THE WORLD BANK

UKRAINE Policy Recommendations to a new Government

October, 2007

Background:

On September 30, 2007, the Ukrainian people elected a new parliament. These were the second parliamentary elections in only 18 months, and they are likely to lead to the appointment of a new government, which would be the fourth administration since the last Presidential elections of December 2004. The main strategic challenges facing the new administration are well known: (i) improving competitiveness and the investment climate, (ii) modernizing public infrastructure, (iii) strengthening economic and public governance and (iv) improving the quality of public services. Indeed, the first and foremost task of any new government will be implementation of long overdue reforms rather than the development of new strategies.

Against this background, the following short note provides a set of selected policy recommendations, divided into three parts: (i) quick wins – policies or laws that could be adopted in the next 6 months and would signal new reform commitment; (ii) opportunities – policy areas that are likely to benefit over the short to medium term from significant support from private investors, external actors and other stakeholders and may thus have strong momentum; and (iii) challenges – policy areas that require attention, but where progress is likely to be gradual and meet with significant resistance from affected interest groups and in some cases the Ukrainian people themselves.

Quick wins:

- Enact a new Law on State Procurement – the current system is a blemish on Ukraine's international reputation, it is prone to corruption, and a key obstacle to improving the effectiveness of public investment (including IFI assistance); a new law could be drafted quickly with donor assistance and enacted as a key step forward in public sector governance.
- Enact the Joint Stock Company Law – the draft passed by the Rada in first reading marks a big step forward in corporate governance; its enactment would signal to investors that Ukraine is serious about meeting international standards of corporate governance.
- Adopt a Realistic 2008 Budget – with inflationary expectations rising, fiscal policy needs to be prudent. Specifically, the authorities should aim for a moderate deficit, a modest headline rate of nominal wage and pension increases, use the opportunity to cut subsidies and plug tax loopholes, and set the stage for a fundamental reform of the capital budgeting system to set the foundation for a gradual increase in public investment into infrastructure and improved services. The VAT system should be improved but not abolished.

Opportunities:

- EU Free Trade Agreement – the "deep" free trade agreement is an opportunity to look at behind the border obstacles to trade and make a breakthrough on deregulation. Key milestones would be the abolition of compulsory standards except for a few high risk cases and the harmonization of the standards regime with WTO obligations, the streamlining of permits again on a risk-basis, and the full harmonization of customs legislation and practices with the revised Kyoto convention.
- EURO 2012 – the football championships provide a unique opportunity for Ukraine to attract international attention and investment. However, the tournament will also require substantial public and private investment. The momentum created by the urgency to prepare for Euro 2012 is a great opportunity to improve the capital budgeting system at both the central and local levels, make it consistent with strategic plans, improve project evaluation and project management capacity and clarify and test the legislative framework for public private partnerships. The Government should attract international expertise to review the national plan, as well as help municipalities develop their own local plans, as a basis for determining funding allocations.

- The Emerging Markets boom and financial sector regulation – Ukraine is on the map of international investors. In the banking sector, improved corporate governance and stronger regulation has led to rapid expansion. It is time to extend these gains to the non-bank financial sector. For this, the non-bank financial regulators must become autonomous and independent, and the law must give them the power to do their jobs properly. Rapid expansion without proper regulation would create significant economic risks.

Challenges:

- Reduce the burden of the tax system – Ukraine ranks second to last in the global Doing Business rankings on the "ease of paying taxes". Issues requiring urgent attention include VAT refund arrears, reform of the Single Tax System, and the adoption of clear rules for tax administration, which balance the interests of the state and the tax payer. Over the medium-term, budget savings should be used to lower tax rates. The new Government should make another effort to consult widely with all stakeholders and then bring a Tax Code for approval that moves Ukraine decisively towards European standards.
- Re-launch pension reform – Ukraine's pension system costs 14 percent of GDP – one of the highest levels in the world. Costs will rise further as the population ages. The introduction of a multi-pillar system that encourages private savings will help, but parametric changes such as tightened eligibility criteria and higher retirement rates are also needed. The adoption of the draft Law on Single Social Security contributions would be a first step to reduce administrative costs of the system.
- Energy and utility tariff reforms – this is not a popular measure, but it is nonetheless necessary. Users worry that higher tariff revenue will disappear in non-transparent structures. They are right. Therefore tariff reforms must go hand in hand with improvements in transparency and the attraction of private investors. But without tariff changes, debts will pile up, giving rise to non-competitive ownership transfers, while the urgent investments needed to sustain service (including to avoid disasters such as in Alchevsk or recently Dnipropetrovsk) and improve efficiency will be delayed.
- Reforms in the delivery of social services – people demand better healthcare and education. Few realize, however, that Ukraine already spends considerable amounts on the delivery of these services. The social sectors are over-staffed, leaving insufficient funding for supplies, training and investment. Improving the quality of service will require more than just money: greater autonomy at the regional level to take cost-saving measures, the move from input to performance based controls, and greater local accountability of service providers. Only with these changes will wage increases not lead to cost explosions, and will the best staff be retained for the benefit of Ukrainian service users. Particular attention is warranted to the HIV/AIDS epidemic – public leadership is needed to increase awareness, improve prevention and provide more effective treatment.
- Privatization and management of SOEs: Close to half of all employment continues to be in the public sector in Ukraine. The scope for efficiency improvements and public revenues from privatization is significant. However, privatization targets have been repeatedly missed due to the absence of a political consensus. Should a political consensus continue to remain elusive, we recommend strengthening the governance of existing state-owned enterprises and adopting a sector by sector approach to bringing in private investment where politically feasible.
- Establish a transparent land market: The issue of the agricultural land market has been politically divisive for many years. It would be desirable to establish a market for rural land titles to benefit the rural poor but progress here may continue to be slow. Where greater scope for reform exists is in the urban market for land and real estate. Creation of a unified registry for immovable property is key, but equally importantly, there needs to be greater oversight over land transfers by local authorities (sometimes at symbolic or zero prices), which are non-transparent and have already cost local budgets billions of potential revenues to improve social services.
- Judicial and Administrative Reforms: The judicial system does not protect contract and property rights well in Ukraine. This adds to the cost of doing business and undermines trust in the impartiality of the judiciary. Reforms are urgently needed, but will be difficult to launch as long as fundamental constitutional ambiguities on the distribution of power between different branches of government persist. The same is true for the introduction of a modern civil service, which appears unlikely as long as political divisions remain deep and political turnover is consequently high.

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