuring. Four IMF programs supported this effort – the Stand-by Arrangement (SBA)

approved in 2014, replaced by the Extended Fund Facility (EFF) in 2015, and two subsequent SBAs in 2018 and 2020. The EFF involved partial debt reduction negotiated with private foreign investors in 2015-2016. No program was fully disbursed due to problems with meeting conditionality.

Nevertheless, Ukraine managed to avoid the danger of debt, the balance of payments, and banking crises that could happen in 2014 and early 2015. It returned to moderate growth between 2016 and 2019 and 2021 (interrupted by a Covid-19-related output decline in 2021). During the same period, the general government (GG) deficit and gross debt to GDP were reduced, NBU gross international reserves increased (Figure 2), and the hryvnia's exchange rate stabilized. Inflation went down. However, it started growing again in 2021, on top of global inflationary pressure – see Table 1).

The Groysman government (2016-2019) continued reforms. It eliminated subsidies for natural gas and district heating and initiated the restructuring of the Naftogas (2016). It helped to reduce excessive natural gas consumption and dependence on gas imports from Russia. The government also started the reform of the electricity market. In 2017, it managed to get parliamentary approval for pension reform, which helped partly reduce the liabilities of the public pension system in the subsequent years. It also initiated the reform of the healthcare sector.

The years of Groysman's cabinet were marked by the beginning of the implementation of the Association Agreement between the European Union (EU), including a Deep and Comprehensive Free Trade Area (DCFTA), which entered into force on January 1, 2016. Together with the unilateral revoking of the previous bilateral free trade agreement by Russia, it led to the radical reorientation of Ukrainian trade from Russia to the EU (Dabrowski et al. 2020).

Unfortunately, the governments of Yatsenyuk and Groysman did practically nothing to privatize SOEs, accounting for a large share of the Ukrainian economy. Only Honcharuk's government (2019-2020) tried to relaunch a privatization process. It initiated small privatization via the electronic public procurement platform, Prozorro. The parliament elected in 2019 replaced the old long list of companies for which privatization was prohibited with the new, much shorter list in 2020. In March 2020, it also partially lifted the moratorium on the sale of agricultural land, which had been in place since 2001 (the new law entered into force in July 2021).

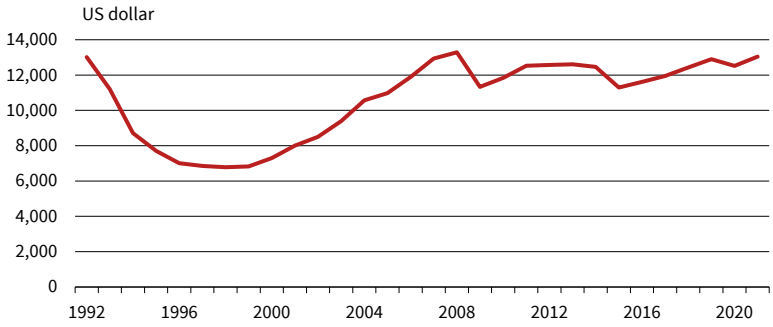
The Honcharuk government also started preparations for privatizing several big companies. However, a replacement of the Honcharuk's cabinet with the new one led by Prime Minister Denys Shmyhal in March 2020 and the Covid-19 pandemic stopped implementing these plans. Nevertheless, small privatization has been further continued.

Generally speaking, the pace of reforms has slowed down substantially since March 2020. The macroeconomic situation also deteriorated in 2020 due to the Covid-19 pandemic and related lockdown

Figure 1

Gross Domestic Product per Capita

Constant prices, purchasing power parity, 2017 international dollar, 1992–2021

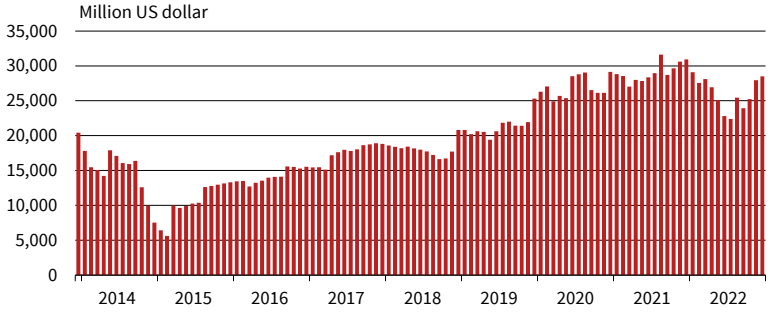


Source: IMF World Economic Outlook database, October 2022. © ifo Institute

Figure 2

NBU Official Reserve Assets

December 2013–December 2022



Source: National Bank of Ukraine (NBU), https://bank.gov.ua/files/SDDS/IREZ_en.xlsx. © ifo Institute

Table 1

Ukraine: Fundamental Macroeconomic Indicators, 2013-2021

Variable	2013	2014	2015	2016	2017	2018	2019	2020	2021
GDP, constant prices, % change	0.0	–6.6	–9.8	2.4	2.4	3.5	3.2	–3.8	3.4[a]
Inflation, end of period, %	0.5	24.9	43.3	12.4	13.7	9.8	4.1	5.0	10.0
GG net lending/borrowing, % of GDP	–4.8	–4.5	–1.2	–2.2	–2.3	–1.9	–1.9	–5.9	–3.3
GG gross debt, % of GDP	40.5	70.3	79.5	79.5	71.6	60.4	50.5	60.6	47.6
Current account balance, % of GDP	–9.2	–3.9	1.7	–1.5	–2.2	–3.3	–2.7	3.3	–1.6[a]

Note: GG = general government; [a] IMF staff estimates.

Source: IMF World Economic Outlook database, October 2022.

measures. In 2021, the economy recovered partly from the pandemic shock (see Table 1).

The continuous perception of the unfavorable business and investment climate reflected the uneven and incomplete reform process before the pandemic and war. The World Bank *Doing Business Survey 2020* placed Ukraine sixty-fourth among 190 countries, scoring 70.2 out of 100. In *Doing Business 2014*, Ukraine ranked 112 out of 189. An even less favorable assessment came from the Heritage Foundation Index of Economic Freedom 2020, in which Ukraine was ranked 134 out of 180 countries evaluated in the category of "mostly unfree" economies. However, there has been a systematic improvement in Ukraine's position in this ranking since 2014.

THE POLITICAL AND GOVERNANCE REFORMS 2014-2021

In 2014, just after the Euromaidan, the 2004 constitutional amendments were reinstated. They moved part of the President's power to the parliament by granting the latter the authority to appoint and control the government (previously subordinated to the President).

In 2016, a package of constitutional and legislative changes initiated the reform of the judicial branch of government, with the ultimate goal of strengthening the rule of law and radically improving contract enforcement and the protection of property rights. The structure of the Ukrainian court system was simplified (moving from four to three tiers), and merit-based recruitment of supreme court judges was initiated. However, this reform has been progressing slowly with many zigzags, and Ukraine is still only at the beginning of building an independent and professionally credible judiciary.

The same relates to various law-enforcement agencies, many of them being from the Soviet-era legacy and a source of harassment of the business community and ordinary citizens. Again, reforms in this sphere have been only partial. They concentrated on the formation of the new patrol police and reform of tax enforcement, and the tax and customs administration (still unfinished). Reform of other police formations and the Security Service of Ukraine (*Sluzhba Bezpeki Ukrainy*, SBU) is less advanced. Reform of the General Prosecutor's Office has been tried a few times but never completed.

However, since 2014, Ukraine has managed to successfully reform its armed forces, which has been able to resist Russian aggression in 2022-23. Between 2014 and 2019, in response to the donor-imposed conditionality, Ukraine created a system of anti-corruption institutions. It includes the National Agency for Prevention of Corruption (NAPC), the National Anti-Corruption Bureau (NABU), the Special Anti-Corruption Prosecutor's Office (SAPO), and the High Anti-Corruption Court (HACC). The NAPC collects e-declarations of civil servants and inspects correspondence of declared funds and assets with the lifestyle of public officials and members of their families. The NABU investigates top-level corruption cases and submits them under the supervision of SAPO, an independent unit of the General Prosecutors Office. The HACC litigates the indictments filed by the NABU. However, establishing these institutions did not diminish corruption in Ukraine and its international perception in a meaningful way. For example, the Transparency International Corruption Perception Index 2021 placed Ukraine at 122 out of the 180 countries assessed (with a grant score of 32 out of 100), with the only marginal improvement since 2013.

Worse, in 2019-2020, the Constitutional Court of Ukraine issued several rulings concerning the unconstitutionality of the NABU Law and its Head's appointment. These rulings paralyzed the work of this institution for a certain period.

After years of political fighting, the parliament adopted a new election code in December 2019, which reintroduced the proportional system (which existed before 2012) based on partly open lists and multi-seat constituencies. The mixed electoral system that governed parliamentary elections in 2012, 2014, and 2019 weakened political parties, helped oligarchs and other interest groups to elect their representatives, and encouraged political corruption. However, there is still a long list of election-related issues requiring further legislative action, including rules on financing election campaigns, use of the media, including social media in election campaigns, and strengthening the independence of the Central Election Commission.

The long-awaited decentralization of the Ukrainian state has only been partly implemented. The drafting of constitutional changes intended to open the way for genuine local and regional self-government were blocked by parliament in 2015, primarily because of opposition to the special status of Eastern Donbas, which was part of the same legislative package. However, some essential decentralization reforms have been conducted, such as the voluntary amalgamation of the lowest territorial units, *hromadas*, into the United Territorial Communities (UTC) and some degree of fiscal decentralization, mainly related to education and healthcare. This partial decentralization has been considered successful and has strengthened the resilience of local communities during the Russian aggression.

THE DEVASTATING IMPACT OF THE WAR

The Russian invasion of Ukraine, which started on February 24, 2022, caused enormous human and economic losses that are difficult to assess[1] at the moment of writing this paper (late January 2023). Furthermore, the war continues, and the damage toll

[1] According to IMF (2022) forecast, Ukraine's GDP will decline by 33 percent in 2022.

increases every day. However, beyond human and material losses, the logic of the war economy and martial law led to command management and administrative restrictions in many policy areas.

The NBU introduced numerous foreign exchange restrictions and tight control of the hryvnia exchange rate. It also had to return to monetary financing of the budget deficit, which ballooned to more than 20 percent of GDP in 2022 (IMF 2022), despite sizeable foreign grants amounting to almost 10 percent of GDP. The size of the fiscal gap and its potential inflationary consequences should serve as the argument for scaling up international financial aid to Ukraine from all possible sources (Åslund 2022).

Borrowers affected by the war can benefit from credit vacation and debt restructuring. The same relates to tax and social insurance liabilities.

Energy tariffs have remained frozen since 2021. As a result of heavy Russian attacks against energy infrastructure, the economy and population suffer from frequent electricity blackouts. In such a situation, energy supplies must be administrated and strictly regulated. Air transportation has had to be suspended and railway transportation subordinated to the priority of military needs. Infrastructure enterprises have had to deliver on public sector obligations regardless of their economic interest. The same relates to industries producing various war-related supplies, which were partly militarized.

Large-scale privatization has been placed on hold (in fact, it was not launched before the war). Furthermore, some companies belonging to Russian owners or pro-Russia oligarchs have been brought under government control. Competitive procedures of selecting SOE managers and other corporate governance rules introduced in previous years have been partly abandoned.

The Prozorro electronic procurement, the flag reform achievement of the post-Euromaidan era, has also been partially suspended. The government limited the collection and publication of economic and financial data, especially concerning the military and security sectors. The war environment has made civil society and media monitoring government activities more complex, including fighting corruption (Melkozerova 2023).

AFTER THE WAR: POLICY CONCLUSIONS

Although the war continues, international development institutions and various teams of experts work on the proposals for post-war reconstruction (see, e.g., Becker et al. 2022; CASE 2023), and accompanying economic and political reforms in Ukraine.

On June 23-24, 2022, the European Council granted the EU candidate status to Ukraine and Moldova. It also approved the opinion of the European Commission (2022), which presented recommendations for Ukrainian authorities, the fulfillment of which is a condition to start membership negotiations. They include completing institutional reforms of a judicial system, including the process of merit-based selection and vetting of judges, strengthening anti-corruption bodies and their independence, strengthening free and pluralistic media and civil society, fighting organized crime and money laundering, further reform of public administration, and de-oligarchization. And indeed, these are the most important and urgent reform steps which can strengthen the rule of law and democratic foundations of the Ukrainian state. However, adopting the above conditions in the second half of 2022 was slow and incomplete (Sydorenko 2022).

The experience of the previous European Economic Community/EU enlargement rounds since the mid-1980s has demonstrated that the accession process and its conditionality play the role of solid pro-reform and pro-modernization incentives (Roland 2002; Dabrowski and Radziwill 2007). In the case of Ukraine, it can be another potential incentive, namely the conditionality attached to the post-war reconstruction aid.

Beyond the recent European Commission's recommendations, there is a long list of reforms in various areas which should be completed or undertaken to ensure a better investment climate, lower business costs, macroeconomic and financial stability, the rule of law, more transparency, and less corruption.

Once the war ends, martial law regulations and other war-related restrictions and administrative-control measures should expire. Some rules, especially those related to economic management, can be lifted even earlier.

The list of needed reforms remains long in the political and institutional sphere. It includes transitioning from a presidential-parliamentary to a parliamentary-cabinet regime, legislation on political parties and election campaigns, completing an overhaul of the judiciary and law-enforcement agencies, and building apolitical and merit-based civil service. The respective constitutional guarantees must back the decentralization reform. The role of oblasts and rayons should be determined and supported by revenue sources.

The list of most needed actions in the socio-economic sphere is also substantial. It consists of large-scale privatization of SOEs and banks, returning to corporate governance reform in both private and public sectors, further liberalization of the agriculture land turnover, including legal persons and non-residents, liberalization of the energy market, completing the implementation of the Association Agreement with the EU, simplification of the tax system and tax administration, better targeting of social assistance, further increase in effective retirement age, and continuation of healthcare and education reforms.

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