“UKRAINE: MOVING BEYOND STALEMATE?”

TESTIMONY OF ANDERS ÅSLUND

SENIOR FELLOW
PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

MARCH 16, 2010

THE COMMISSION ON SECURITY AND COOPERATION IN EUROPE

Mr. Chairman,

I would like to thank you for this opportunity to speak on an important topic, will Ukraine move beyond stalemate in the sphere of economic reform. Geopolitically Ukraine is an important country that has still not found its space and its relations with the United States are entirely friendly.

Ukraine must be congratulated on having carried out a series of free and fair elections. The country has undergone no less than three democratic and peaceful presidential transfers of power in sharp contrast to other countries in the former Soviet Union. Since 2005 Freedom House has classified Ukraine as a free country.

<u>Ukraine's Predicament</u>

Ukraine has established an open market economy with predominant private ownership. From 2000 to 2007, the country enjoyed an average economic growth of 7.5 percent, but the global financial crisis hit it hard. The economic crisis has illuminated the malfunction of the Ukrainian state and economy. Last year, Ukraine's gross domestic product slumped by no less than 15 percent, one of the biggest plunges in the world. Economically, Ukraine is not performing up to its potential. In 2009, the International Monetary Fund (IMF) assessed that its GDP per capita will be as little as $2,540 in current US dollars, placing it 110th in the world.

Qualitative international comparisons present an even more worrisome picture. I its 2009 overview, the World Economic Forum ranked Ukraine 72nd among 131 countries. Ukraine is lagging behind most in three areas: institutions, macroeconomic stability, and goods market efficiency, while it is doing comparatively well with regard to education, labor market efficiency, and innovation. This impressive human capital does not produce as much as it could because the state malfunctions, not delivering macroeconomic stability while impeding the free operation of private enterprise.

According to the European Bank for Reconstruction and Development, Ukraine is a relative laggard among the post-Soviet countries in terms of economic and institutional reforms. A comparative World Bank study in 2005 assessed that Ukraine was one of the post-Soviet countries with the least amount of novel market economic legislation. Since then Ukraine has adopted minimum new legislation, while another laggard, Georgia, has forged ahead.

A more specialized international comparison, the World Bank Doing Business index, shockingly ranks Ukraine 142nd out of 183 countries by business environment. It is particularly arduous to obtain construction permits and carry out tax payments, but it is also difficult to start and close a business, to register property, and to trade across borders. Similarly, Transparency International ranks Ukraine 146th out of 180 countries on its 2009 corruption perception index.

Because of the many years of neglecting reform, tasks have in many ways become more difficult in Ukraine. First, legislation is substandard. The common statement that Ukraine has good laws but they have not been implemented is not true. On the contrary, the country has few modern laws, and the quality of new legislation is generally considered unsatisfactory. Too much Soviet legislation has persisted for too long, and it permeates many new laws. During the many years of distorted markets, multiple vested interests have twisted many laws to their advantage. Endemic corruption has bred legislation that offers corrupt officials the opportunity to reap more corrupt revenue. The competence to draft laws has also been insufficient.

Second, not only the legislation but also the legislative process is tilted to the advantage of vested interests. This process is inordinately complex and non-transparent in Ukraine. It should be opened up, abridged, and made more cohesive. It must be made easier for the ruling political forces to have legislation adopted in line with their design.

Third, the government's capacity to formulate and carry out reforms is limited. The great bureaucratization and centralization mean that central authorities are overwhelmed by decision making on all kinds of current matters, leaving them little time for reforms. Therefore, the Ministry of Finance or the Ministry of Economy can hardly lead reforms as has been the case in other countries.

On the other hand, because many other postcommunist countries have already undertaken the necessary reforms, Ukraine can learn from their successes and failures, which renders it an advantage to be a laggard.

<u>A Window of Opportunity for Economic Reform</u>

At present, Ukraine faces an extraordinary window of opportunity. The country has both a unique political possibility and great economic need to launch a new wave of reform that will lay the foundation for sustainable economic growth. The new Ukrainian authorities need to act fast and forcefully to shore up the state. A presidential election offers a great opportunity for a new start. The new president enjoys a political mandate and parliamentary majority. A new government has just been formed and is ready to govern. But the period of "extraordinary politics," when the parliament and public allow the president to act fast and radically, will probably be brief.

So far, Ukraine has experienced two waves of substantial reform. The first reform wave started in the last quarter of 1994, after Leonid Kuchma was elected president. The second wave arose in the first quarter of 2000, when Kuchma was reelected and Victor Yushchenko became prime minister. In these two cases, reforms occurred immediately after a presidential election and in the midst of financial and economic crisis, underlining that Ukraine currently has a great chance to reform. Today, Ukraine is once again in such a situation. It badly needs to launch a new wave of substantial and comprehensive reforms.

Seeing this situation arising last fall, I initiated and served as co-chairman of an Independent International Expert Commission on a reform program for Ukraine after the presidential elections together with Ukrainian colleagues. It was meant to be an action program for the first year of a new presidency. Our proposal was endorsed by Ukraine's prime minister last September and also the new administration has expressed its appreciation. Half of the commissioners we invited were Ukrainians and the other half foreigners. They were prominent experts on different aspects of reform and policy and independent of government, political parties, and business. The work of the Commission was financed by the Swedish and Netherlands Ministries for Foreign Affairs, with additional support from the United Nations Development Program. We have published our report "Proposals for Ukraine: 2010 - Time For Reforms," and I would like to report to you our key findings.

Reform Priorities for Ukraine in 2010

Mr. Chairman,

The new presidential mandate, the shock of a recent severe economic crisis, and popular dissatisfaction with the status-quo create ideal conditions for successful reforms. Our three main conclusions are: Ukraine needs (1) new organizational capacity for reforms, and (2) clear prioritization of reforms, and (3) utilization of international organizations as lighthouses to guide its reforms.

Our Commission's first conclusion was that Ukraine needs to establish new capacity to carry out reforms that is independent of the agencies to be reformed. We recommend the creation of a Reform Commission at the Cabinet of Ministers, headed by a Deputy Prime Minister with overarching authority. The Reform Commission should have its own budget and a single goal: to design and implement reforms. Together with the European Integration Secretariat, it should lead Ukraine's reforms from the Cabinet of Ministers. President Yanukovych formed a Reform Committee at the Presidential Administration that he chairs himself on his second day in office. He has also appointed a Deputy Prime Minister for Economic Reform.

Our second conclusion was that Ukraine needs to formulate clear priorities for reforms. First things need to be done first. Ukraine must: (a) improve the effectiveness of the state, (b) achieve financial stability, (c) allow private enterprise freedom on the market, and (d) make social policy more effective. Our selection is based on experts' views of priorities that are also politically feasible within one year. The new government has adopted a coalition program called "Stability and Reform." To a considerable extent, it reflects the views of our commission as Ukraine benefits from a broad consensus on what needs to be done.

The problem in Ukraine has not been what to do but who should do it, as far too often policymaking ends up in gridlock. Our third conclusion is therefore that it is necessary for Ukraine to use its international leverage or external guidance to break through the domestic logjam on reforms. The Commission has identified three anchors that can guide Ukraine to realize its commitment to its reforms: The IMF, the European Union and the World Bank. All these organizations are ready to engage with the new Ukrainian administration. Naturally, the United States should also engage in the promotion of reforms beneficial for Ukraine's future governance and economic welfare.

In the view of our commission, Ukraine's ten top priorities for 2010 are:

1. Carry out gas reform!
2. Make the National Bank of Ukraine (NBU) independent!
3. Move toward inflation targeting!
4. Cut public expenditures!
5. Undertake comprehensive deregulation of enterprise!
6. Conclude a European Association Agreement!
7. Get privatization going again!
8. Legalize private sales of agricultural land!
9. Adopt a Law on Public Information!
10. Complete the modern commercial legislation!

All these measures have been chosen on the basis that they are truly vital and can be implemented within one year. Some of them are simple, such as the legalization of private sales of agricultural land and the adoption of a law on public information, while others require some explanation.

The top priority is to *reform the gas sector*. At present, Ukraine is actually subsidizing imported Russian gas to the tune of 3 percent of GDP a year. This must cease. The government needs to adopt a realistic energy pricing policy. All energy prices should be brought to the level of full cost recovery plus a profit margin for operators as soon as possible. The Cabinet of Ministers should develop and adopt a Concept for Liberalization of the Gas Market in Ukraine, which should lead to the adoption by parliament of a Law on Principles of the Natural Gas Market Functioning to establish the principles for the natural gas market so that it performs transparently and efficiently, and stimulate competition. In line with the EU-Ukraine Brussels Declaration on renovation of the Gas Transit System of March 2009, the government should develop a plan for renovation and modernization of the gas transit system and attract financing from interested international financial institutions. In parallel with the price hikes, the Cabinet of Ministers should introduce a new system of targeted social assistance for the least protected groups of consumers who suffer because of high gas, electricity, and coal prices. Gas reform must be an absolute condition for international assistance.

In order to secure macroeconomic stability, it is essential to minimize potential conflicts between the government and the NBU. *The independence of the NBU needs to be reinforced and its governance improved*, as it is currently seen as being unduly influenced by both commercial and political forces. The NBU Council, whose role is unclear and is dominated by prominent business representatives and politicians, should be abolished in its present form, while the NBU chairman and his/her deputies should be given fixed terms. The political authorities should refrain from enacting legislation that impinges on NBU independence, such as proposals to finance various government expenditures by advancing the payment of NBU profits. The Ukrainian monetary policy should instead be governed by an independent Monetary Policy Committee consisting of independent professionals with well-defined powers and fixed terms. The NBU should also raise its professional quality and include prominent international expertise. A new law on the NBU reflecting these elements should be drawn up and adopted.

Ukraine should move toward *inflation targeting regime* within the next three years, which presupposes a floating exchange rate. The transition period should offer the NBU enough room to bring down inflation to the 2 to 3 percent range and provide guidance to the public on the future development of the exchange rate, as well as fostering a reduction of dollarization. In the meantime, the NBU should proceed expeditiously with streamlining its monetary policy instruments and its decision-making process.

Ukraine needs to balance the state budget in the medium term by cutting public expenditures. The government should reconsider the obligations of the state in order to make them financially affordable. The authorities should resist any expansionary fiscal initiatives. Three public expenditures stand out as excessive: price subsidies, enterprise subsidies, and pension expenditures. Price subsidies and enterprise subsidies should be minimized, while pension expenditures need to be brought under control through a profound pension reform. It appears both unrealistic and harmful to try to increase the level of state revenues in Ukraine.

An overall aim must be a *major improvement of the business environment*, which should entail the strengthening of the legal base and property rights. The state's interaction with private enterprises needs to be reduced and simplified. Starting a business currently requires ten procedures that take 27 days, according to the Doing Business in Ukraine report. This process should be reduced to one procedure: registration of the business with the tax authorities and receiving a taxpayer number. It should take only one day and cost nothing as is the case in New Zealand. A new law on the liquidation of enterprises is needed to minimize the time needed as well as the cost, while maximizing the recovery rate. The issuance of construction permits is exceedingly difficult in Ukraine. The goal should be to simplify the process from 30 procedures to a small fraction and reduce the time required from 476 days to a small fraction. Procedures for registering property can be reduced from ten to probably three. The list of economic activities subject to mandatory licensing should be minimized to only those that are dangerous to human health and life, environment, or national security. A new Law on Licensing should establish firm legal limits of licensing. The requirement of official permits should be reviewed and limited to an exclusive list of economic activities, which should be sanctified by law. The government should sharply reduce the number of agencies entitled to undertake inspections as well as slash the number of legitimate reasons for inspections to the safeguarding life and health.

All these measures can be implemented within one year. The IMF will play a central role in implementing the gas reform and the macroeconomic policies in return for a two-year standby agreement with substantial financing. The European Union is currently negotiating a substantial association agreement including a comprehensive and deep free trade agreement. The EU is also deeply involved in the gas reform.

The United States plays a key role in the IMF as its biggest shareholder, and it should also engage in the gas reform which will be crucial not only for state finances and energy efficiency but also for the improvement of governance in Ukraine. The United States has a major interest in the economic success of a democratic and friendly Ukraine.