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Economic Growth with Equity:
Ukrainian Perspectives

John Hansen, Anatoli Halchynsky,
Vira Nanivska, Vasyl Rohovyi, and Ihor Shumylo
(Editorial Board)
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The analysis in this report draws on a series of policy studies that were prepared by Ukrainian teams of experts, including the following: 

**Agrarian Policy**: Mr. Sablouk (Director, Agrarian Policy Institute) and Mr. Fesina (Leading Research Fellow, Agrarian Policy Institute); **Energy Policy**: Mr. Vrublevsky (Deputy Minister of Economy), Mr. Kirinichenko (Head of Department, Ministry of Economy), and Mr. Skarshevsky (Expert, Prime Minister Service); **Education Policy**: Mr. Vitrenko (Head of Department, Ministry of Economy); **Health Care Policy**: Mr. Vitrenko (Head of Department, Ministry of Economy); **Fiscal Policy**: Mr. Chechetov (Deputy Minister of Economy), Mr. Skarshevsky (Expert, Prime Minister Service), Mr. Lomynoha (Head of Department, State Treasury of Ukraine), and Mr. Soldatenko (Head of Sector, State Tax Administration); **Industrial and Foreign Trade Policy**: Mr. Vrublevsky (Deputy Minister of Economy), Mr. Trynyev (Head of the Main Department, Ministry of Economy), and Mr. Yakubovsky (Deputy Director, Research Institute of Ministry of Economy); **Shadow Economy Policy**: Mr. Borodiuk (Doctor of Economics, Accounting Chamber of Ukraine), and Mr. Turchinov (Member of Parliament, Budget Committee, Verkhovna Rada); on **Social Protection Policies**: Mr. Yaremenko (Deputy Minister of Economy), Mr. Soldatenko (Head of the Main Department, Ministry of Economy), and Ms. Zinkevych (Deputy Head of the Main Department, Ministry of Economy).

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

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

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

Traditionally the World Bank’s periodic economic studies on borrowing member countries, studies known as “Country Economic Memorandums,” are written almost entirely by staff and consultants from the Bank’s main office based on a 2-3 week visit to the country. The report is written in Washington, formally reviewed inside the Bank, further revised, and then, as much as 6-9 months later, it is sent to the Government for review and clearance.

Last year the Bank decided to try a distinctly different approach to preparing a CEM for Ukraine. Instead of having outside experts do most of the research and writing, they instead were used primarily to support the work of local experts in a highly participatory process designed to maximize the involvement of the Ukrainians themselves in the analysis, discussion, and writing about the problems of their own country, thereby helping to build local capacity for analysis and consensus for reform.

The participatory process during the past year centered on eight Ukrainian research teams that were established to analyze the most difficult and important areas of the Ukrainian economy—agriculture, education, energy, fiscal management, health, industry, shadow economy, and social protection. Specialists from the World Bank and other bilateral and international organizations participated in the work of each group. Each research team went through a demanding process of issues papers, seminars, and final reviews.

The paper titled “Agrarian Policy” analyzes and assesses Ukraine’s agrarian policy. It is very important to ascertain why agricultural reforms have failed to achieve their goal and produce favorable social and economic effects. It is important not only to reveal the main causes of the crisis in agricultural production but also to define high-priority directions of short and long term agrarian policies for the future.

The report on “Policy in Education” presents strategic goals to be pursued by the state in education and proposes ways of achieving those goals. In addition, this chapter provides a comparative analysis of policy alternatives.

Significant volumes of human, material, and financial resources are involved in education, and the key role of education in social and economic development justifies the need for an in-depth examination of the scale and results of education, and how effectively resources are allocated in the sector.

The report on “Energy Policy” describes the current energy policy, provides its critical analysis and outlines prospective policies and obstacles that may hinder their implementation. It proposes a strategy for reforming the power sector aimed at establishing an efficient market for fuel and power resources.

“Fiscal Policy” analyzes the tax and budget policies currently pursued that have resulted in increased tax arrears and arrears payable from the budget; and proposes a strategy which would foster economic growth, and provides a comparative analysis of this policy with an alternative one.

Based on the analysis of the state of the health care system, paper “Health Care Policy” provides the objectives and strategic goals of this policy. Furthermore, it defines ways of fulfilling those goals and solving inherent problems. It also examines basic obstacles that may prevent the fulfillment of strategic goals as well as recommendations for planning in the short term (for 1999 – 2000) and long term (for 3 and more years).

The report titled “Industrial and Foreign Trade Policy” focuses on the fact that, during a period of falling demand for industrial products on internal markets, industrial production needs increasingly to be oriented towards exports. Successful implementation of proposals aimed at improving efficiency and competitiveness of domestic production would help Ukraine to enter world commodity markets, establish currency reserves required for modernization and restructuring of production, and foster economic prosperity.

The report “Shadow Economy Policy” defines peculiarities and causes of growth and transformation of the shadow economy in Ukraine, and how it affects the political and
socio-economic condition of the state. We give a definition of the shadow economy and list the main types of shadow economic activity requiring practical restrictive measures. The dynamics of shadow economy activity in Ukraine between 1990-1997 are given. The report gives evidence of the adverse effects of large-scale shadow economy growth. Short and long-term tasks and activity of power authorities aimed at reducing the shadow economy are discussed. It also describes the economic benefits which may be achieved by reducing the shadow sector and legalizing it.

The report on “Social Protection Policies” supports efforts to overcome and deter poverty through radically reforming the pension system and enhancing public influence over employment policies; to identify the key issues in pension provision and employment; to establish reform guidelines, to assess readiness to adopt reforms; and to measure success thereof in both the long and short-term.
LIST OF ACRONYMS AND ABBREVIATIONS

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

MONETARY UNITS

UAH = Ukrainian Hrivnya
USD = U.S. Dollar
USD 1.00 = UAH 4.50
(October 1999)
This report is one of three volumes about the economy of Ukraine that was produced during 1998-99 by an innovative, experimental partnership of World Bank and Ukrainian experts. Traditionally the World Bank's periodic economic studies on borrowing member countries, studies known as “Country Economic Memorandums,” are written almost entirely by staff and consultants from the Bank’s main office based on a 2-3 week visit to the country. The report is written in Washington, formally reviewed inside the Bank, further revised, and then, as much as 6-9 months later, it is sent to the Government for review and clearance.

Last year the Bank decided to try a distinctly different approach to preparing a CEM for Ukraine. Instead of having outside experts do most of the research and writing, they instead were used primarily to support the work of local experts in a highly participatory process designed to maximize the involvement of the Ukrainians themselves in the analysis, discussion, and writing about the problems of their own country, thereby helping to build local capacity for analysis and consensus for reform.

The participatory process during the past year centered on eight Ukrainian research teams that were established to analyze the most difficult and important areas of the Ukrainian economy—agriculture, education, energy, fiscal management, health, industry, shadow economy, and social protection.

Each research team had one to four Ukrainian professionals who did the analytical research and wrote the reports presented in this volume. The experts in each area worked under the guidance of an advisory panel of senior specialists, including both Ukrainians and non-Ukrainians. Specialists from the World Bank and other bilateral and international organizations participated in the work of each group. Each research team went through a demanding process of issues papers, seminars, and final reviews.

Before launching its actual research work, each research team met with its advisory panel and drew up an outline of the sector’s key problems. An issues paper summarizing the priorities tentatively established among the contending topics was then discussed in the launch seminar that was sponsored by each research team.

Based on the discussion of the issues during the launch seminars, each research team developed a questionnaire designed to determine what leading thinkers and practitioners in each sector saw as (a) the most important problems in each sector, (b) the policies needed to fix those problems, and (c) the readiness of the Ukrainian leaders and people to implement these policies. This innovative “Policy Readiness Survey” process polled an average of 35 individuals in each of the eight sectors, thus involving nearly 300 people in this dimension of the CEM process. The results of these surveys play an important role in the papers presented in this volume, providing quantitative support for the analysis of these difficult issues.

Based on the conclusions of the launch seminars, the teams moved ahead with their research. About half way through the process, each team presented its interim findings in a work-in-progress seminar. With this additional guidance, the teams then completed their papers and held one or more dissemination seminars to discuss the results. These seminars, which sometimes involved over 50 people from a broad cross-section of civil society in Ukraine, provided additional inputs which the teams used to revise their papers for presentation at the joint Government/World Bank review of “decision drafts” in Kyiv.

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Total participation in the launch, work-in-progress and dissemination seminars exceeded 800. Another 200 or so participated in the two-day joint Bank/Government review of the decision drafts, which also involved senior officials from both the Government and the World Bank Office in Washington plus dozens of representatives from national and local government offices, multilateral and bilateral donor agencies, NGOs, public and private enterprise, academic institutions and the press. Simultaneous three-way translation (Russian/Ukrainian/English) was provided for all seminars and for the final joint review, thus assuring a free exchange of ideas across language barriers throughout the process.

This complex network of research teams and seminars, which involved working with scores of Ukrainians and outsiders, was designed and organized by the International Center for Policy Studies (ICPS) in Kyiv, a leading think-tank NGO which plays an important role in promoting market-focused policy analysis and discussion in Ukraine. The CEM Facilitation Team at ICPS included Sergiy Loboyko, Volodymyr Hnat, Andriy Bega, Vasyl Lashchivsky, Nazar Mahera, Larisa Romanenko and Christina Lashchenko.

The entire CEM process was guided by the members of a CEM Advisory Board (who also serve as the Editorial Board for this report) — Mr. Vasyl Rohovy (Minister of Economy and Chair of the Board), Prof. Anatoliy Halchinskiy (Advisor on Macroeconomy to the President of Ukraine), John Hansen (Economic Advisor, World Bank Office in Kyiv), Vira Nanivska (Director of the ICPS), and Ihor Shumylo (Deputy Minister, Ukrainian Ministry of Economy).²

The dialogue generated by the CEM process was enhanced and extended through two other mechanisms — a series of “10/10 Policy Notes” and an active media campaign. The Bank offered to prepare notes of not more than 10 pages in no more than 10 days on any policy issues where the government needed additional information. These notes commonly focused on the policy experience of other countries in specific areas — an area of special comparative advantage for the World Bank as a knowledge-based international organization. Notes covered topics such as the reform processes in Estonia, Belarus, and Argentina; value added taxation of exports and imports, design of social safety nets, the merits and risks of special economic zones, and excise tax rates in the EU. In addition to facilitating convergence on policy recommendations for the CEM, these notes also helped the government carry out the reforms needed to qualify for assistance under IMF and World Bank adjustment loans.

A major effort was made to discuss issues emerging from the CEM process with the public at large — the goal being to build awareness and support for the findings that would ultimately emerge in the final CEM documents. The team leader in Kyiv worked with one of the leading television stations in Kyiv to prepare a bi-weekly series of issue-oriented discussions focusing on key economic policy problems of current interest, and sector specialists visiting from Washington to work with the local research teams were encouraged to do segments for the show whenever possible. Throughout the year-long process, members of the Kyiv Economic Team at the World Bank Office in Ukraine participated actively in seminars, roundtables, workshops, and interviews for the print media, a two-way interaction that enhanced the CEM documents as well as building public understanding of the key issues.

In short, in contrast to the relatively limited number of one-time meetings that CEM mission members from Washington normally have while visiting the country to collect information, the participatory CEM involved hundreds of Ukrainians repeatedly over the course of a year in analyzing and discussing the country’s economic problems and policy options for the future and in preparing written analysis and recommendations.

² For a full list of the research groups and advisors, both formal and informal, see Annex A
1. AGRARIAN POLICY

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IV. **CONCLUSIONS** ........................................................................ 20
I. INTRODUCTION

Ukraine’s agro-industrial complex (AIC) is one of the largest and most important sectors of the Ukrainian economy. In 1998 it accounted for UAH 30.2 billion or 30% of total GDP. Of the total population, almost one third lives in agriculural areas.

The AIC to a significant extent determines the development of the economy and the standard of living of the population.

Seven years of AIC reform are sufficient to make not just provisional but definitive conclusions. This paper analyzes and assesses Ukraine’s agrarian policy. It is very important to ascertain why agricultural reforms have failed to achieve their goal and produce favorable social and economic effects. It is important not only to reveal the main causes of the crisis in agricultural production but also to define high-priority directions for short and long term agrarian policies for the future.

The AIC is in need of urgent reform. Policy-makers should shift the main focus of reform to the micro level, because it is here that crisis has to be overcome.

Agriculture and its organizational framework continue to be under significant influence of political factors, making reform of the agro-industrial complex more complicated. As a result of disagreements between the executive and legislative branches of government, Ukraine has not yet approved the Agrarian Policy Concept, and this aggravates the crisis in the sector.

II. ANALYSIS OF THE EXISTING POLICY

CHARACTERISTICS OF THE CURRENT STATE

The agro-industrial complex is in crisis. The crisis is primarily attributable to the fact that the majority of agricultural producers as well as enterprises and organizations from other sectors have difficulties marketing their products: more than 60% of the domestic demand for consumer goods is covered by imports. Moreover, domestic consumption of the main foodstuffs has decreased dramatically (see Table 1).

Ukraine still lacks both an Agrarian Policy Concept approved by Verkhovna Rada and a clearly defined strategy. The production decline, including in processing and food sectors, is not the result of the reform implemented in Ukraine but rather the result of the lack of such reform.

In the agrarian area, the issue of private ownership of land and property has been resolved only in part. Agricultural enterprises have not been reorganized into market structures. A market-oriented agricultural infrastructure has not been established. Reform of the system of AIC administration proceeds slowly, and lending has virtually dried up.
Peasants, having received land shares, in theory, conclude unconditional agreements on transferring their land deeds to enterprise managers. In the process they unwittingly become hired workers rather than lessors.

Unresolved issues related to impoverishment in certain pockets of society, wage arrears plus stagnation of rural health care, services, and education are the realities of rural life. The production crisis in rural areas where up to 28% of all the labor force is concentrated causes mass unemployment, bringing social tension to the country at large.

With the breakdown of the pre-reform state system of distribution, non-market forms of distribution became popular. Barter and in-kind labor remuneration are used to distribute a major proportion of the grain, vegetable oil, potatoes, sugar beet, cattle, and poultry output. This undermines market forces and hinders the development of free competition in the agrarian market.

**Drawbacks of mass privatization**

On the one hand, the distribution of land and property titles is almost over; on the other hand, in the majority of collective farms this distribution was nominal rather than real. Mass privatization was only one step towards the achievement of the main goal—the formation of landowners in the agrarian sector.

Mass privatization has complicated the marketing of products, especially in to the State. Previously intermediaries had been actively involved in procurement and distribution of agricultural products. However, they have either went out of business due to excessive tax pressures or reoriented themselves instead to importing.

**Table 1. Per capita consumption of the main foodstuffs, in kilograms**

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Meat and meat products</td>
<td>68.2</td>
<td>37.1</td>
<td>34.7</td>
<td>33.6</td>
</tr>
<tr>
<td>Milk and dairy products</td>
<td>373.2</td>
<td>230.2</td>
<td>210.4</td>
<td>208.6</td>
</tr>
<tr>
<td>Eggs</td>
<td>272</td>
<td>161</td>
<td>151</td>
<td>160</td>
</tr>
<tr>
<td>Fish and fish products</td>
<td>17.5</td>
<td>4.3</td>
<td>5.0</td>
<td>5.1</td>
</tr>
<tr>
<td>Vegetable oil, margarine, and other fats</td>
<td>11.6</td>
<td>8.6</td>
<td>8.4</td>
<td>8.3</td>
</tr>
<tr>
<td>Vegetables, melons and gourds</td>
<td>102.5</td>
<td>91.9</td>
<td>90.5</td>
<td>88.7</td>
</tr>
<tr>
<td>Fruits, berries and grapes</td>
<td>47.4</td>
<td>34.8</td>
<td>39.5</td>
<td>36.6</td>
</tr>
<tr>
<td>Sugar</td>
<td>50.0</td>
<td>32.6</td>
<td>30.6</td>
<td>31.3</td>
</tr>
<tr>
<td>Bread and baked products</td>
<td>141.0</td>
<td>123.5</td>
<td>126.5</td>
<td>124.6</td>
</tr>
<tr>
<td>Potato</td>
<td>131.0</td>
<td>127.9</td>
<td>134.4</td>
<td>128.7</td>
</tr>
</tbody>
</table>

**Box 1. Some results of 1998**

In 1998 a modest growth was achieved in the production of essentials including potato, vegetables, milk, eggs as well as oil crops and flax fiber. These products are in steady demand and small collective and private entities that cannot afford to take risks prefer to produce them. Seventy percent of settlements are done on a barter basis, and ever-increasing debts have virtually blocked the grain market.

Gross output of grain decreased by a quarter relative to 1997 to 26.5 million tons, which is twice as low as in previous years. Catastrophic losses during the harvest season reached the critical level and import of grain may be required (Ukraine needs 32 million tons of grain per year). In 1999 the government set a target of 35 million tons of grain—this is very optimistic, given the negative developments of recent years.
Box 2. Definition of agricultural producers

According to existing legislation, agricultural producers include collective agricultural enterprises (CAEs), joint-stock companies (JSCs), co-operatives, peasants' unions (a modification of CAEs), limited liability companies (LLCs), additional liability companies, unlimited partnerships, general partnerships that combine the features of an unlimited partnership and LLC, and individual farms, including family farms. Leased enterprises (agrofirms) do not differ from them. The entities listed above are full owners of their products.

Table 2. Profitability (in percent) of agricultural products in the public sector of the AIC

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>All products</td>
<td>13.6</td>
<td>-11.7</td>
<td>-23.9</td>
<td>-23.0</td>
</tr>
<tr>
<td>including:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plant growing</td>
<td>55.5</td>
<td>29.7</td>
<td>14.5</td>
<td>6.6</td>
</tr>
<tr>
<td>Grain</td>
<td>83.6</td>
<td>64.6</td>
<td>37.5</td>
<td>12.5</td>
</tr>
<tr>
<td>Sunflower</td>
<td>170.9</td>
<td>53.0</td>
<td>19.4</td>
<td>49.5</td>
</tr>
<tr>
<td>Sugar beets</td>
<td>31.2</td>
<td>3.8</td>
<td>-10.4</td>
<td>-5.5</td>
</tr>
<tr>
<td>Vegetables</td>
<td>12.8</td>
<td>-26.5</td>
<td>-37.4</td>
<td>-15.0</td>
</tr>
<tr>
<td>Potato</td>
<td>34.3</td>
<td>6.4</td>
<td>-24.1</td>
<td>-10.2</td>
</tr>
<tr>
<td>Livestock farming</td>
<td>-16.5</td>
<td>-39.7</td>
<td>-54.3</td>
<td>-49.8</td>
</tr>
<tr>
<td>Milk and dairy goods</td>
<td>-23.2</td>
<td>-44.0</td>
<td>-53.7</td>
<td>-42.8</td>
</tr>
<tr>
<td>Beef</td>
<td>-19.8</td>
<td>-43.1</td>
<td>-61.5</td>
<td>-63.9</td>
</tr>
<tr>
<td>Pork</td>
<td>-16.7</td>
<td>-42.1</td>
<td>-57.4</td>
<td>-48.7</td>
</tr>
<tr>
<td>Wool</td>
<td>-61.3</td>
<td>-77.8</td>
<td>-85.6</td>
<td>-85.0</td>
</tr>
<tr>
<td>Eggs</td>
<td>36.5</td>
<td>-2.4</td>
<td>-5.5</td>
<td>-1.5</td>
</tr>
</tbody>
</table>

The number of collective enterprises is on the increase due to division and "de-nationalization" of a portion of radhosp (so-called Soviet farms, state-owned agricultural enterprises) and transformation into CAEs or joint-stock companies. Significant changes have also occurred in the use of agricultural land (Graph 1).

The agricultural output decreased considerably

Agricultural output continues to decline (see Table 3). The main goal of reform—the development of a competitive agricultural sector and establishment of a private sector—has not been achieved. Though the majority of former radhosp and kolkhoz were transformed into CAEs and JSC, privatization of their land and assets is purely formal.

A major portion of agricultural output, excluding high-tech crops (i.e. grain and technical crops), is produced by the private sector. Currently, private sector accounts for 76% of potato output, 84% of vegetable output, 68% of meat output and 62% of milk output. However, without increasing output in the public sector, a sufficient volume of foodstuffs cannot be produced.

Graph 1. Land-use, in thousand hectares

Ukraine has failed to augment the progress made in agrarian sector before 1991 and previous advances have even been reversed. It is unbelievable but output of some crops has fallen to pre-second world war and even pre-revolution levels.
Table 3. Gross agricultural output (by category; at 1996 prices; mln UAH)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Agricultural output</td>
<td>48,629</td>
<td>31,634</td>
<td>28,643</td>
<td>28,421</td>
<td>27,568</td>
</tr>
<tr>
<td>Plant-growing sector</td>
<td>24,346</td>
<td>17,949</td>
<td>16,386</td>
<td>17,654</td>
<td>17,200</td>
</tr>
<tr>
<td>Livestock sector</td>
<td>24,284</td>
<td>13,685</td>
<td>12,256</td>
<td>10,767</td>
<td>10,300</td>
</tr>
</tbody>
</table>

Source: State Statistics Committee

The downward trends in output which marked the 1993-1994 period and hit all spheres of the agrarian sector continue, though to a lesser degree. For example, while the overall volume of agricultural output decreased by 32.6 percent in 1994 relative to 1991, between 1994 and 1998 the drop was 21.5 percent.

Stagnant agricultural production endangers state security. Output of certain products reached critically low levels. For example in 1998 the output of milk (12.9 million tons versus the minimum nutrition standard of 22.8 million tons), meat (1.4 million tons versus 2.3 million tons), eggs (7745.3 million versus 13144.2 million), grain (26.5 million tons versus 32 million tons), vegetables, melons and gourds (5.5 million tons versus 6.4 million tons).

Livestock farming is in a critical state, the number of heads is decreasing, especially in the public sector (Table 4).

Box 3. The state of “de-nationalization”

Land has been distributed in almost 11,000 private agricultural enterprises, or 98% of the total. 5.6 million citizens in 96.5% of agricultural enterprises were granted land share ownership certificates.

Currently the infrastructure under the jurisdiction of the Ministry of Agriculture includes 6,000 processing, agro-servicing, and construction enterprises and organizations. Of this number, 5,300 are in state ownership and 700 in communal ownership. Currently, 4,900 enterprises and organizations, or 87% of those subject to privatization, including 4,200 enterprises in state ownership (86%) and 700 (100%) communally-owned enterprises, are being privatized. 1,200 processing enterprises (93% of those subject to privatization) either have been privatized or are being privatized. The privatization of meat, milk, oil-fat, and confectionery enterprises has been finished, and 180 sugar factories (93% of total) have been privatized.

Recently work has been initiated in Ukraine to reform ownership relations in the baking sector and related enterprises, including flour-grinding, cereals, fodder industries, grain-elevators, grain-procuring organizations, as well as related maintenance and construction facilities. The overall number of such enterprises is 878, including 204 grain depots, 91 elevators, 281 processing enterprises. The total capacity of enterprises enable daily delivery of 1.3 million tons of grain, purification of 900,000 tons and drying of 530,000 tons of grain and 270,000 tons of corn. Capacity of Ukraine’s elevators is 30 million tons of grain.

Processing enterprises are engaged in processing and packaging of grain, production of flour, groats, and fodder. Their average annual capacity is 7 million tons of flour and 800,000 tons of groats.

Taking into account the outlook for the grain market development in Ukraine in the near future, baking and related enterprises are likely to be the most attractive objects for investors.
### Table 4. Livestock (as at year end; thousand heads)

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>Entities in all categories</strong> *</td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Cattle</td>
<td>23727.6</td>
<td>15313.2</td>
<td>12741.8</td>
<td>11955.1</td>
<td></td>
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<tr>
<td>Cows</td>
<td>8851</td>
<td>8262.6</td>
<td>6971.9</td>
<td>6259.4</td>
<td>5953</td>
</tr>
<tr>
<td>Pigs</td>
<td>20088</td>
<td>17838.7</td>
<td>11235.6</td>
<td>9472.2</td>
<td>10329</td>
</tr>
<tr>
<td>Sheep and goats</td>
<td>9222</td>
<td>8419</td>
<td>3047</td>
<td>2829</td>
<td>2663</td>
</tr>
<tr>
<td><strong>Agricultural enterprises</strong></td>
<td></td>
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<td></td>
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</tr>
<tr>
<td>Cattle</td>
<td>22797</td>
<td>20185.7</td>
<td>11545.3</td>
<td>8950.4</td>
<td>8005.2</td>
</tr>
<tr>
<td>Cows</td>
<td>6550</td>
<td>5986.1</td>
<td>4039.2</td>
<td>3321.6</td>
<td>2977.9</td>
</tr>
<tr>
<td>Pigs</td>
<td>15655</td>
<td>12557</td>
<td>5496</td>
<td>3979.3</td>
<td>4363</td>
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<tr>
<td>Sheep and goats</td>
<td>8336</td>
<td>7166</td>
<td>1540</td>
<td>1437</td>
<td>1340</td>
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<tr>
<td><strong>Individual self-supporting households</strong></td>
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<td></td>
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</tr>
<tr>
<td>Cattle</td>
<td>3841</td>
<td>3541.9</td>
<td>3767.9</td>
<td>3791.4</td>
<td>3797.4</td>
</tr>
<tr>
<td>Cows</td>
<td>2301</td>
<td>2276.5</td>
<td>2932.7</td>
<td>2937.8</td>
<td>2975.1</td>
</tr>
<tr>
<td>Pigs</td>
<td>4433</td>
<td>5281.7</td>
<td>5739.6</td>
<td>5492.9</td>
<td>5966</td>
</tr>
<tr>
<td>Sheep and goats</td>
<td>886</td>
<td>1253</td>
<td>1492</td>
<td>1392</td>
<td>1323</td>
</tr>
</tbody>
</table>

* Including peasant (farmer) households.

In many cases, this also true for plant-growing. Because of reduced purchasing power, domestic products sell slowly and producers have to sell them below cost. This results in a reduction of areas under crops (Table 5).

Collective agricultural enterprises have suffered the largest volume of agricultural output decline (Graphs 2 and 3).

By 1998 the volume of livestock produced by all categories of farms decreased 2.5 times relative to 1990 and that produced by the public sector decreased 4 times.

**Graph 2. Output of plant-growing, at 1996 prices, billion UAH**

The situation in the AIC in general continues to be unsatisfactory. In 1998 arrears on accounts payable increased by 22% (UAH 13.2 billion), arrears to the budget increased by 90% (UAH 593 million), to the Pension Fund increased by 150% (UAH 1.5 billion), wage arrears grew by 40% (UAH 2 billion). All products, except for grain and sunflower, are loss-making. In the livestock sector, all branches are loss-making. Graph 4 shows the absolute level of losses.

**Graph 3. Output of the livestock sector per year, billion UAH**

The financial position of agricultural enterprises, irrespective of the organizational or legal form,
tends to deteriorate. For example, agricultural enterprises in the public sector ended 1997 with losses amounting to UAH 3324 million versus UAH 1421 million in 1996. Of 12,177 enterprises, 11,588 (90%—see Graph 5) were loss-making. Virtually all enterprises in the livestock sector were loss-making. In 1998 the losses amounted to UAH 2.8 billion; 9 out of 10 agricultural enterprises incurred losses.

As a result of high interest rates, loans became unobtainable for agricultural enterprises. Over the last 7 years, lending to farms decreased more than 20-fold. Budget financing of agriculture also decreased to a critically low level. The above factors resulted in a payment crisis, hindered cash settlements (including those with budget) and caused barterization.

Table 5. Area under crops (at farms of all categories; mln. ha)

<table>
<thead>
<tr>
<th></th>
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<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Grain crops *</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Area under crop (thousand hectares)</td>
<td>16064</td>
<td>14522</td>
<td>13963</td>
<td>12506</td>
<td>14502</td>
<td>12449.1</td>
</tr>
<tr>
<td>Gross yield, thousand tons</td>
<td>47431</td>
<td>51009</td>
<td>33930</td>
<td>24571</td>
<td>35472</td>
<td>26462</td>
</tr>
<tr>
<td>Crop capacity, centners/hectare</td>
<td>30.7</td>
<td>35.1</td>
<td>24.3</td>
<td>19.6</td>
<td>24.5</td>
<td>20.6</td>
</tr>
<tr>
<td>Sugar beet (factory grade)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Area under crop (thousand hectares)</td>
<td>1636</td>
<td>1605</td>
<td>1448</td>
<td>1260</td>
<td>1005</td>
<td>968</td>
</tr>
<tr>
<td>Gross yield, thousand tons</td>
<td>43845</td>
<td>44264</td>
<td>29650</td>
<td>23009</td>
<td>17663</td>
<td>16300</td>
</tr>
<tr>
<td>Crop capacity, centners/hectare</td>
<td>267</td>
<td>276</td>
<td>205</td>
<td>183</td>
<td>176</td>
<td>172.0</td>
</tr>
<tr>
<td>Sunflower seeds *</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Area under crop (thousand hectares)</td>
<td>1487</td>
<td>1626</td>
<td>2008</td>
<td>2025</td>
<td>2001</td>
<td>193</td>
</tr>
<tr>
<td>Gross yield, thousand tons</td>
<td>2,602</td>
<td>2571</td>
<td>2860</td>
<td>2,123</td>
<td>2,308</td>
<td>2,100</td>
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<tr>
<td>Crop capacity, centners/hectare</td>
<td>16.5</td>
<td>15.8</td>
<td>14.2</td>
<td>10.5</td>
<td>11.5</td>
<td>10.8</td>
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<tr>
<td>Long-stalked flax (fiber)</td>
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<td></td>
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<tr>
<td>Area under crop (thousand hectares)</td>
<td>208</td>
<td>169</td>
<td>96</td>
<td>55</td>
<td>32</td>
<td>40</td>
</tr>
<tr>
<td>Gross yield, thousand tons</td>
<td>110</td>
<td>108</td>
<td>48</td>
<td>18</td>
<td>9</td>
<td>14.0</td>
</tr>
<tr>
<td>Crop capacity, centners/hectare</td>
<td>5.8</td>
<td>6.4</td>
<td>5.0</td>
<td>3.3</td>
<td>2.9</td>
<td>3.1</td>
</tr>
<tr>
<td>Soy</td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Area under crop (thousand hectares)</td>
<td>70</td>
<td>88</td>
<td>23</td>
<td>16</td>
<td>14</td>
<td>13</td>
</tr>
<tr>
<td>Gross yield, thousand tons</td>
<td>95</td>
<td>99</td>
<td>22</td>
<td>15</td>
<td>18</td>
<td>13.0</td>
</tr>
<tr>
<td>Crop capacity, centners/hectare</td>
<td>12.0</td>
<td>11.3</td>
<td>9.7</td>
<td>9.5</td>
<td>13.6</td>
<td>12.4</td>
</tr>
<tr>
<td>Potato</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Area under crop (thousand hectares)</td>
<td>1528</td>
<td>1433</td>
<td>1531</td>
<td>1549</td>
<td>1577</td>
<td>1533</td>
</tr>
<tr>
<td>Gross yield, thousand tons</td>
<td>17965</td>
<td>16732</td>
<td>14729</td>
<td>18410</td>
<td>16701</td>
<td>16199</td>
</tr>
<tr>
<td>Crop capacity, centners/hectare</td>
<td>122</td>
<td>117</td>
<td>96</td>
<td>119</td>
<td>106</td>
<td>112.0</td>
</tr>
<tr>
<td>Vegetables</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Area under crop (thousand hectares)</td>
<td>499</td>
<td>447</td>
<td>489</td>
<td>452</td>
<td>452</td>
<td>442</td>
</tr>
<tr>
<td>Gross yield, thousand tons</td>
<td>7449</td>
<td>6666</td>
<td>5880</td>
<td>5070</td>
<td>5168</td>
<td>5130</td>
</tr>
<tr>
<td>Crop capacity, centners/hectare</td>
<td>151</td>
<td>149</td>
<td>120</td>
<td>112</td>
<td>114</td>
<td>117.0</td>
</tr>
</tbody>
</table>

* In weight after processing.

Productivity of agricultural land and livestock is falling. This leads to a reduction in the volume of biomass available for industrial processing. Taking into account that imports are relatively expensive, this causes a decline in the output of processing enterprises.

**Graph 4. The absolute level of losses of enterprises of the public sector, million UAH**

![Graph 4](image)

*Source: Ministry of Agriculture*

**Graph 5. Number of loss-making enterprises in the public sector**

![Graph 5](image)

*Source: State Statistics Committee*

**Processing sector**

The raw material base has deteriorated and volume of processed agricultural products is steadily falling. For example, while production of sunflower was 18% higher in 1995-1998 than in 1991-1994, production of vegetable oil over this period was down 30%.

The trend towards rapid reduction in the volume of processing is observed in the production of sausages, butter, canned food, and baking. This implies that agricultural production in Ukraine is becoming more oriented towards production of primary agricultural commodities (see Table 6). Currently, there is no rational combination of an efficient owner and efficient manager which would provide for a rapid increase in hi-tech agricultural production by market-type enterprises based on private ownership.

The majority of processing enterprises have a low profitability of 3-12% (Table 6), and they are operating at 19-20% of their capacity. The fishing industry is loosing money heavily.

**Table 6. Profitability of production in processing sectors (%)**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Food industry</td>
<td>22.6</td>
<td>12.2</td>
<td>7.4</td>
<td>8.3</td>
</tr>
<tr>
<td>Food-flavoring industry</td>
<td>30.2</td>
<td>14.9</td>
<td>9.8</td>
<td>11.7</td>
</tr>
<tr>
<td>Meat and milk industry</td>
<td>13.5</td>
<td>8.8</td>
<td>3.6</td>
<td>2.8</td>
</tr>
<tr>
<td>Meat industry</td>
<td>12.1</td>
<td>7.8</td>
<td>3.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Butter-cheese and milk industry</td>
<td>14.9</td>
<td>9.9</td>
<td>4.5</td>
<td>4.3</td>
</tr>
<tr>
<td>Fish industry</td>
<td>1.1</td>
<td>-2.9</td>
<td>-7.3</td>
<td>-17.6</td>
</tr>
</tbody>
</table>

**Characteristics of the policy**

Government actions, which are hasty and unpredictable, resulted in an extremely complicated situation. The rural population is especially dissatisfied by the government's actions. The majority of agricultural enterprises is functioning without cash. Non-payments are rapidly rising.

The opposition uses the confrontation between the executive and legislative to discredit market reforms and to shake the faith of the population. Ukraine still lacks up-to-date land legislation. In this context, it is unclear why the state ignores the ownership issues. As a result, the management of the majority of large and medium-scale enterprises does not report properly neither to private shareholders nor to the state.

In the first half of 1998, the President issued a set of economic decrees to support agricultural producers. These decrees provided for debt write-offs, a 5-year moratorium on some debt repayments, tax exemptions totaling UAH 2 billion, leasing of machinery, reduction of the amount of mandatory deductions to special
funds, value-added tax; price support to meat and milk sectors, material and technical support and so on. In total, the sector received UAH 4 billion from state coffers. In 1999, agricultural sector is expected to receive subsidies of around UAH 6 billion and more domestically produced agricultural machinery.

As the results of 1998 show, financial support provided by the state fails to foster any growth in production, and the number of loss-making enterprises increases. If support in 1999 continues to be non-targeted, it will not produce positive results.

Our research also shows that:

- Official state policy related to agriculture and AIC is mainly aimed at settlement of immediate problems.

- The state uses mainly non-market methods and grant support only to collective agricultural enterprises (of which 90% incur losses and one third is on the brink of bankruptcy), including delivery of goods to insolvent buyers.

- The state has failed to create an economic background that would promote the normal functioning of all forms of enterprise. At the same time, adequate conditions have not been created for domestic and foreign operators in the Ukrainian market.

- The government has neither its own Agrarian Policy Concept nor a concrete program for AIC development backed by the legislation.

- The actions of both central and local governments are unpredictable. In particular, in many cases the government violates its obligations (arrears for state orders, wage and pension arrears, etc.).

So far, the Verkhovna Rada of Ukraine and the Cabinet of Ministers have failed to officially approve the Agrarian Policy Concept, its goals and its strategy. In addition, there is a rapid turnover of top officials responsible for AIC development. Newly-assigned heads of the government and the sector bring new ideas which are not always consistent with preceding reforms, strategic tasks and problems.

A transition to market relations was done without legally-defined models and directions of reform. On the one hand, something was done to liberalize market activity; on the other hand, there was almost no institutional and organizational innovation and transformation.

Key problems

The state does not execute its function as a regulator of the economy. Instead, it tries to manage business processes in the AIC at all levels, using so-called “loans against goods”— easy loans against physical procurement of raw materials by processing enterprises, various forms of leasing, etc. Officially, this intervention in the economy is called “support to the agrarian sector.” Numerous changes in the “rules of the game”, including retroactive ones, have become common practice.

In Soviet times, agro-food policy was short-sighted. Products were supplied to the state at procurement prices, which failed to cover even a quarter of the primary costs. These unrealistic prices were well below prices at kolhosp markets, to say nothing about world prices. Price discrimination in agriculture is still in place. This results in an inflow of foreign foodstuffs into the Ukrainian market.

The price disparity between industry and agriculture, city and village, affects the profitability and development of the agrarian sector. This primarily concerns significantly increased prices for power resources and means of production.

One more key problem is the tax and lending policy of the state, which turned from an active stimulator of agro-food reform into an adverse factor ruining production and market potential. As a result, agricultural production continues to be a low-profit or loss-making sector, except in the case of some agricultural products, like grain and sunflower.

Another key problem is the issue of developing the processing industry and market infrastructure in the AIC. This is decisive for the sector’s return to growth. Resolving the problem of improvement of the economic and regulatory mechanisms applied in the AIC should become a government priority. This is the main prerequisite for the development of the AIC at the current stage.
Agrarian Policy 11

Reform of land relations

Agrarian reform was on the political agenda only in 1994-1995. Up to 1994 land reform had proceeded at a very low rate. Transfer of land into collective ownership was suspended and issues of peasant ownership were not resolved. Existing legislation provided a right to land attached to a house, farmland, and land plots received by citizens that quit kolhosp and radhosp. But for those who continued to be members of collective agricultural enterprises (CAEs), land titles were not stipulated.

To give reform a new impetus, the President of Ukraine signed Decree # 166 of 10 November 1994 entitled On Urgent Measures to Accelerate the Land Reform in Agricultural Production and Decree # 729 of 8 August 1995 entitled On Procedure for Sharing Land Transferred to Agricultural Enterprises and Organizations as Collective Ownership.

The decrees established a legislative framework for transformation of collective ownership into private ownership. The issue of Certificates of Private Ownership was introduced. New legislation stipulated that a land plot may be subject to purchase, sale, donation, exchange, inheritance, or pledge.

According to expert estimates, such an approach is the most acceptable from both organizational and political standpoints since it does not engage peasants in land border struggles and allows preservation of the property and land integrity. Moreover, it is based on private land and property ownership. Peasants who show interest in independent private or collective business have the right to quit the CAE with their land and property shares.

Thus, the first stage of land reform—demonopolization of land ownership—appears to have been accomplished. But the second stage—distribution of land plots among CAE members in the form of property and land shares—is inexplicably suspended.

As a result, we have arrived at the most important stage of agrarian reform—transformation of CAEs into new organizational forms of business based on private ownership.

Constraints

To some extent, the privatization process is constrained by the lack of money. But a more important constraint, according to respondents of our opinion survey, is the lack of procedure for granting land titles to individuals.

Due to over-regulation, the cumbersome and intricate scheme of mutual settlements between farmers and suppliers of fuel and energy, mineral fertilizers, and railway cars usually fails. Private suppliers tend to abandon the market because they do not get paid. The 1999 budget does not provide for financing deliveries of mineral fertilizers against future harvest.

A land market does not exist in Ukraine. The few owners who received land can neither lease or let it, nor use it as collateral for a mortgage loan which could become a major source of working capital required to lease machinery, purchase fuel, and so on. However, many experts fear that the Ukrainian government will continue to provide “comprehensive help” to the agrarian sector in exchange for a share in future harvests, which has resulted in barterization and hindered the formation of a formal market for agricultural products.

Some problems have still not been resolved legislatively. Individual kolhosp (and radhosp) show little interest in taking land into collective ownership. This is explained by anticipation of debt write-off and reluctance to bear responsibility for the state of business from the side of managers. Collectives of some agricultural enterprises have not yet received state certificates formalizing the land rights. According to government policy, these issues may be resolved by local or state administrations.

The restructuring of agricultural enterprises into efficient businesses proceeds too slowly. One constraint is the unsettled issue of rental payments and debt restructuring, as well as the lack of a favorable economic environment for market activity.

Poor understanding of market

Agriculture is adversely affected by current pricing policies, credit policy, taxation, and inadequacy of other economic instruments. Macroeconomic policy was so imperfect in its
essence and subordinated to state fiscal interests that it began to contradict the interests of agriculture and peasants.

A simplistic understanding of the market and market relations as an elementary system based on free purchase and sale, which excludes any state regulation, dominates. The main feature of market relations is the legislatively fixed right to private, collective, cooperative, and state ownership of land with the right to free purchase and sale of land.

There is an out-dated approach to structuring subjects acting in the market. It has been stated that only private owners can efficiently operate in a free market. This statement was the basis for adoption of legislative acts about accelerated reorganization of large-scale state-owned and collective enterprises without assessment of their real efficiency. At the same time, Ukrainian and world experience suggest that any owner may participate in the market; whether private, collective, cooperative, or state. The experience of recent years has suggested that the most expedient approach is diversity in the market, since it establishes conditions for sound competition. It is important for a seller to be a real owner of the goods offered and incomes gained and to independently make decisions on selling goods and setting prices for them.

A lack of a coherent state agricultural policy

Having defined strategic goals, the government failed to develop a program for stage-by-stage reform of the agro-industrial complex. Governmental agencies failed to develop mechanisms for the achievement of these goals.

On the one hand, the state wished to urgently implement formal de-nationalization to create an impression of market transformations and thereby accelerate integration into European structures. On the other hand, the state made and continues to make efforts to retain control over the administration of the agro-industrial complex and agricultural enterprises.

III. FRAMEWORK OF THE PROSPECTIVE POLICY

The goal of agrarian policy

There is an urgent need for drastic changes in the strategy and tactics of agrarian reform. At this stage of transition there is a need for regulation, with the focus of agricultural reform on the micro level.

We believe that Ukraine’s agrarian policy should nurture and develop a competitive agrarian sector by establishing efficient ownership.

In our opinion, in terms of market economics the state must assume responsibility only for those tasks which the private sector is unable to carry out. This process should involve millions of individuals who show desire to create yields on land plots. According to this principle, owners would undertake full responsibility for outcomes. The task of the state is to create favorable economic and legal conditions.

Given the points hitherto discussed and results of the poll, focusing on the following two interrelated strategic tasks is required for achievement of the goals of agrarian policy:

1. Formation of efficient ownership.

2. Creation of a favorable economic environment and equal "rules of the game."

FORMATION OF EFFICIENT OWNERSHIP

Earlier practice of privatization and reform of the AIC not only failed to create efficient ownership in the rural areas but also precipitated the outflow of investment from the agrarian sector. In addition, state ownership almost entirely lost its functional certainty.

As regards the creation of efficient ownership, the following problems must first be addressed:

1. Redistributing land and assets from inefficient to efficient owners through:
   - implementing private ownership and mechanisms of getting ownership rights,
   - restructuring ownership relations,
   - implementing legal, economic, and organizational (administrative) mechanisms of reaping the benefits of private ownership,
• developing and supporting small and medium-sized organizational forms of business.

2. Privatizing processing enterprises.


4. Establishing a cooperative sector in the AIC.

5. Advanced training of personnel, especially at managerial level, and improvement of the quality of training for machine operators.

6. Restructuring social assets and transferring them to local governments.

7. State support of efficient landowners and agro-industrial enterprises.

8. The state should create conditions for successful functioning of the sector, these conditions should be equal and transparent for all sectors. The state must also create stable “rules of the game” in the market.

9. Formation of specialized market infrastructure (wholesale markets for foodstuffs, raw materials, labor, etc.).

In the system of new economic relations, land should have an owner: either associations of owners, or individual peasants or farmers. It is impossible for an individual or collective to organize an enterprise or business (which is decisive in a market economy) on land without owning it.

The right to sell and buy land would enable rural residents to make considered decisions; whether to conduct agricultural activity or not, and in what volume.

In Ukraine, where the required legislative framework for restructuring of inefficient kolkhozes and radishpods and transition to new forms of organization of agriculture was created three years ago, reform processes are in reverse, deepening the unsatisfactory state of the sector. Without defining the place of land in economic turnover, problems in the agrarian sector cannot be solved. It is groundless to anticipate a rapid pay-off from new organizational forms of agrarian business. Restructuring inefficient large-scale agricultural enterprises is aimed at accelerated creation of working ownership in the form of peasant households, farms, and small and medium-sized enterprises. Thereby, large-scale enterprises would become mobile, market-type structures.

The issue of development of the social sphere should be gradually transferred to bodies of local self-government and, therefore, conditions would be created fostering the improvement of competitiveness of manufacturers of agricultural goods.

Private agricultural enterprises that range from 10 to 500 hectares and more, and which specialize in plant-growing and livestock breeding in accordance with internal and international demand, will form the organizational basis for agriculture. Large corporations (associations) should orient themselves mainly to export activity.

State support to small and medium-sized business in the AIC must be an important policy direction. Flexibility and ability to respond to fluctuations in demand, as well as readiness to assimilate technological innovations, this sector would be able to rapidly extend the product mix with modest capital investment and foster productive employment of the population.

**Creation of a Favorable Economic Environment**

As regards creation of a favorable economic environment and equal “rules of the game” in the agricultural market, the following problem areas require immediate attention:

1. Pricing policy: support to prices and profits of producers.

2. The market for agricultural products and foodstuffs.

3. Credits and interest policy: financial capital market.

4. Taxes with allowance for the specific peculiarities of agriculture.

5. Market infrastructure: informational and consulting provision, market for material and technical resources.

The state must undertake the following high-priority measures:

- Implement a compensation mechanism for industrial goods consumed in agricultural production.
- Establish minimum guaranteed prices and quotas for staples.¹
- Form a commodity exchange market for agricultural goods and foodstuffs, with an active state regulatory role (established according to the pattern of the National Bank of Ukraine in the currency exchange market).
- Fulfill state procurements exclusively through the agrarian exchange market on an equal footing with all participants in the market.
- Establish a specialized state land-credit bank and insurance company (with its further incorporation) for targeted crediting and insurance of risks in the AIC. The starting capital of these establishments should be no less than UAH 3.5 billion.²
- Extend the levy of lump-sum tax to include agricultural manufacturers.
- Tax exempt those enterprises which are specialized in providing informational and consulting services to agro-industrial enterprises subject to re-investment of saved resources.
- Simplify export regulations.
- Provide support to enterprises able to manufacture competitive goods.
- Define a policy to protect the internal market from imported agricultural products where they can be domestically produced.³

As regards financial support, there are serious problems and discrepancies regarding these issues:

- Non-targeted subsidies and annual commodity credits against goods increase debts and take a sizable chunk of budget and credit resources.
- As a result of these Government actions, loss-making enterprises find themselves in a better situation because their debts may be written off.
- Enhancement of financial influence on improvement of the financial state of agricultural enterprises should be achieved not by flooding them with funds at the expense of the budget, but aimed at production, re-orientation of the credit policy to satisfy needs of the agrarian sector, investment activity, implementation of an active social policy in rural areas and protectionist policy in the internal commodity market.

¹ Ed. Experience in other countries indicates that having the government establish minimum prices is a bad idea. Political pressures built over time to raise the prices to provide implicit subsidies to farmers. Eventually, when the price gets too high the government has to step in and buy at the artificially high floor price, creating the direct budgetary burden and distorting the market. A much better option is a well-run commodities exchange with the option to buy and sell futures. A farmer can then lock in the price for his crop or herd by selling now on this market for future delivery.

² Ed. World experience with dedicated single-sector banks has generally been bad. The banks commonly fail because (a) they become beholden and subject to political pressure groups in the sector, and (b) they have no protection through cross-sector diversification, from a bad crop year, for example. A much better approach, as outlined elsewhere in this report, is to establish private land holdings that can be used as loan collateral and to develop a strong commercial banking sector that will lend for any good business opportunity—including crop, livestock, food processing and agricultural input/output distribution systems.

³ Ed. If a product can be produced efficiently, it does not need protection, provided the exchange rate and other sector/macro policies are right. If the product needs protection, it is probably not being produced efficiently – and protecting its production will waste domestic resources and raise costs to domestic consumers. A better approach is to remove any barriers to efficient production.
### COMPARATIVE ANALYSIS OF THE ALTERNATIVE AGRARIAN POLICIES

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Development of a competitive agrarian sector</th>
<th>Secured food supplies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Goals</strong></td>
<td>Formation of efficient ownership. Creation of a favorable economic environment and stable “rules of the game” in the market.</td>
<td>Provision of the country with a minimum required volume of foodstuffs. Restoration of the AIC’s vitality.</td>
</tr>
<tr>
<td><strong>Problems to be solved</strong></td>
<td>Low competitiveness and losses incurred by the sector. Need to use fiscal mechanisms for implicit and explicit subsidization of the sector. Need for the state to provide manufacturers of agricultural goods with fuel, material and technical resources, fertilizers, etc. Implement functions of organization of processing, storage, transportation, sales, and so on. Instability of the “rules of the game” and discrepancies therein.</td>
<td>Lack of markets for agricultural products Lack of market infrastructure, including information and consulting and financial-and-credit and insurance services. Lack of transparency</td>
</tr>
<tr>
<td><strong>Way to solve the problems</strong></td>
<td>Include agricultural lands into economic turnover: • accomplishment of privatization and issue of appropriate state acts. • adoption of the Land Code, which would establish a land market Create conditions for restructuring of loss-making agricultural enterprises. Accomplish privatization of processing enterprises of the AIC with focus on investment obligations and establishment of export zones for production and large, export-oriented corporations and cooperatives. Restructure social assets in the agrarian sector. Restrict government intervention. Regulate sales opportunities in the agricultural market through procurements and interventions, minimum procurement prices, customs duties, and taxes. Stabilize legislation dealing with agrarian business and agrarian relations. Introduce temporary restrictions on importing those products which are produced in sufficient quantities in Ukraine and are exported where conditions exist to increase the volume of their output.</td>
<td>Restoration of state orders for major agricultural products. Budget support to the AIC: subsidies and tax exemptions, restructuring of debts and write off of tax and other arrears, other benefits. Steady participation of the Government in a supportive capacity at all stages of the economic cycle by making appropriate governmental and legislative decisions. Protectionist policy in respect to internal producers. State support to a non-market system of export, in particular, efforts to hold the positions in traditional export markets through subsidizing exports and inter-governmental barter operations.</td>
</tr>
<tr>
<td>Strategy</td>
<td>Development of a competitive agrarian sector</td>
<td>Secured food supplies</td>
</tr>
<tr>
<td>----------</td>
<td>--------------------------------------------</td>
<td>----------------------</td>
</tr>
<tr>
<td><strong>Long-term (3 years +)</strong></td>
<td>Provision of a minimum level of foodstuffs and agricultural products.</td>
<td>Significant increase in competitiveness of the sector in general, except for individual enterprises.</td>
</tr>
<tr>
<td></td>
<td>Increased volume of outputs of agro-industrial enterprises.</td>
<td>Increased need for implicit and explicit subsidization.</td>
</tr>
<tr>
<td></td>
<td>Increased need for implicit and explicit subsidization.</td>
<td>Development of large-scale state and semi-state companies that provide the agrarian sector with mineral fertilizers, fuel, etc. and distribute their outputs in exchange for these deliveries.</td>
</tr>
<tr>
<td></td>
<td>Decrease of real attractiveness of land financial attractiveness.</td>
<td>Decay of social infrastructure in rural areas.</td>
</tr>
<tr>
<td></td>
<td>Increased volumes of production and export of products of processing enterprises of the AIC, privatization with due allowance for interests of agricultural commodity manufacturers.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Increased real level of incomes of both agro-industrial enterprises and their employees.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Improved financial provision of infrastructure in the rural areas.</td>
<td></td>
</tr>
<tr>
<td><strong>Short-term (first 2 years)</strong></td>
<td>Increased tax disparity between the agrarian and other sectors of the economy.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Lack of improved investment and financial attractiveness of the sectors (except for individual short-term projects and state-supported projects).</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Substitution of private investment and crediting with state investment and crediting.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Reduced foreign competition against Ukrainian commodity</td>
<td></td>
</tr>
</tbody>
</table>

**Consequences of implementation:**

- Establishment of real ownership of land and agricultural enterprises of the AIC, opening an opportunity to obtain money equivalent to land and property shares when quitting the collective enterprise.
- Formation of efficient economic mechanisms for the AIC.
- Increased volume of production in accordance with the need to make profit, foreign trade and reserves.
- Merged competitive sectors of agrarian business.
- Identification of leading enterprises as models of innovative experience.
- Development of specialized market infrastructure.
- Development of the wholesale food markets and markets for agricultural raw materials, land, labor resources, financial and production capital, scientific-technological products, etc.
- Increased volumes of production and export of products of processing enterprises of the AIC, privatization with due allowance for interests of agricultural commodity manufacturers.
- Increased real level of incomes of both agro-industrial enterprises and their employees.
- Improved financial provision of infrastructure in the rural areas.
<table>
<thead>
<tr>
<th>Strategy</th>
<th>Development of a competitive agrarian sector</th>
<th>Secured food supplies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Decreased volume of barter operations and outstanding mutual debts.</td>
<td>manufacturers and decreased volumes of legally imported food and agricultural products.</td>
</tr>
<tr>
<td></td>
<td>Increased investment attractiveness of the agro-industrial sector.</td>
<td>Stabilized production and some increase in the volume of sales of outputs of AIC enterprises.</td>
</tr>
<tr>
<td></td>
<td>Formation of primary markets for market-exchange agricultural raw materials.</td>
<td>Continuation of barter settlements and outstanding mutual indebtedness, especially in collectively owned enterprises.</td>
</tr>
<tr>
<td></td>
<td>Privatization of processing enterprises.</td>
<td>Increased pressure on the expenditure side of the budget and budget deficit.</td>
</tr>
<tr>
<td></td>
<td>Leveling of inter-sector price disparities, increased profits of agro-industrial enterprises and their payments to the budget.</td>
<td>Aggravation of the problems of rural social sphere.</td>
</tr>
<tr>
<td></td>
<td>Creation of conditions reducing the need for constant subsidization.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Formation of social reform conditions at the level of local self-government.</td>
<td></td>
</tr>
</tbody>
</table>

**IMPLEMENTATION OF THE PROSPECTIVE POLICY**

In Ukraine several concepts and programs of agrarian policy and prospective socio-economic development of the AIC exist concurrently. They differ in the goals and scale of transformation, as well as methods and means to achieve these goals. Advocates of some concepts support the breakup of the existing system of agriculture; adherents of another set of concepts work for temperate, conservative measures and propose restoration and preservation of the pre-reform system. Promoters of one more set of concepts propose considered constructivism. This very position is shared by the authors. However, none of the existing concepts has been officially considered by the Verkhovna Rada of Ukraine to date.

The policy promoted by the authors is a strategy aimed at creating a competitive agrarian sector through accelerated formation of efficient market-type organizational and legal forms of business based mainly on private ownership.

**Major differences in opinions**

Taking into account results of the investigation of differences in expert opinion and having analyzed responses to the questions concerning the contents of a prospective agrarian policy outlined in our questionnaire, the authors conclude that the majority agrees with the goals of the proposed policy, its strategies, key short-term challenges and those challenges that are to be addressed after 3-5 or more years. The most important issue on which expert opinion differs concerns processing enterprises—should they be fully owned by agricultural enterprises as cooperative associations or should they be independent privatized entities? The fact that opinions on this matter differ may adversely affect the pace of privatization.

Today practically all land is shared, but owners of land plots cannot dispose of their land shares because they are only offered monetary compensation in cases where membership in collective enterprises is discontinued. Therefore, the lack of consensus on the issue of whether just monetary compensation for land and property share should be granted to a person quitting a collective enterprise or land itself should be put at his/her disposal may become a significant obstacle to the strategy of efficient ownership formation.

**Issues supported by the majority**

There is a consensus between governmental and non-governmental experts in agrarian policy proposed by the authors.
Regarding the key problems of agrarian policy, it should be noted there is an understanding that further reforms are required. Respondents prefer private ownership and there is a unanimity between both governmental and non-governmental experts in this matter. This concerns both land redistribution in general and land relations in particular, including the issue of land markets. There is virtually no support for the collective form of ownership, even in its current form. All participants of the poll critically assess the existing pricing policy and systems of financial and credit provision and taxation. They point to the importance of accelerated development of real agricultural markets.

There are reasons to state that respondents support conceptual ideas outlined in this analytical report as well as the goal of agrarian policy that provides for development of competitive agriculture. Private ownership in the agrarian sector should dominate, though conditions for realizing owners’ rights remain unsettled. This is also true for property relations in the agro-industrial complex.

**Obstacles to implementing the new policy**

Despite the fact that the majority of respondents prefer private ownership to land rather than collective and state ownership, creation of efficient ownership in practice is hindered by the unsettled issue of ownership rights in case of discontinued membership in a collective enterprise. This is the largest obstacle to the strategy of nurturing and developing a competitive agrarian sector.

In addition, there is uncertainty over privatization in the processing sectors. Manufacturers of agricultural goods are opposed to the transformation of state-owned monopoly enterprises into private or commercial monopoly enterprises. Ukraine needs a new concept of how to develop processing sectors.

### Table 7. The issues with the lowest degree of agreement (the highest level of dispersion in responses)

<table>
<thead>
<tr>
<th>Dispersion</th>
<th>Supported</th>
<th>Not supported</th>
<th>No opinion</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>Governmental</td>
<td>Total</td>
</tr>
<tr>
<td>Processing enterprises should be in full ownership of agricultural enterprises as cooperative associations.</td>
<td>1.81%</td>
<td>46.9%</td>
<td>55%</td>
</tr>
<tr>
<td>Money compensation for land and property share on discontinuation of membership in a collective enterprise.</td>
<td>1.71</td>
<td>50%</td>
<td>60%</td>
</tr>
</tbody>
</table>

### Table 8. Consensus on the main strategies

<table>
<thead>
<tr>
<th>Strategic areas of agrarian policy</th>
<th>% of consensus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Essence and goals of the proposed agrarian policy</td>
<td>87.8</td>
</tr>
<tr>
<td>Formation of efficient ownership</td>
<td>88.1</td>
</tr>
<tr>
<td>Creation of a favorable economic environment and “rules of the game” in the market</td>
<td>77.8</td>
</tr>
</tbody>
</table>
Respondents consider that the factors hindering creation of a favorable economic environment include: imperfect prices and pricing policy, lack of exchange mechanisms, a poorly organized internal market, barter operations, lack of regulated prices and incomes, state intervention in production, and an imperfect financial and credit system (especially the shortage of credit resources and complicated access to them).

Reform may be hindered by:

- the lack of agreement between branches of power regarding the strategy and key issues of agricultural development.
- the Government’s adoption of its familiar role of permanent guiding and making decisions in the agrarian sector through the system of commodity credits, various financial privileges, etc.
- discrepancies between levels of qualification of personnel (at managerial and lower levels) and the requirements of modern agriculture.

Drawbacks and points for criticism include:

- social and infrastructural problems in rural areas,
- permanent wage arrears,
- unprofitability of enterprises,
- “shadowization” of the sector,
- inadequate skills and training.

**Recommended sequence of actions**

In the short term:

- involve agricultural lands in market-economic turnover:
- accomplish privatization and issue relevant state acts.
- introduce new typical standards of rent payments allowing regional peculiarities.
- adopt the Land Code, which should establish a mechanism for land market operation.
- restructure loss-making agricultural enterprises.
- accomplish privatization of processing enterprises engaged in the AIC with emphasis on investment commitments and creation of export production zones and large-scale, export-oriented corporations and cooperatives.
- establish the land market and a set of mortgage (land) banks.
- restrict intervention of authorities in the activity of participants in the agrarian market.
- regulate (by economic means) sales opportunities in the agrarian market through procurement and intervention, minimum purchase prices, customs duties, and taxes.
- stabilize legislation dealing with agrarian business and agrarian relations, except for their further liberalization.
- impose temporary restrictions on the import of goods which are produced in Ukraine in a sufficient volume and are exported, or whose output may be increased. Adopt at the level of a legislative act a Concept of agrarian policy based on the proposed strategy.
- initiate the integration into processing enterprises of manufacturers of agricultural goods by establishing integrated professional associations with defined productive and marketing functions aimed at achieving final results.
- improve the system of AIC administration and personnel provision by establishing nongovernmental management structures based on professional peculiarities and forms of ownership. Re-organize the system of personnel training.
- apply agrarian protectionism in connection with price disparity, monopoly, and unregulated imports. Gradually introduce a mechanism regulating market prices and income by stabilizing markets. Support internal prices by application of mortgage operations and wholesale purchases through tenders and auctions.
- set up cooperatives on the basis of private self-supporting farms and their integration with public enterprises.
- cooperation at the level of administrative region by integrating the entire resource potential for production of final products, and implementation of targeted comprehensive programs of agricultural development.
- introduce a new system of training and advanced training of personnel.
• establish a special fund for credit support to manufacturers of agricultural goods.

In the long term:
• create a multi-structure competitive agrarian economy dominated by domestic ownership.
• create incentives to rapid acceleration of capital in high-priority directions of agricultural development.
• terminate the practice of explicit subsidization.
• restrict relations with the budget to that mediated by tax policy.
• create a system for protecting investment and insurance activity of the credit and financial structures servicing the AIC.
• Create mechanisms of financial and credit servicing of agricultural good manufacturers that would receive money in the productive sphere.
• Develop equal "rules of the game" in the market, that is, provide equal conditions and level of legal and economic framework for all business subjects (enterprises, establishments, organizations with various forms of ownership).

IV. CONCLUSIONS

The Government should limit its role to nurturing and developing large-scale agricultural producers through an efficient use of market instruments. The agricultural producers should represent various forms of ownership and range from an individual farmer to international corporations, transportation companies, distributors, equipment-producing firms and so on. The Government should always be involved in managing the agriculture but should not be a monopolist. Government at all levels should ensure the security of citizens, foster fair competition, and provide public services—assist in providing consumers with the best goods for their money and help manufacturers get the best price and the highest profit from selling their goods. The Government, however, should not do business itself, because as the experience of Ukraine’s agrarian sector suggests, this may have adverse consequences for the entire economy.
2. POLICY IN EDUCATION

Y.M. Vitrenko,
Head of Department
Ministry of Economy
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I. INTRODUCTION

More than 1.7 million are employed in the Ukrainian education sector. This represents more than 7 percent of total employment in all sectors of the economy. This number is much greater than the number of employees engaged in such sectors as construction, transportation, housing, and communal services. The overall number of direct and indirect participants in education is almost 11 million, or about 22 percent of the population. Spending on education represents almost 12 percent of the consolidated budget. Only the Pension Fund (21 percent) and social benefits are higher. Education significantly influences all spheres of social life and public attitude.

Significant volumes of human, material, and financial resources are involved in education, and the key role of education in social and economic development justifies the need for an in-depth examination of the scale and results of education, and how effectively resources are allocated in the sector.

The investigation is based on an analysis of education between 1985 and 1998, including sectors of pre-school education, secondary-level education, vocational education, and higher education. Results of this analysis are presented in Section II. In the same sector-by-sector analysis, consolidated budget expenditure was analyzed for the period between 1992-1998. Characteristics of state policy are considered in light of the Constitution of Ukraine, the Laws of Ukraine, Presidential Decrees, resolutions of the Cabinet of Ministers of Ukraine, and regulatory documents of the Education Ministry and other ministries and departments.

Analysis of the existing policy is followed by proposals regarding a new education policy. Section III presents strategic goals to be pursued by the state in education and proposes ways of achieving those goals. In addition, this Section provides a comparative analysis of policy alternatives.

Section IV discusses obstacles that may hinder implementation of the prospective policy and presents a list of sequential measures in the short term (in 1999) and long term (during the next 5 years and onwards).

The report is based on materials of various governmental and research and development establishments, comments of Ukrainian and international experts and expert discussions. Of special importance for preparation of this document were results of the investigation Differences in Expert Opinions (based on a poll conducted among 7 governmental and 6 non-governmental establishments and organizations).

II. EDUCATION TODAY AND OUTLOOK FOR ITS DEVELOPMENT

ANALYSIS OF THE CURRENT SITUATION

According to UN statistics, Ukrainian education ranks in the fourth dozen behind most European countries, including Russia, Belarus, Estonia, and Latvia.

The short duration of schooling is partly responsible for this. In all developed countries, instruction at secondary schools is 12-13 years, and more than 80 percent of children receive this instruction. In Ukraine, secondary-level instruction lasts 10 years and only 70 percent of children receive it.

The educational potential of countries accumulates during centuries. In the majority of European countries laws on compulsory secondary education were adopted last century, and at the beginning of this century the literacy rate was virtually 100%. At the same time, czarist Russia failed to adopt such a law. Even in 1930 more than 30 percent of Ukraine's population over the age of 10 was illiterate.

It is widely assumed in Ukraine, however, that the standard of Ukrainian education is either higher or more or less the same as developed countries. As suggested by the poll, more than 80% of respondents are of that opinion.

It should be emphasized that deficiencies arose in the Soviet era. Since independence, quantitative indices remained virtually unchanged. Thus, relative to 1990:
the amount of people studying as percentage of the overall population remains the same (18.2 percent),

the number of students in secondary day educational establishments increased by 1.1 percent,

the number of students in higher educational establishments decreased by only 0.1 percent (the number of students of universities, academies, and institutes increased by 10.8 percent)

the number of postgraduate students and doctoral candidates increased by 47.2 percent.

Even in the complicated economical conditions of 1990-1997, school construction continued with 1,356 schools for 647.5 thousand students, pre-school establishments for 157.2 pupils, vocational colleges for 10.4 thousand students, and training and laboratory facilities with a total area of 284.5 thousand square meters being built.

Despite stability and even some increase in the scale of educational activity, the volume of financial resources spent on running educational establishments has decreased considerably. For example, the amount of current budget expenditure on education as a share of GDP decreased from 4.8 percent in 1992 to 4 percent in 1997. Allowing for the reduction in GDP and for inflation, this share decreased by at least 60-70 percent in real terms.

This decline has resulted in:

- significant wage arrears in the sector,
- arrears of payments for power resources and communal services,
- suspended replacement of equipment and library stock,
- deferred infrastructure repairs.

Eventually, this will all hurt the quality of educational and instructive work.

There are a number of legally established structural forms of educational activity in Ukraine (pre-school education; compulsory secondary education; out-of-school education; vocational education; higher education; postgraduate studies; apprenticeships; doctoral studies; and self-study). Each have clear peculiarities and, hence, significant differences in financing. This report, then, must separately consider the financing of:

- pre-school education,
- compulsory secondary education,
- vocational education,
- higher education.

**Pre-school education**

The student headcount at 18,400 permanent pre-school educational establishments operative in late 1997 was 1.2 million children, or 35 percent of the overall number of children in that age group. 24.1 percent of places in urban areas and 57.4 percent of places in rural areas were unused.

Relative to 1985, the number of establishments decreased by 20 percent, the number of children attending these establishments by 52.8 percent (the main reason for this trend is the lower birthrate, which decreased from 762.8 thousand to 442,600 per year, or by 42 percent). The coverage decreased by 21 percentage points, the rate of bed load decreased in urban areas from 111 children per 100 beds to 76, and in rural areas from 81 to 43. The number of unplaced applications decreased from 192,600 to 15,000 the load of kindergartners decreased from 11 to 6 children per kindergarten, or by almost a half. The above data suggest that the number of permanent pre-school establishments actually satisfy the need of the population.

The activity of pre-school establishments is financed at the expense of both the State budget and local budgets as well as entrepreneurial funds and parental contribution.

Of consolidated budget, spending on pre-school establishments represents about 2 percent and ranks third after spending on secondary and higher educational establishments. It should be noted that more than 93 percent of spending on pre-school education comes from local budgets. Therefore, the issue of improving the efficiency of financial resources in this sector depends primarily on local administrations. Existing Ukrainian legislation on local self-government allows financial support of schools. According to independent analytical publications, budget receipts are more than 150 percent of the
budgeted target in some towns, and they have no wage arrears.

Of total expenditure on pre-school education in state-owned and communal kindergartens and nurseries, the contribution made by parents is 15-20 percent (as a result of budget arrears, the share of this contribution in the actual expenditure is much higher). A clear list of expenses which should be covered by the state (and those which should be a responsibility of parents subject to changes in legislation) has not been defined and established by regulatory acts so far. Budgets are regulated by a resolution of the Cabinet of Ministers of Ukraine and depend typically on the level of parental incomes rather than on the quantity and quality of services provided. (Facts suggest that a large proportion of parents are exempt from fees for various social reasons.) In 1997 the cost of pre-school establishments amounted to UAH 98 million (UAH 79.5 per child).

**Compulsory secondary education**

Ukrainian citizens have the constitutional right to free education in general schools (primary, basic, and high schools), evening schools, classes and groups with a day or extra-mural form of education, general schools, in vocational and higher education establishments (training colleges, junior technical colleges, etc.). In the 1997/98 school year, about 67 percent of the total sector enrollment were schooled in general schools, 16 percent in vocational establishments, and 14 percent in higher educational establishments.

**Table 1. Permanent pre-school educational establishments (end of year)**

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>1990</th>
<th>1997</th>
<th>1997 % relative to:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1985</td>
</tr>
<tr>
<td>1. Number of permanent pre-school establishments (thousands)</td>
<td>22.9</td>
<td>24.5</td>
<td>18.4</td>
<td>80</td>
</tr>
<tr>
<td></td>
<td>in urban areas</td>
<td>11.7</td>
<td>11.9</td>
<td>8.7</td>
</tr>
<tr>
<td></td>
<td>in rural areas</td>
<td>11.2</td>
<td>12.6</td>
<td>9.7</td>
</tr>
<tr>
<td>2. Number of places in permanent pre-school establishments (thousands)</td>
<td>2515</td>
<td>2277</td>
<td>1770</td>
<td>69.2</td>
</tr>
<tr>
<td></td>
<td>in urban areas</td>
<td>1838</td>
<td>1662</td>
<td>1255</td>
</tr>
<tr>
<td></td>
<td>in rural areas</td>
<td>677</td>
<td>615</td>
<td>515</td>
</tr>
<tr>
<td>3. Number of children in pre-school establishments (thousands)</td>
<td>2600</td>
<td>2428</td>
<td>1171</td>
<td>47.2</td>
</tr>
<tr>
<td></td>
<td>in urban areas</td>
<td>2048</td>
<td>1877</td>
<td>952</td>
</tr>
<tr>
<td></td>
<td>in rural areas</td>
<td>552</td>
<td>551</td>
<td>219</td>
</tr>
<tr>
<td>4. Number of children per 100 places</td>
<td>103</td>
<td>107</td>
<td>66</td>
<td>64.1</td>
</tr>
<tr>
<td>5. Number of kindergartners in pre-school establishments (thousand)</td>
<td>238</td>
<td>262</td>
<td>151</td>
<td>63.4</td>
</tr>
<tr>
<td>6. Number of children per kindergarten</td>
<td>11</td>
<td>9</td>
<td>6</td>
<td>54.6</td>
</tr>
<tr>
<td>7. Volume of paid services related to keeping children in pre-school establishments (million UAH)</td>
<td>206.9</td>
<td>212.2</td>
<td>97.6</td>
<td>47.2</td>
</tr>
<tr>
<td>8. Number of unplaced applications (thousand)</td>
<td>192.6</td>
<td>181.1</td>
<td>15.0</td>
<td>0.08</td>
</tr>
<tr>
<td>9. Volume of paid services per child (UAH)</td>
<td>79.6</td>
<td>87.4</td>
<td>79.5</td>
<td>99.9</td>
</tr>
</tbody>
</table>
Table 2. Day secondary educational establishments (as at the beginning of the school year)

<table>
<thead>
<tr>
<th></th>
<th>1985/86</th>
<th>1990/91</th>
<th>1997/98</th>
<th>1997/98 school years (%) relative to:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1985/86</td>
</tr>
<tr>
<td>1. Number of establishments, thousand</td>
<td>20.86</td>
<td>21.31</td>
<td>21.87</td>
<td>104.8</td>
</tr>
<tr>
<td>in urban areas</td>
<td>6.05</td>
<td>6.21</td>
<td>6.83</td>
<td>113.0</td>
</tr>
<tr>
<td>in rural areas</td>
<td>14.81</td>
<td>15.1</td>
<td>15.04</td>
<td>101.6</td>
</tr>
<tr>
<td>2. Number of students, thousand</td>
<td>6648</td>
<td>6939</td>
<td>6971</td>
<td>104.9</td>
</tr>
<tr>
<td>in urban areas</td>
<td>4587</td>
<td>4765</td>
<td>4730</td>
<td>103.1</td>
</tr>
<tr>
<td>in rural areas</td>
<td>2016</td>
<td>2174</td>
<td>2241</td>
<td>111.2</td>
</tr>
<tr>
<td>3. Share of students continuing study in 10th-11th forms (in percent to the overall number of graduates of 9th forms), percent</td>
<td>52.1</td>
<td>54.9</td>
<td>67.0</td>
<td>x</td>
</tr>
<tr>
<td>4. Number of students who study in the second and third shifts, thousand</td>
<td>818</td>
<td>1029</td>
<td>719</td>
<td>87.9</td>
</tr>
<tr>
<td>5. Number of students who study in the second and third shifts (in percent to the overall number of students)</td>
<td>12</td>
<td>15</td>
<td>10.4</td>
<td>x</td>
</tr>
<tr>
<td>6. Average number of students per class</td>
<td>26.4</td>
<td>23.2</td>
<td>22.4</td>
<td>88.4</td>
</tr>
<tr>
<td>in urban areas</td>
<td>29.4</td>
<td>27.0</td>
<td>28.1</td>
<td>95.6</td>
</tr>
<tr>
<td>in rural areas</td>
<td>22.0</td>
<td>17.9</td>
<td>16.4</td>
<td>74.5</td>
</tr>
<tr>
<td>7. Number of teachers in secondary day schools</td>
<td>473</td>
<td>37</td>
<td>571</td>
<td>120.7</td>
</tr>
</tbody>
</table>

General schools are funded at the expense of local budgets; higher educational establishments at the expense of both local budgets and the state budget; vocational education establishments providing secondary education at the expense of the State budget. There is no separate accounting for secondary education and vocational training in vocational and higher educational establishments. Given the above and the volume of activity and financial resources used, economic problems may be considered by analyzing day (non-boarding) secondary educational establishments.

In the 1997/98 school year, 7 million students were schooled in 21,900 day general schools. Relative to the 1985/86 school year (which is used as a benchmark in this report) the number of schools increased by 4.8 percent, the number of students by 4.9 percent. The share of students of 10th-11th forms increased from 52 percent in 1995-96 to 65 percent in 1997-98. The number of students taught in the second and third shifts decreased from 12 percent to 10 percent, the average number of students per class decreased from 26 to 22, or by 15 percent. At the same time, the number of teachers increased by 20.7 percent, and their load decreased from 15 students per teacher to 12, or by 20 percent. Thus, there are grounds to state that Ukraine, despite the economic decline, not only managed to maintain the standard general of secondary education, but even improved it to some extent.

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1 Ed. Educational standards should not be measured in terms of the number of teachers or buildings but in terms of the quality of education delivered. Spending too much on teachers and buildings can actually reduce the quality of educational output by reducing...
However, it should be stated that the provision of handbooks, manuals, and visual aids deteriorated. For example, the shortage of resources in the 1998/99 school year resulted in the plan for textbook publication being fulfilled by only 16 percent. It should be added that the situation continues to be unsatisfactory not only from the standpoint of quantitative indices of handbook provision, but also from the standpoint of the quality of school materials and manuals. In the opinion of many Western and independent domestic experts, even those books that are available are out-of-date.

It is also necessary to point to the low level of computerization. Out of 21,900 general schools only 4,000 possess modern computers, 5,000 schools are equipped with obsolete computers, and 12,000 schools, including more than 4,000 secondary-level schools, have no computers at all. Just in 1988, about 150,000 graduates of general schools had not reached even elementary computer literacy. As a result of this, their chances of finding gainful employment are circumscribed.

Spending on general secondary education represents 5.2-5.7 percent of the overall volume of the expenditure side of the consolidated budget and exceeds spending on defense or Chernobyl expenditure. In the structure of education-related expenditures, spending on general secondary education represents almost one half. This sector accounts for the majority of wage arrears, arrears of payment for communal services, etc. Financial problems in general secondary education are complicated by the fact that individual establishments are funded from several hundred local budgets, whose financial positions vary widely. In some regions (e.g. Kyiv) there are almost no arrears, in some others (e.g. Crimea, Volynska, Kirovohradska, Rivnenska, Ternopilska, and Chernivetska oblasts) wages are not paid for 3-7 or more months.

Vocational education

The measure of success in vocational education is directly related to production. The availability of an efficient system for training new workers meeting modern requirements is a prerequisite for economic stability.

In 1997, there were 1,003 establishments in this sector, which trained 528.1 thousand students. Relative to 1985, the number of establishments decreased by 15.2 percent and the number of students fell by 25.8 percent. The reduction mainly concerned those vocational schools which suffered as a result of a poor material and technical base. The decrease in the number of students trained in vocational schools is mainly attributable to the decreased need of enterprises for new manpower and increased number of students who opted to study in 10th-11th forms of general secondary schools.

Significant adverse changes occurred in the standard of instruction and resource base of vocational schools. For example, between 1996 and 1997, 275 vocational educational establishments in the agricultural sector received only 67 tractors, 89 motor cars, and 24 combines. This machinery was not of the highest standard. This is mainly attributable to the limited financing of vocational schools.

In the structure of consolidated budget expenditure, vocational education represents 0.7-1.0 percent, in the structure of State budget expenditure of Ukraine - 1.4-1.5 percent. Virtually all activity of vocational establishments is funded at the expense of the State budget - local budgets provide almost no funds for these establishments. In earlier years, up to 40-50 percent of vocational schools were funded by basic enterprises and sector ministries and departments. This assistance mainly took the form of free transfers of equipment, tools, raw materials, as well as provision of space for field training and remuneration of mentors' labor. This type of assistance has decreased, and there are no grounds to anticipate a considerable improvement of the situation in the next 3-5 years. The fact that a significant number of students of vocational establishments are orphans or members of low-income families and require significant resources in the form of social assistance exacerbates the problem.
Table 3. Vocational educational establishments (as of the beginning of a school year)

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>1990</th>
<th>1997</th>
<th>1997 (%) relative to:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1985</td>
</tr>
<tr>
<td>1. Number of establishments</td>
<td>1196</td>
<td>1226</td>
<td>1003</td>
<td>83.9</td>
</tr>
<tr>
<td>2. Number of students, thousands</td>
<td>711.3</td>
<td>643.4</td>
<td>528.1</td>
<td>74.2</td>
</tr>
<tr>
<td>3. Enrolment, thousands</td>
<td>458.7</td>
<td>380.5</td>
<td>311.2</td>
<td>67.8</td>
</tr>
<tr>
<td>4. Number of skilled graduates, thousand</td>
<td>427.9</td>
<td>376.7</td>
<td>264.5</td>
<td>61.8</td>
</tr>
</tbody>
</table>

Higher education

The main feature of developed economies is their readiness to accept modern technology. In terms of human resources, this implies inherent ability (of managers, workers, personnel, etc.) to actively master new and reject old technologies. This may be considered (and is in reality) a qualitative peculiarity of specialists in one or another area: if goods and services are supplied to outlets and are competitive, the specialists also may be reckoned as having up-to-date professional qualifications.

The low level of training is reflected in real terms. The professional level of Ukrainian engineers is suggested by the fact that Ukraine uses 7-12 times as much oil equivalent units to produce 1 kg of GDP as industrialized economies (data for 1994).

The number of higher educational establishments has increased by 7.2 percent (from 877 to 940) since 1985 due to new non-state and state higher educational establishments. The number of students decreased by 1.6 percent. At the same time, the number of professorial and teaching staff increased by 15 percent.

In terms of expenditure, higher education ranks second after general secondary education. In the structure of the consolidated budget, the share of this expenditure is 2.3-2.7 percent, in the State budget about 4 percent. Expenditure on higher education from the 1998 State Budget was equal to spending on the Armed Forces and does not exceed spending on law enforcement bodies.

Higher education raises a significant amount of non-budget resources, primarily on account of a partial tuition charge. According to estimates, the overall amount of tuition is UAH 100-120 mln, or 20 percent of the amount of the higher education budget.

However, higher education also suffers from a shortfall in financing. Wage arrears amounted to UAH 170 mln; tuition arrears exceeded UAH 70 mln. Budget-financed refurbishment virtually stopped altogether. The educational base and library stocks are in urgent need of targeted funds.

Table 4. Higher educational establishments (as of the beginning of a school year)

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>1990</th>
<th>1997</th>
<th>1997 (%) relative to:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1985</td>
</tr>
<tr>
<td>1. Number of establishments</td>
<td>877</td>
<td>891</td>
<td>940</td>
<td>107.2</td>
</tr>
<tr>
<td>2. Number of students (thousands)</td>
<td>1662.0</td>
<td>1638.3</td>
<td>1636.0</td>
<td>98.4</td>
</tr>
<tr>
<td>3. Enrollment (thousands)</td>
<td>446.3</td>
<td>415.5</td>
<td>430.9</td>
<td>96.6</td>
</tr>
<tr>
<td>4. Graduation (thousands)</td>
<td>387.5</td>
<td>365.6</td>
<td>348.9</td>
<td>90.0</td>
</tr>
<tr>
<td>5. Competition (number of applications per 100 enrolled)</td>
<td>169</td>
<td>191</td>
<td>146</td>
<td>86.4</td>
</tr>
<tr>
<td>6. Number of main personnel (thousand)</td>
<td>103.6</td>
<td>109.2</td>
<td>119.5</td>
<td>115.3</td>
</tr>
</tbody>
</table>
CHARACTERISTIC OF THE POLICY DURING THE PERIOD UNDER CONSIDERATION

The following documents constitute the organizational and legislative framework of education:

- Constitution of Ukraine;
- Law of Ukraine On Education;
- Law of Ukraine On Vocational Education;
- Presidential Decree On Main Guidelines of Reform in Higher Education;
- Presidential Decree On Main Guidelines of Reform in Vocational Education;
- Presidential Decree On Measures to Improve Functioning and Development of General Secondary Education;
- a number of resolutions of the Cabinet of Ministers.

As well as these, the following draft laws were developed:

- On Pre-school Education;
- On General Secondary Education;
- On State Support to Out-of-school Education;
- On Higher Education.

They defined the guidelines and points of reference for the development of education in line with radical changes in Ukrainian society. They may serve as a starting point for a further search for ways of activating the work of teachers’ groups, education administrators, and the educational community. They are a basis for a new economic model of the sector.

Legislative framework of the budget and tax systems is a key factor forming mechanisms in education. The status of this financing framework does not meet requirements at any level of administration and, from this viewpoint, is a significant obstacle hindering improved efficiency of the education sector.

The above data suggest that state policy in this area has enabled Ukraine to preserve the educational infrastructure and avoid reduction in educational activity and total breakdown of the system. In difficult conditions, current budget expenditure on education was 4.2-5.4 percent of GDP and 11.7-14.7 percent of the consolidated budget of Ukraine between 1992-1997.

It is encouraging that the state increases spending on general secondary and vocational education, respectively reducing spending on pre-school education and higher education where non-budget resources may be raised. For example, the following expenditure levels on individual sectors as a share of the 1995 and 1998 consolidated budgets respectively:

- pre-school education: 1.9 percent versus 2 percent
- higher education: 2.2 percent and 1.9 percent
- general secondary education: 6 percent and 5.7 percent
- vocational education: 1.5 percent and 0.8 percent

At the same time, the volume of arrears in wages and communal charges are increasing. Investment in educational equipment and library stocks in schools and higher educational establishments and maintenance of premises has virtually stopped. These facts suggest that legislative and regulatory acts do not meet goals and fail to improve the situation.

Moreover, many facts suggest that budget resources are inefficiently used. For example, while the number of pre-school establishments decreased by 20 percent relative to 1985, the number of pupils decreased by 50 percent, and the number of pupils per kindergarten halved. This implies that budget spending per pupil increased relative to 1985.

At the same time, a significant number of legislative and regulatory acts do not allow economic forces to work in the education sector. This is true for provisions of the law of Ukraine On Vocational Education (Article 5), which establishes that “vocational education shall be provided to citizens of Ukraine in state-owned and communal vocational educational establishments free of charge, at the expense of the state.” This prevents educational establishments from raising revenue on their principal activity. This aspect of existing policy is also characteristic of other sectors of education. If this policy continues, there will be a permanent mismatch between the needs of modern education and ability of the state to finance them.
Table 5. Current budget expenditure on education.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>Pre-school education</th>
<th>Primary and general secondary education</th>
<th>Vocational education</th>
<th>Higher education</th>
<th>Other education establishments and activities</th>
</tr>
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¹ Preliminary data
² Estimated data
III. NEW POLICY FRAMEWORK

GOALS AND KEY MEASURES OF THE NEW POLICY

Taking into account above data characterizing the situation in education and considering it a result of the existing state policy, it is possible to define the following strategic goals:

1. The educational potential of the population should meet respective indices of industrially developed countries and, first and foremost, of EU member states.

2. The quality of training and instruction of workers and specialists should meet the requirements of employers from industrially developed countries. In other words, workers and specialists trained in Ukrainian educational establishments should be able to operate and compete in world and European labor markets.

3. The training level of workers and specialists should satisfy economic needs.

4. Sufficient financing of education should be provided by balancing the volume of activity and the volume of needed financial resources through both budget and non-budget receipts. This may be achieved by increasing and diversifying paid educational services and creating conditions for a private education sector.

Taking into account significant differences between educational sectors, the key measures needed to reach strategic goals for each sector may be specified.

In pre-school education, based on birthrate projections and labor market development (especially regarding the number of women having children of a pre-school age) the following recommendations are made:

- increase the effective use of state and communal pre-school establishment premises (the number of children per establishment is about 80 percent of capacity in urban and 50 percent in rural areas),
- increase the number of private pre-school establishments through long-term leasing,
- reconsider kindergarten quotas,
- establish national average per-student benchmarks of budget financing in state and communal pre-school establishments, expenses in excess of these benchmarks should not be taken into account when appropriating national taxes and charges. This benchmark should include only the outlay for wages of personnel - the rest should be financed by parental contribution and local budgets.\(^2\)

In the general secondary education sector, the following recommendation are made:

- Reconsider the legislative framework in education, in particular, the number of students per class, division of classes into groups, etc.
- Start selling handbooks and manuals; special underprivileged children should be entitled to free textbooks.
- Impose a "school levy" on sales of luxury goods.\(^3\)

\(^2\) Ed. Even better would be to abandon the past practice of allocating funds in terms of buildings and staff, which tends to lock in existing resource allocation even where inefficient. Instead, resources would be allocated in terms of the number of students of school age. Furthermore funds should not be earmarked for wages. This encourages an over-staffing and reduces resources needed for purchasing educational materials, heating and other priority inputs.

\(^3\) Ed. Earmarking tax revenues in this manner usually turns out to be a bad idea because it makes it hard to allocate resources to highest priority uses as needs change. Also, luxury tax would be a bad source of revenue for education. Financing requirements of education tends to be stable in good times and bad, but luxury tax receipts will drop off sharply during economic downturns as people postpone luxury purchases. A solid stable general revenue system based on a good blend of VAT, PIT, CIT and other standard taxes combined with a well-functioning budgetary system would be a better way to assure adequate funding for education.
• Develop and implement measures aimed at the efficient use of teaching staff.

• Develop regulatory documents to engage parents’ committees, school boards, etc.

• Develop regulatory documents to engage foreign and domestic donors, investors, and entrepreneurs in providing financial and technical assistance to secondary schools.

• Raise money from international organizations for training and re-training of teachers, training of managers and education administrators.

• Over 3-5 years, mobilize local budget resources for computer purchase.

• Increase the proportion of the education budget used to finance career oriented training and career-guidance, in particular by such courses as “Careers in Business”, “Business Training for Students” and other additional studies and career guidance programs during school holidays and for out-of-class work students.

For the sector of higher education we proposed to:

• Integrate budget-sustained educational establishments, since there are too many institutes and universities in given regions and oblasts,

• Reconsider curriculums to focus on student self-training after the pattern of the world’s top universities. The tutor-to-students ratio should be aligned with indices of US and Western European universities in the early 80s.

• Reconsider the set of subjects taught in secondary schools where teachers’ wages are not as high as in higher educational establishments,

• The majority of colleges, technical schools, and special schools should become a part of universities. It would be reasonable to extend to course of training to a degree of “junior specialist,” and then for a bachelor’s degree within an accelerated program, since schooling in colleges is much less expensive than the first and second years of university education,

• Continue the work aimed at integrating the systems of civil and military education,

• Transfer some research-and-development institutions to leading universities. This measure would allow the improvement of the material and technical bases of education and research, including post-graduate studies,

• Improve the level of professorial and teaching staff, efficiency of use of human, material, and financial resources of both higher education and science.

---

4 Ed. Expenditure in other countries indicates that most vocational training should be left to the enterprise sector to provide programs combining classroom with “on-the-job” training. This assures that the training will be fully relevant to the needs of the employer. Schools should focus instead on basic numeracy, literacy and learning skills.
### COMPARATIVE TABLE NEW STRATEGIES

<table>
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<tr>
<th>Strategy</th>
<th>“Reform of education and mechanisms of its financial provision”</th>
<th>“Improvement of the existing educational system and provision of legislative guarantees of its functioning”</th>
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| **Goals** | - Bring the educational potential of Ukrainian population up to the level of industrially developed countries.  
- Improve the quality of workers training to meet the requirements of the European labor market.  
- Balance the volume and structure of worker training and specialists at the expense of budget resources to meet the requirements of the national economy and financial possibilities of the state. | In keeping with Article 53 of the Constitution of Ukraine:  
- Provide accessible and free general secondary, vocational, and—higher education in state and communal educational establishments  
- Develop pre-school, comprehensive general secondary, vocational, and post-graduate education as well as other forms of training  
- Grant state scholarships and allowances to students. |
| **Problems to be solved** | - Mismatch between educational potential and quality of training  
- Mismatch between the activity of educational establishments and available financial resources  
- Insufficient social mobility of graduates and low ability to adapt to market conditions | - Reduced control over the use of budget resources  
- Social protection of students and teaching staff. |
| **Means** | - Reconsidering legislative and regulatory acts dealing with education administration that lead the above mismatches;  
- Reconsidering curricula in all sectors to meet international and European standards;  
- Developing a system of measures to improve the use of budget resources (increased number of pupils per group, students per class, etc.); increase of the load of teaching staff; extension of paid services; sale of handbooks, etc.;  
- Engaging the involvement of public educational organizations in education reform. | - Enhancing control over the use of budget resources  
- Improving the material-technical base of the education sector of education  
- Improving the existing regulatory framework for operation of educational establishments  
- Bringing non-state establishments under strict control of the state. |
| **Consequences** | Short-term (1-2 years)  
- Create legal conditions for accelerated educational reform;  
- Establish a real index of the educational | Short-term (1-2 years)  
- Unchanged scope of education; |
### Improvement of the existing educational system and provision of legislative guarantees of its functioning

- Increased volume of arrears of wages, communal and other payments;
- Continued social protection of students and educational staff, as well as reduced social tension.

### Reform of education and mechanisms of its financial provision

- Level of population of Ukraine relative to European counties which would dissolve the illusion of a high level of education in Ukraine
- Organization the education services market
- Enhance activity of public educational organizations.

#### Long-term (3 years +)

- Increased educational potential of the population of Ukraine and improved quality of training
- Integration of the Ukrainian market into the world educational market
- Efficient functioning of educational establishments in market conditions.

---

### Implementation of the Prospective Policy

It is obvious that each prospective policy and especially has both supporters and opponents. The analysis of the poll results suggests that opinions of Ukrainian experts regarding the ways of resolving the problems in education differ somewhat, and not all the proposed measures are supported. However, support for the main economic issues is considerable. For example, almost 80 percent of the canvassed experts understand that in defining the volume of financial support given to education it is real economic possibilities of the state rather than the need to support the existing set of educational establishments that should be primarily taken into account. It is also important that there is an understanding that in current terms, the educational level of population is a decisive factor in economic growth – this opinion is supported by 70 percent of respondents. The polled experts support the majority of proposed measures.

At the same time, there are a number of issues supported by less than 50 percent of polled experts. This may be viewed as a possible obstacle to implementation of the proposed policy.

### Possible obstacles

#### Student/Teacher ratios

It is obvious that reconsideration of the load norms and the ratios of pupils per group and students per class would provoke criticism from kindergarten managers, teachers, parents, and political forces, especially leftists.

This is suggested by the fact that only 44 percent of non-governmental experts support increasing the load of kindergartners and 22 percent support increasing the load of teachers. However, new legislation should retrospectively utilize the norms that were in effect before 1984, that is, prior to so-called school reform. The fact is that norms in education were much stricter prior to 1984 compared to current norms. Development of new norms close to those that were in place in earlier years would allow for a substantiation of this indicator. There would be a return to previous norms and therefore less criticism.

Majority of the population remembers that handbooks used to be sold, and this system had
some advantages. And more than 70 percent of experts’ support resumes such sales.

Cost recovery. Proposals relating paid educational services also meet with opposition. This is related to the constitutional provision about accessibility and free provision of general secondary and vocational education on the other hand.

As a result of economic problems, the volume of support to educational establishments granted by private sector business has decreased significantly. Low average disposable income population is a serious obstacle hindering the development of private schools. The number of private schools does not exceed 200, and only 3.7 thousand children (less than 1 percent of the overall number of students) study in them. The majority of parents consider that all services, even those of non-educational nature, should be provided free of charge.

The attempts of school principals to improve education through levy of parental contributions cause dissatisfaction. At the same time, it should be noted that some economists estimate the volume of parents fees paid to teachers at UAH 40—50 million, “half-voluntary, half-forced” parental aid to schools at UAH 350—400 million, and sponsorship at UAH 70—80 million. This implies that the overall amount of off-budget (mainly “shadow”, unofficial) financing is almost UAH 0.5 bln per year, or one third of the budget allocation.

Quality of existing education system. A significant obstacle that may hinder the new policy is the inadequate assessment of the current literacy rate of the Ukrainian population. About 40 percent of government experts consider that the contents and programs of education meet international standards and current conditions in the labor market. More than 90 percent of governmental experts and about 70 percent of non-governmental experts think that the educational level in Ukraine is higher than the level of developed countries or is at the same level, which is inexplicable.

Moreover, 92 percent of governmental and 55 percent of non-governmental Ukrainian experts believe that the level and quality of education provided to students by Ukrainian secondary and higher school is higher than or about the same as in developed countries. Given this lack of understanding, it would be optimistic to count on political will to actively undertake reforms.

Recommended sequence of short and long-term actions

In 1999:

1. Inform the public on the current state of education from the economic standpoint, discuss this information broadly at various all-Ukrainian and regional meetings of the educational community, in the mass media, etc.

2. Conduct an All-Ukrainian Meeting of Educational Staff, where top education officials would take part in discussions on the current state of education, adopt recommendations regarding legislative and regulatory provision of education reform.

3. Adopt the Law On General Secondary Education and On Higher Education, and concrete amendments to the Laws of Ukraine aimed at improving the condition of educational establishments (in particular, by implementation of a “school tax”).

4. Establish the State Inter-sector Organizational Structure with wide-scale involvement of non-governmental, public educational organizations, experts and consultants from international educational organizations and industrially developed countries in supervising education reform.

Between 2000—2005:

1. Switch to a new set of standards in teaching and instruction in (by late 2000).


5. Extend the role of parents and public organizations in reforming education and administration of educational establishments.

6. Undertake other measures set forth in Section III The Framework for the Prospective Policy.
IV. CONCLUSIONS

The investigation and analysis of the economic problems in the education sector reveal that they are closely connected with general economic problems, which exert a significant influence on the economy, the budget, and virtually all aspects of society. The main conclusion of the investigation is the indisputable fact that it would be very difficult or even impossible to overcome general crisis phenomena in the economic and social development of Ukraine without improving the use of human, material/technical, and financial resources. The following measures are also of great importance:

- Virtually all sectors of the education system need reforming.
- For purposes of reform, resources of both the state budget and citizens as well as resources of non-state organizations and international donors should be used.
- Parents, public educational organizations, experts, and consultants from international educational organizations should be involved in the reform process.
3. ENERGY POLICY

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First Deputy Minister of Economy

V.I. Kiriniachenko
Head of Department
Ministry of Economy

V.G. Skarshevsky
Expert
Prime Minister Service

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I. INTRODUCTION

In the Ukrainian energy sector, difficulties are brought about by excessive power consumption. Significant resources are required for modernization of the energy complex, but they are scarce. The shortage of these resources is primarily attributable to payment arrears. The main cause of non-payment for consumed energy is that the majority of enterprises, as a result of outdated technology, produce non-competitive goods which are in low demand even in the domestic market.

In general, the Ukrainian energy complex has a developed network of oil and gas pipelines, electric power transmission lines, many electric power plants and oil-processing factories, all of which could ensure an adequate supply of power resources to consumers.

However, the payment crisis and lack of capital investment has endangered the stability of the power supply to consumers, affecting production in enterprises and causing inconvenience to consumers.

This report describes the current energy policy, provides its critical analysis and outlines prospective policies and obstacles that may hinder their implementation.

The Analysis of the Existing Policy section presents a critical analysis of the existing policy pursued by the Government in the energy sector, which includes the coal industry, oil-gas complex, and electricity sector. The analysis primarily addresses pricing problems.

The Framework for the New Policy section proposes a strategy for reforming the power sector aimed at establishing an efficient market for fuel and power resources. The A Comparative Table of the Alternative Strategies section compares the proposed strategy with an alternative one, whose goal is to achieve power self-sufficiency while ignoring the issues of economic efficiency. The final section – Implementation of the Prospective Policy – is based on a poll among governmental and non-governmental experts and analyzes the differences in opinions among polled experts and points to major obstacles that may hinder the implementation of the new policy.

II. ANALYSIS OF THE EXISTING POLICY

CHARACTERISTICS OF THE CURRENT SITUATION

Consumption of fuel and energy dropped 40% between 1990-1997; over the same period, GDP decreased by 58%. This implies that the energy consumption-GDP ratio increased from 1.59 kg of conventional fuel/UAH in 1990 to 2.28 kg/UAH in 1997, or by 43.4%.

The problem of excessive energy consumption results, first and foremost, from low energy prices (which had been heavily subsidized since Soviet times). Moreover, the energy consumption-GDP ratio is 9 times higher than the European average. This shows that there is a huge scope for the implementation of power-saving technologies in Ukraine.

Domestic oil and gas production covers only 15% of Ukraine's current level of energy consumption. The rest is covered by loss-making production (mainly coal) and imports (primarily from Russia). Annually Ukraine imports 100% of its nuclear fuel, 90% of oil, 80% of natural gas, and about 15% of coal. Even a moderate cut in energy consumption would significantly decrease the trade deficit.

In the energy sector, a significant increase in efficiency may be achieved by fostering market relations between enterprises engaged in energy generation, processing, transportation, and distribution. As a result of this, savings would be passed on to the consumer.

Coal sector

The international competitiveness of Ukrainian coal is very low. The low quality of coal deposits (calorie content being about 4000-5000 kilocalories/kilogram versus 7000 kilocalories/kilogram in other countries), extraction difficulties, poor equipment in mines, an excessive number of workers, and large distances of trans-
portation of processed coal increase the production
cost of Ukrainian coal.

In the coal sector, 252 mines employ more than
600 thousand workers. They produced about 70
million tons of coal last year. Labor productivity
is therefore very low: 4 times lower than in Po-
land and 2 times lower than in Russia.

Restructuring of the coal industry proceeds
slowly. Of about 250 mines, 30% (75 mines)
produce only 5% of overall coal output. The aver-
age cost of coal is 150% of the selling price,
that is, profitability is -50%.

The Coal Ministry is attempting to regulate the
rapidly increasing mutual indebtedness of enter-
prises. It gives subsidies from the State budget,
but there is little investment in production; a
large proportion of subsidies is spent on wages.

Oil-gas complex:

Ukraine has large gas storage capacity (32 mil-
lion cubic meters) as well as an extensive trans-
portation system (10,000 km of main pipelines
with a diameter of tubes of more than 100 mm,
850 compressor stations with a capacity of 5600
MW), and a widespread system of distributing
pipelines. In total, the gas industry employs 110
thousand people.

In 1998, Ukraine’s gas consumption fell by 5.7
billion cubic meters to about 80 billion cubic
meters per year. The share of gas in primary con-
sumption of power resources is 50%. Com-
pared to other countries, Ukraine ranks very high
in gas consumption. Gas consumption by house-
holds, budgetary, and communal sectors in-
creased by 58% since 1990. At the same time,
gas consumption in the energy and industrial
sectors fell by 57% and 40% respectively.

In 1998, energy accounts payable to State Oil
and Gas Committee enterprises rose by UAH
7.3 billion (i.e. more than doubled) to UAH 13.6
billion as of 1 January 1999.

According to the National Joint-Stock Compa-
y Naftogaz Ukrainy, natural gas available for
Ukrainian consumers in 1999 is estimated at 83
billion cubic meters. Of this, 55 billion cubic
meters is to be received from the Russian Joint-
Stock Company GasProm, including 30 billion
cubic meters in payment for transit of Russian
gas through Ukraine; Turkmenistan is to deliver
10 billion cubic meters; and about 18 billion cu-
bic meters is to be extracted domestically.

During 1997 and 1998 Ukraine extracted 4 mil-
lion tons of oil per year, which is about 10% of
consumption. In 1998 the downward trend in oil
supply to oil-processing plants (OPP) halted:
while in 1997 the output of oil processing plants
totaled 12.2 million tons, in 1998 this increased
to 12.7 million tons (up 4%).

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Electric power

The electricity output went down from 296 bil-
lion kW-hours (in 1990) to 170 billion kW-hours
(in 1998), a fall of 42%. The structure of pro-
duction underwent significant changes: while
thermal electric power plants (those using coal,
gas, or oil) were forced to decrease their output
as a result of the shortage of fuel, the output of
nuclear power plants has remained practically
the same since 1990 and they account for about
50% of the current electricity output. Hydro-
electric power plants produce 10% and thermal
power plants account for 40% of the overall
electricity output.

In 1998, Ukrainian nuclear power plants (NPP)
exceeded their production target by 0.1 billion
kW-hours; they produced 73.6 billion kW-hours
(about 45% of the overall volume). In 1997, they
produced about 79 billion kW-hours, or 45% of
the overall output of electric power produced in
Ukraine. Five Ukrainian nuclear power plants
utilize 14 reactors with an installed capacity of
12.8 GW, which accounts for about 25% of the
overall capacity of power plants. Thus the nu-
clear power sector is the main stabilizing factor
of the electric power sector in general.
In 1998, consumers paid for about 18% of the energy supplied. If barter settlements and offsets are included, the level of payments for electric power is about 85%.

The cost of electricity produced by various types of generators differs considerably:

- the lowest cost electricity is produced by hydroelectric plants.
- the cost of power produced by nuclear power plants is up to 2.7 cents per kW-hour (low cost of energy would decrease the cost of final products).
- the cost of power produced by thermal power plants is 4 cents per kW-hour.

**Efficiency of the Energy Policy**

The National Energy Program for the Period Ending 2010, approved by Verkhovna Rada in 1996, lays down the State policy for the energy sector. The main provisions of the Program are as follows:

- demand for fuel and energy in 2010 is estimated at 291.5 million tons of conventional fuel and equals 82.6% of what was actually consumed in 1990,
- the share of domestic energy will be 203.4 million tons of conventional fuel (69.8% of the overall consumption), the share of import 88.1 million tons of conventional fuel (30.2%). In 1990 domestic resources accounted for 44.6%, import for 55.4%,
- domestically-produced coal will represent a major portion of the fuel supply by 2010
- energy production targets for 2010 include: coal – 150 million tons (compared to 76.3 million tons in 1997), natural gas–35.3 billion cubic meters (18.1 billion cubic meters), oil – 7.5 million tons (4.1 million tons)

Since power resources represent more than half of all merchandise imports ($8-10 billion), the fact that the Program sets the goal of decreasing dependence on imported power resources (this is an element of power security) is a welcome point. On the other hand we feel that coal, natural gas, and oil output targets cannot be reached due to the lack of investment. In addition, increased coal output would result in higher losses and increased subsidies to the sector. Given the scarcity of budget resources, this may lead to a significant increase in the budget deficit. Measures to diversify power suppliers envisaged by the Program would enable Ukraine to decrease its reliance on Russia for most of the energy.

Almost all European economies (except for those exploiting oil and gas in the North Sea) have solved the problem of self-sufficiency by building nuclear power plants. These include Belgium (nuclear power accounted for 93% of its energy production in 1992), France (81.5%), Finland (48%), Sweden (57%), Switzerland (62%), and Germany (27%).

**Unresolved Issues**

Currently, the main problem is not unreliable import deliveries but rather the inability of Ukrainian consumers to pay their energy bills. There are two aspects of the problem:

1. In Ukraine, energy prices are lower than their average production cost (price for electricity and natural gas supplied to households).
2. Enterprises do not maximize their profits because of the lack of tight budget constraints because of the Government’s intervention in commercial operation through provision of privileges and offsets, organization of barter delivery schemes, etc. The weakness of budget constraints manifests itself in the high volume of non-payments\(^1\) and wide application of non-cash settlements (barter, money substitutes, mutual settlements), which distort price indicators.

\(^1\) Ninety percent of the polled experts consider non-payments for consumed energy a major problem of the fuel-power complex.
The Government expects to decrease power intensity due to power-saving measures to be developed and implemented by the State Power-Saving Committee. However, without economic incentives (as a result of lower energy prices) these measures may be inefficient.

**Table 2. Degree of energy self-sufficiency, %**

<table>
<thead>
<tr>
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<th></th>
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<td>8</td>
<td>14</td>
<td>28</td>
<td>23</td>
<td>22</td>
<td>20</td>
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<tr>
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<td>25</td>
<td>50</td>
<td>57</td>
<td>59</td>
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<tr>
<td>Great Britain</td>
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<td>94</td>
<td>117</td>
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<td>95</td>
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<td>Sweden</td>
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<td>Switzerland</td>
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<td>32</td>
<td>38</td>
<td>39</td>
<td>39</td>
<td>40</td>
</tr>
</tbody>
</table>

**Box 1. Outlooks for the world nuclear power sector**

Nuclear power accounts for 7% of world energy and about 17% of electricity output.

Increased capacity of NPPs is anticipated in Asia and in the Asian-Pacific rim (China, South Korea, India, Japan), as well as in some Eastern European countries (Czech Republic, Slovakia, Romania). A number of countries (Turkey, Iran, Indonesia, Vietnam) intend to initiate NPP construction programs. However, if one excludes the Asian-Pacific region, it may be stated that there is no long-term world outlook in the nuclear power sector.

This is suggested by the lack of orders for NPP construction in the USA, the stagnation of the NPP sector in Germany and many other European countries, and considerable activity and influence of NPP opponents in many countries. According to the MAGATE forecast, even with NPP development in a number of countries, the world share of nuclear electric power would not exceed 12-15% in 20-25 years; that is, it will begin to decrease, despite some increase in the capacity of the nuclear power sector.

However, the majority of experts have no doubts as to the future of this sector.

The main advantages of nuclear power include:

- it is highly concentrated and virtually unlimited.
- natural resources required for a nuclear power production are hundreds of times lower than those for the organic fuel-based power sector (this is especially relevant in Ukraine given the permanent shortage of working capital available to enterprises).
- the reserves of fuel would suffice for hundreds or thousands of years, depending on the energy production technology.
- due to the high calorific content of nuclear fuel, NPPs could be located at a large distance from fuel sources.
- deposits of uranium are allocated more evenly than those of organic fuel.

Major uranium producers currently include Canada, Australia, African countries, Kazakhstan, and Russia. Though nuclear power has some disadvantages, they are surmountable and are mainly attributable to imperfect technology, which is typical at initial stages of development.

The trends of further development of the NPP sector in Ukraine and CIS are in line with world trends. In the near future, nuclear power will retain its position as an important source of world energy.
Box 2. The power sector requires significant investment

The World Power Council (WPC) has published a paper on the need for investment in the energy sector (based on estimated demand and supply of power). The WPC concluded that during the period up to 2020. annual investment would generally have to remain at the same level - about 3-4% of the world's GDP. The investment needs depend on the region, level of economic development, industrialization, electrification, etc.

The need for investment is the highest in transitional economies, whose the required level of investment almost 10 times as high as that of OECD member states. This difference is attributable to the current low level of GDP in these economies and the need to invest in modernization and renovation of old infrastructure and facilities.

To achieve National Power Program targets, the Government envisages a significant volume of financing. However, excessive reliance on State budget financing (in particular, in the coal sector) creates budget imbalances. On the other hand, the Government provides one-off privileges (in particular, in the oil and gas sector) to encourage investment from internal resources of power enterprises.

Moreover, in late 1998 Verkhovna Rada passed a law extending the application of a zero VAT rate for operations with power resources for the period ending 1 January 2000. (When this law was passed in the first reading, it was intended to extend this period up to 2003.) The law applies the zero VAT rate for sale of coal, enriched coal, coal and peat briquettes, including barter operations, as well as sale and transportation of electricity, including on a barter basis.

The mechanism for implementing the zero rate by the enterprises defined by the Law provides for refunding from the budget. This implies that expenditures out of the budget will be covered by other sources. It would be more reasonable to decrease the VAT rate across the board instead of introducing a preferential tax treatment of these enterprises.

Another source of financing that may help meet the Government plans is foreign investment. The current modest volume of foreign investment is mainly due to inadequate legislation and the lack of tax exemptions and guarantees. In addition, the environment is not transparent as a result of Government intervention at micro level.

Administrative structure

The Government has developed a project to establish a single executive body in the energy sector. This body is the Energy Ministry, which will take over the functions of the existing Ministries of Power and Coal, as well as the State Oil and Gas Committee.

The single administrative structure would simplify the system that provides power resources and the system of settlements.

The project will be implemented in the following two stages:

- During the first stage the Power Ministry will join the State Oil and Gas Committee, since the Government considers that the pace of transformations in the power sector is the same as in the oil and gas sector.
- During the second stage the Coal Ministry will join the newly-established structure after the state-owned joint-stock company Coal Ukraine starts to function properly.

Social assets of coal enterprises would be transferred to communal ownership or to a company named VuhillaSotsSfera.

However, officials from the Power Ministry think that it should be liquidated after transferring some economic functions of power enterprises that are not subject to privatization and state-owned stakes in these enterprises to a company named UkrEnergo.

COAL SECTOR

In terms of deposits and extraction technology, Ukraine’s coal sector is classified as a West-
European (low-efficient) type, where coal extraction is subsidized by the state. In 1997 and 1998, the output of coal was 76.3 million tons, which is only 46.1% relative to 1990.

The degree of “barterization” in the sector is 60%. However, as recently as in early 1998 it was up to 77.5%. The law stipulates that 60% of settlements for coking coal and 50% of settlements for other types of coal should be done in cash.

Last June, strict control was imposed over all cash resources received by the sector. Payment of wages is of high priority. Of the total amount of cash money proceeds (more than UAH 3 billion), UAH 2.2 billion (72.8%) was spent on current wage payments and payment of wage arrears. In the coal industry in general (including auxiliary enterprises) this share is even higher at 87.7%.

In the second half of 1998, the growth of wage arrears decreased for the first time. While in the first half of the year it amounted to UAH 51.9 million monthly, in the second half it was only UAH 4 million.

Another direction of the existing policy is personnel policy. In the second half of 1998, 14 new general directors and 31 directors of mines were replaced. Taking into account that the main link in putting enterprises in order is the controller department (CD), the CD was directly subordinated to the minister. Highly qualified staff was recruited for the CD and given additional authority.

A decisive role in countering criminal activity will be played by a special document developed by the working group and entitled Regulation on the Procedure for Selling Coal Products in Ukraine. This Regulation should be completed and adopted as soon as possible. Implementation of principles underlying the Regulation will contribute to transparent cash flows, reduction of barter operations, and the establishment of direct contacts between producers and consumers.

In order to prevent abuses in setting prices for coal products, equipment, and material resources, the Government took a number of measures to unify the structure and function of coal-distributing organizations. This helped to reveal numerous flaws in concluding agreements, prevent non-standard barter, and counteract tax evasion.

In order to prevent the purchase of material and technical resources at exaggerated prices, the Coal Ministry instructed directors to be guided by producer prices when entering delivery agreements. The establishment of a company named VuhleTechPereozbroyeinnia will contribute to improving the mechanism of settlements since this company is able to replace a large number of doubtful intermediaries.

The Government intends also to normalize the coal market by establishing a state joint-stock company Vuhillia Ukrainy, which will create a clear system of mutual settlements in the entire complex. Currently, the company is being set up. According to preliminary proposals, its functions may be to:

- collect requests for delivery and procurement of coal,
- create a price corridor for coal,
- assess the demand and quality of the domestic coal supply,
- form and quote for lots of coal proposed for sale,
- organize an auction-based lot sale,
- register direct agreements for delivery and payment of coal,
- arrange mutual settlements (clearing) and accompanying payment documents,
- establish a bill of exchange depository.

New mechanism for state support

Accounting for extracted coal based on the extracted amount does not meet reform standards and provides grounds for various abuses. In the coal sector in general, the ash content of extracted coal is 0.4 percentage points lower than the standard (40%), and the standards themselves have unjustifiably increased during recent years. This implies that more dead rock is extracted.
tracted and transported along with coal and more ballast is delivered to thermal power plants.

The first step towards control over the use of budget resources should be the establishment of transparent budget procedures. In connection with this, the Government has radically changed the procedure and mechanism for providing state support. This change which will allow the improvement of state control over budget spending, ensure simplicity of settlements and receipt of money by coal-extracting enterprises without involving Coal Ministry, and extend managerial responsibility for targeted use of state support.

Moreover, the procedure for adopting development programs has changed radically. This year, the main indicator used to assess an enterprise's work is commercial output. Budget resources will be allocated through tender only. This will ensure an equal approach to all enterprises for purposes of budget financing. The main idea is that money should be invested in those enterprises which may ensure a quick pay-off and efficient use of resources.

All the above measures and some additional ones are provided for in the draft Program of Reforming and Financial Rehabilitation of the Coal Industry for 1998–2000 developed by the Coal Ministry and submitted to Verkhovna Rada for approval. When approved, this document will allow to strengthen legal basis, improve financial discipline in the sector, and successfully fight against crime and corruption.

Restructuring of the coal sector

The coal sector restructuring program supported by the World Bank identifies loss-making mines and provides for a full closure of 83 coal mines within three years. In 1998, 43 mines and 2 open pits were under liquidation. Mine closures create considerable complications related to social protection of laid-off miners.

More than fifty percent of budget outlays on mine closures is earmarked for social protection. In the first 7 months of 1998, this amount was UAH 64.1 million out of UAH 121.1 million spent on the mine-closing program. For the mine-closing program to be fully implemented (20 mines annually should be closed), subsidies from the State budget must amount to UAH 1,200 million in 1999, according to Coal Ministry estimates.

Box 3. Coal sector restructuring in Great Britain and Poland

All coal-extracting countries have had to restructure their coal sector.

Great Britain restructured it in the mid-80s. There were mass strikes, fights between miners and the police, victims and imprisonment. There were about 200,000 miners and 170 mines in Great Britain at the time (total population was 57 million). As a result of restructuring, more than 100 mines were closed. Currently, Great Britain has only 15 mines and 10,000 miners. The dismissed received compensation (30,000 pounds sterling) and unemployment benefit and the government paid for re-location and re-training.

In Poland, there are 230,000 miners. Recently, the government adopted a detailed four-year program for reforming the coal industry which begins in January 1999. 24 loss-making mines out of 65 mines are to be closed. Over 4 years, 120,000 miners will be dismissed. $4.5 billion is earmarked for reform, including $1 billion for social protection of miners.

It is anticipated that the sector will become profitable in 2001 due to modernization, restructuring, and reduction of the number of workers. The reductions will be implemented as follows. Almost one half of workers (55,000) will retire and 27,000 will go on leave. In other words, those who retire in less than 5 years would be paid 75% of the retirement benefit if they retire. Those 11,000 who are dismissed in the first reform year will receive 100% payment of annual wages, and those who are made redundant in the second reform year 65%.

In addition, this group will receive free re-training. Thirty thousand who find jobs independently would be paid wages for 1.5 years. A proportion of financing for the program is granted by the world community, another portion by the state, but the main portion will be represented by proceeds of privatization.
The 1999 State Budget Law earmarks UAH 500 million for capital construction in coal industry. This amount is allocated for establishing new capacity and would initiate the operation of 4 new mine complexes within 2 to 3 years, which would bring about an increase in the sector's capacity by 1.8 million tons of coal per year. In addition, some of those resources will be invested in further reconstruction of 9 mines with an overall increased in capacity to 2.7 million tons and preparation of 17 new coal extraction sites which are needed to maintain capacity to the volume of 15 million tons of coal per year. Unfortunately, the efficiency of such investment is rather low since a major portion of appropriations for the coal sector is spent on consumption, in particular, wages (about 85% of resources appropriated between 1997-1998 was spent on repaying wage arrears).

**OIL AND GAS COMPLEX**

**Rent exemptions**

In order to improve the financial position of oil and gas enterprises, Verkhovna Rada and the Government decided for the period from July 1997 to December 1998 to exempt oil and gas extracting companies from oil rental payments (about UAH 90 million annually) and decrease by 45.5% the rate of rental payment for natural gas (from 9.59 to 4.27 USD/1,000 cubic meters). This considerably increased the potential of the sector to finance production development programs (in prospecting and exploitation drilling, equipment for deposits, etc.).

As a result, in 1997-98, the State Oil and Gas Committee, for the first time in the last 7 years, managed to halt the fall of deep test drilling (the amount of test wells drilled in 1997 was 177 % relative to 1996; the amount of test wells drilled between January and August 1998 was 122 % relative to 1997) and increase the volume of exploitation drilling (over the first eight months of 1998 the increment was 102.4 % relative to the same period last year).

**Gas payments**

Consumer settlements for gas and collection of payments for oil products from agricultural consumers continues to be a weak point in the sector. Accounts receivable for gas increased from UAH 6.3 billion in early 1998 to UAH 13.6 billion in late 1998. Due to stricter requirements regarding payments for consumed gas and termination of free deliveries, the ratio of payments increased in 1998.

As of 1 November 1998, industrial consumers paid 62.7% of the value of gas consumed (in January - only 7.1%, in January-June - 50.0%); households, social establishments, and budgetary organizations - 51% (in January-June - 43.3%). However, cash payments for gas continue to be a problem for industrial and agricultural consumers and budgetary organizations. Most payments are made on a barter basis and through offsets. The problem with delivery of oil products to agricultural enterprises is that they are influenced by governmental decisions and suppliers are forced to supply oil products to insolvent consumers. This policy contradicts the Government’s intention to improve the financial position of the energy sector and increase payment collection.

One major task which the newly established National Company NaftoGaz Ukrainy has to cope with is increasing the rate of payments for consumed gas and other products of oil and gas enterprises. In 1998, auction sales of gas began.

Introduction of auction sales of gas is a step forward as it helps to create a transparent competitive environment in the gas market. However, the experience of the electric power sector suggests that an improved market structure alone cannot solve all problems. Level of payment collection is primarily determined by solvency of consumers (which fundamentally depends on enterprises’ ability to produce goods for which consumers are ready to pay cash), discontinuance of deliveries to insolvent consumers, and efficient bankruptcy procedures for consumers in arrears.

**Lack of reliable gas consumption measurement**

Last year, selective inspections revealed that 82.5% of enterprises violated the gas supply norms and state standards and neglected the requirements of regulatory and methodological documents. Naturally, all the revealed violations were aimed at overestimation of quantitative and qualitative indicators of gas supplied. Eventually the consumer has to pay for everything.
In order to implement reliable measurement of quantity and quality of gas, the State Oil and Gas Committee must introduce quantitative and qualitative control of gas supplied and provide access for representatives of consumers to relevant documents. The rules for quantitative and qualitative control over shipped gas must be displayed in places where gas is sold.

**Depreciation of pipelines**

The total length of Ukrainian pipelines is about 185,000 kilometers. The majority was developed and produced by Khartsyzsk Pipe Plant between 1960—1970 when rustproof coating had not been used yet. After 1983, when such covering became a standard, a question arose whether to replace pipes in main pipelines or not.

Oil and gas pipelines, whose life span has expired, have not been modernized since the state has no resources for this. For example, according to UkrGasProm experts 30-50% of pipelines are obsolete and dangerous. There is a pressing need to replace 400-500 kilometers of pipes annually. In addition, there are sections of pipelines in need of urgent repair in West Ukraine, where metal erodes much more quickly due to natural conditions.

Several hundred million hryvnias are needed for pipeline rehabilitation and replacement. For political reasons the situation resembles a ‘dog in the manger’, the state has no money to carry out rehabilitation of pipelines and cannot allow privatization of strategic objects for private investors to handle the problem. Therefore the use of existing oil and gas pipelines becomes more and more dangerous.

**Excessive capacities of oil-processing plants**

A significant problem of the Ukrainian oil and gas sector is the excess capacity of oil-processing plants. The capacity of the oil-processing sector of Ukraine allows processing of up to 51 million tons of raw oil, while oil-product consumption is only 50% of this volume (in recent years, less than 30% of the capacity has been used). Apart from this, there is a discrepancy between the structure of oil-product output and the structure of demand for these goods. While demand is mainly oriented at light oil products, the proportion of light products produced by oil-processing plants is small as a result of the low processing depth.

| Table 3. Production characteristics of OPPs, million tons |
|-----------------|-------|-------|-------|-------|
| Characteristic   | 1998  | 1997  |       |       |
|                 | December | January-December | December | January-December |
| Oil deliveries, total | 1.23   | 12.50   | 0.91   | 11.95   |
| Ukraine          | 0.22   | 2.62    | 0.23   | 2.99    |
| Russia           | 0.64   | 7.05    | 0.39   | 5.41    |
| Kazakhstan       | 0.37   | 2.83    | 0.28   | 3.55    |
| Oil-processing   | 1.17   | 12.70   | 0.97   | 12.27   |

**Output of oil products**

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<th>1998</th>
<th>1997</th>
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<tr>
<td>Motor gasoline</td>
<td>0.27</td>
<td>2.73</td>
<td>0.26</td>
<td>2.53</td>
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<tr>
<td>Diesel fuel</td>
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<td>3.76</td>
<td>0.27</td>
<td>3.59</td>
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<tr>
<td>Fuel oil</td>
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<td>4.16</td>
<td>0.37</td>
<td>4.16</td>
</tr>
<tr>
<td>Capacity utilization, %</td>
<td>26.9</td>
<td>24.3</td>
<td>22.4</td>
<td>23.4</td>
</tr>
<tr>
<td>Period out of operation, days</td>
<td>33</td>
<td>564</td>
<td>54</td>
<td>484</td>
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<tr>
<td>Losses, %</td>
<td></td>
<td></td>
<td>1.21</td>
<td></td>
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<tr>
<td>Depth of processing, %</td>
<td></td>
<td></td>
<td>63.2</td>
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</tr>
</tbody>
</table>
Secondary oil-processing is done in the most up-to-date enterprises, such as UkrNafta and Lysychansky OPP. Other OPPs lack efficient units for catalytic cracking, which provide deep processing of fuel oil and production of additional light oil products. The thermal method of processing used in Drohobych is of low efficiency. Complexes for hydrogenerative refining are only available in Odessa OPP in addition to the above-mentioned UkrNafta and Lysychansky OPP.

Millions of dollars are required to modernize the oil-processing sector - sums which cannot be provided from the State budget and by enterprises themselves. A natural way to solve this problem is by selling OPPs to strategic foreign investors (oil companies). However, repeated attempts to sell these assets have revealed that they fail to attract significant interest. The problem of OPP privatization is mainly attributable to excessive investment requirements set by the government and non-transparent privatization procedures.

**Electricity sector**

**Need for private investment**

In Ukraine, the existing structure of the electric power sector and government price policy result in a relatively low profitability of electricity projects. Large government subsidies are provided to support artificially low electricity prices. Private investors have no incentive to enter the power market and investments have be financed mainly by the government.

At the same time, limited state resources cannot satisfy the investment needs of the electricity sector. The need to finance the sector and desire to improve its efficiency has stimulated Ukraine to try to attract private sector to invest in electricity supply systems in line with the worldwide trend towards privatization and deregulation of the power sector.

Participation of the private sector not only provides required financial resources but also allows the application of market-based management experience and skills and opens access to innovative technology and, of course, allows more rapid completion of a project. In addition, private investment allows the government to redistribute public resources and use them to satisfy other needs.

In Ukraine, capital investment in the electric power sector is of primary importance since insufficient investment in the power sector may stifle economic growth. However, the main obstacle to investment is the distorted tariff structure since industrial enterprises pay higher rates in order to allow reciprocal subsidization of the household sector. At the same time, cancellation of this practice would be a very politically sensitive and complicated measure.

**Electric power market**

Currently, there is a wholesale power market which mediates electricity purchase and sale operations and sets prices for electricity. Study of its track record shows that the structure and rules of this market’s operation do not correspond to the current stage of economic transformation. In particular, the system of electricity pricing is not market-based. The system of redistributing proceeds received from consumers causes many complaints from power-generating companies. Widely used barter operations and various non-cash settlements (offsets, promissory notes, debt write-offs) complicate the observance of rules in the power market. Problems continue to proliferate since such fundamental factors as restriction of government interventions and restructuring of enterprises (with bankruptcy of insolvent companies) are still not fully implemented.

The government is preparing documents which reconsider some rules of the electric power market. In addition, implementation of direct deliveries and settlements between power-generating companies and consumers, by-passing the power market, is under consideration.

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4 Only 25% respondents agreed that privatization in the power sector should proceed more quickly.

5 Seventy four percent of polled experts agree that a new policy in the electric power sector aimed at equalizing tariffs payable by households and industrial consumers and leveling tariffs to match the real costs of electric power generating companies is needed.
Furthermore, the National Company for Electric Power Sector Regulation (NCEPSR) strengthened its control over setting tariffs for electric power and relevant methodology. Last May, NCEPSR increased the retail price for electric power by 22%. Though new prices do not cover fully production cost, price adjustments show the Government’s desire to bring the prices for electric power closer to market requirements.

**Non-payments**

According to Power Market, the National Power Company UkrEnergo shipped electricity distribution companies UAH 9.2 billion worth of electric power between November 1997 and October 1998. Out of this amount, UAH 7.7 billion (83.9%) was paid; however, cash payments amounted only to UAH 739 million (7%). UAH 6.9 billion was paid in other forms, including 70% in the form of illiquid promissory notes issued by the former National Dispatcher Center of the Power Ministry (now UkrEnergo) and thermal and nuclear power plants.

Consumer debts for shipped electric power totaled UAH 5.1 billion in early 1999, which equals 4 months’ electric power consumption throughout Ukraine. It is worth noting that in 1998 these debts increased by 63%. Major debtors include utility companies (UAH 1.6 billion), the coal industry (UAH 722 million), and agriculture (UAH 518 million). Household arrears amounted to UAH 93 million in 1998. The debt

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**Box 4. Ukraine’s Power Market governed by “old rules of the game” up to May 1999**

At a meeting of the Wholesale Power Market of Ukraine, participants rejected a new wording of the Agreement of Market Participants, which defines interrelations of subjects in the energy sector. A working group was established to modify this Agreement and submit its proposals no later than 1 May 1999.

The new wording of the Agreement envisaged responsibility of participants in the power market for non-payment of shipped electric power as well as switching to a commission-based form of electricity trade to be implemented by the "Power Market" enterprises under authority of the "UkrEnergo."

According to existing legislation, the "UkrEnergo" is a wholesale buyer and seller of electric power. It was intended that in case of non-payment for electric power a mechanism of claims to power-supplying companies would be initiated through arbitration courts. However, 68% of participants voted against these provisions. They wanted to wait until mid-1999, when Verkhovna Rada was to pass the Law "On Operation of the Power Market".

Apart from power-generating and power-supplying companies, private companies and independent suppliers also revealed their interests. The main point of the new wording of the Agreement is the notion of commissioner. That is, UkrEnergo would no longer be the owner of all electric power produced by Ukraine and transmitted through its network, it would rather be a re-seller, i.e. commissioner.

Power-generating companies would instruct UkrEnergo to sell electric power provided to it by oblast power companies (oblenergo) or independent suppliers. The problem would be solved at last; the owner of electric power (the power plant) would be able press claims against the buyer. However, buyers of electric power oppose these claims. And they have objective reasons for this - oblenergos cannot collect money as the last year’s budget allocated no funds to pay for electric power consumed by budget-sustained organizations.

Another problem is utility companies, which fail to receive subsidies and therefore cannot pay for electric power. These non-payments amount to UAH 1.7 billion. Therefore, a time-honored decision was made - to establish a working group headed by a member of the NCEPSR and the Deputy Minister of Power to modify the text of the Agreement. The main point is whether the commissioner (intermediary) scheme will be implemented or direct agreements will be concluded instead.
due to OPPs totals UAH 1.9 million. The power sector owes its employees more than UAH 195.6 million in wage arrears. Payables to the State budget, resulting from non-payment for shipped electric power, stood at UAH 1.2 billion. Just in 1998 these arrears increased threefold.

The ability to collect payments for shipped electric power is undermined by a large number of consumers who enjoy privileges not provided for in the budgets. In addition, legislation provides some privileged categories with benefits without specifying the sources to fund them.

Budgetary organizations do not have provision for full payment for electric power in their budgets since they rely on mutual settlements as a way of paying power suppliers for electric power. These expectations encourage non-payment and excessive power consumption.

Non-payments are the key factor causing problems faced by enterprises of the power sector, such as:

- large accounts payable for consumed fuel and inability to create its reserves required for reliable operation in winter,
- inability to replace out-dated equipment in a timely fashion.

Electricity generating companies are put at a disadvantage

Electricity generating companies within the existing framework of the Power Market cannot force consumers to pay for produced power. They receive only what the Power Market transfers to them, and the Power Market, in turn, is transferred money by intermediary electricity distributing companies and independent power suppliers. Therefore, payments are collected only at the level of electricity distributing companies and independent power suppliers.

With the privatization of electricity distributing companies, the fact that the currently existing power market lacks sufficient capacity has become more obvious since privatized electricity distributing companies are not interested in re-distribution of collected funds. As a result, cash receipts decreased (currently power-generating companies receive even less than 5% in cash).

Many power companies (both power-generating and power-distributing companies) support the notion of switching to contractual relations between power-generating and power-distributing companies. As a result of this measure, the latter would be directly accountable to the former for payments. Though this may improve payment collection, the main problems related to non-payment include the government’s right to prohibit disconnection of non-payers as well as poor budget discipline and a slow rate of restructuring of insolvent consumers.

Privatization

The government’s position on privatization of power companies has proved to be wrong so far. It has overestimated investment interest and has been reluctant to lose control over the sector. In late 1998, the easy-term sales were made. Blocks of shares amounting to UAH 98.6 million were sold through stock exchanges and PFTS over-the-counter trading systems. Also, there were 18 commercial tenders resulting in conclusion of 9 agreements totaling UAH 192 million.

Apart from this, fixed terms of tenders and respective sale and purchase agreements mean the requirement for investment amounting to UAH 324 million and USD 13.25 million between 1998 - 2003.

It should be noted that private owners of electricity distributing companies make more aggressive efforts to collect payments in cash and in some cases managed to significantly improve payment collection. In addition, they prefer to invest money reducing losses.

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6 Only 35% of respondents support reduced state involvement in the fuel and power complex.
Box 5. Privatization of British Energy

British Energy is Great Britain's top power generating company with a market value of about $4 billion. It has 8 nuclear power plants with an overall capacity of 9,600 MW. They produce one fifth of all the electric power produced in Great Britain. In 1997-98, nuclear power plants produced 66.7 million kW-hour of electric power, and the average rate of capacity utilization was 78%, which is one of the best indices in the world.

In 1995, after careful analysis of the nuclear power sector, the government of Great Britain decided to consider privatizing this company since it had:

- fuel contracts at fixed prices, which solved the majority of problems related to fuel and processing of enriched nuclear fuel;
- clearly defined costs of phasing out: experience in increasing performance.

Privatization took 14 months. Between May 1995 and June 1996, negotiations, consultations, and restructuring took place; and in July 1996 privatization of the British Energy was accomplished.

Privatization opened opportunities for:

- significant inflow of capital,
- independence in making investment decisions,
- discharging of historical liabilities.

Operating as a private company British Energy received:

- an opportunity to optimize management structure (private sector criteria are applicable to management of assets and expenses),
- an opportunity reinvest profits.

In addition, the net proceeds of the British Government from sales of 8 NPPs amounted to $9 billion. Privatization of the British Energy is a good example why privatization of Ukraine's EnergoAtom would be justified.

III. FRAMEWORK FOR A NEW POLICY

CREATION OF A FAVORABLE INVESTMENT CLIMATE

To create a favorable investment climate in the power sector, the state should observe the following principles:

- The problem of raising a large volume of private investment must be solved by liberalizing power markets and fostering fair competition, including 'watchdog' supervision of monopolist behavior.
- Procedures for granting investment rights should be practical, transparent, and based on published criteria.
- When investment possibilities are be widely accessible, the scale of private investment should be extended as much as possible by providing companies with equal access to these possibilities without discrimination. Economic benefit for the country is not defined by the origin of investment.
- Privatization opportunities (except for cases related to clearly defined national interests) should be provided to companies without discrimination. After privatization, there should be no restrictions on further re-sale or purchase of shares and other assets.
- Investment prospectives should be extended by introducing stable and universal legislative treatment, appropriately applied at all administrative levels, including the possible enforcement of contract implementation through court judgement, mechanisms of debt collection and the ability to apply effi-
cient national and international procedures for settlement of disputes. Fields of responsibility of national, regional, and local authorities should be clearly defined. In addition, investors should be efficiently protected against crime and corruption.

- Since existing tax rules regulating investment in prospecting and extracting oil fail to encourage investment, the government ought to use alternatives in its policy mechanisms, e.g., agreements on output-sharing.
- The system of taxation should be clear-cut, stable, non-discriminatory, and oriented mainly at profit rather than gross income or output.
- No restrictions should be imposed on international transfers of financial resources related to activity in the power sector or access to fixed assets.
- With a view to efficient allocation of resources, it is reasonable to allow prices for power to reflect existing market conditions.
- In accordance with international standards, discrimination in national power market operation must be prohibited.
- Legislation should be imposed which would provide equal access to energy transportation systems in keeping with the rules applied by independent regulatory authorities.
- Companies should be authorized to implement free trade of their products in foreign markets subject to Ukraine's full compliance with the rules of the World Trade Organization (WTO). In keeping with WTO's rules, nothing should interfere with purchase of power equipment, services, or technology from the most beneficial sources, irrespective of whether this source is in the country or abroad. The Government's policy should recognize benefits stemming from technology transfer.
- In the policy aimed at attracting investment to the power sector, projects aimed at improving power use should be treated equally with those related to power supply.
- Efforts aimed at the ratification of the 1994 Agreement on the Power Grid should continue. This should be treated as a high-priority goal. This agreement is open for signature by other countries.

It should be added that, in our opinion, one prerequisite for attracting foreign investment is the restructure and privatization of enterprises incapable of paying for consumed power. An important practical step to creation of a favorable investment climate in Ukraine would be Verkhovna Rada passing the Law of Ukraine On Production Distribution, which is currently being considered by VR committees.

It is encouraging that the majority of programs in all sectors of the fuel-power complex are developed with participation of international organizations and supported by them. First and foremost, wide technical assistance is provided to Ukraine by TACIS programs, financial aid is provided by The World Bank and European Bank for Reconstruction and Development (EBRD). In particular, the following joint projects with World Bank participation are at a phase of implementation: restructuring of the coal sector (closure of unfeasible mines), reconstruction of hydroelectric power plants, and development of the electric power market. In addition, a project for reform of the gas sector is being developed.

The projects prepared for submission to The World Bank and EBRD for consideration include the program of restructuring the coal sector, the project of construction of an oil terminal near Odessa, and the oil pipeline between Odessa and Brody (an extremely important project for Ukraine.)

**COAL SECTOR**

The unavoidable task of coal industry reform should be tackled by:

- establishing independent enterprises. The most suitable level for this, from production and economic standpoints, is the level of production associations. Each mine should be a center of independent cost accounting. Only investment funds should be distributed at the level of a holding company. Its tasks should include development of alternative kinds of business activity, in particular undertaking environmental measures, re-training personnel, and establishing independent enterprises to provide social services, etc.
gradual liberalization of internal trade of normal quality and enriched coal, coking coal, etc. Trade organizations may reveal their own strengths (for example, optimal organization of commodity flows, collection and dissemination of information), and efficiency would grow due to diversification of services.

immediate liberalization of foreign trade of coal. Consumers should have a choice of the source for purchasing coal, including abroad. Producers should be given an opportunity to

It should be noted that social consequences of restructuring the coal sector restructuring would be less pronounced if the economy were in a phase of economic growth.

Box 6. Possible outcomes of a restructure of the coal sector

A survey implemented by the Kyiv International Sociological Institute and The World Bank gives an estimate of outcomes of restructuring and causes of social tension in the mining regions. Apart from a mass poll (1273 dwellers of miners’ settlements, including miners and members of their families), informal interviews were conducted with various groups (including the most socially vulnerable groups), such as dismissed miners, recipients of free coal for household needs, managers of mines, officials of local power, and recipients of micro credits (from $2000 to $50000 for setting up an enterprise business, The World Bank’s credit line). In addition, the survey included an analysis of publications in the press and monitoring of the social situation in miners’ settlements by a method of “inside observation” — people wrote reports under a scheme given by investigators (45 reports in total).

Here are some outcomes of this survey. Three quarters of the polled consider that «Western countries would benefit from closure of (Ukrainian) mines as they want to avoid competition with cheap products». And this is despite The World Bank’s assistance. The majority of miners believe that “their” mine was chosen by mistake and 90% consider that a mine should be closed only jobs for dismissed workers are guaranteed.

The rights of dismissed miners are far from satisfied. Work of employment offices is especially inefficient — only 1.3% of the polled found jobs with the help of these offices. Many apply to them for scholarship for the period of re-training or to receive a job placement for a job they have found independently. This improves employment indicators but does not decrease the number of unemployed.

As regards starting their own business, this type of job-finding is not popular among miners – people who are accustomed to making money by hard physical labor. They are afraid of the complicated procedure for securing loans, need of a mortgage, and most importantly, lack the skills and knowledge needed to run a business.

The situation with payment of wages is not better. 84% of the polled stated that they do not receive wages on time. More than 50% of miners have not received wages for five or more months. In non-mining enterprises, the situation is the same.

Generally, results of the survey produce a desperate impression. The situation in those settlements, where pilot restructuring projects supported by The World Bank are implemented is better but also far from perfect. Repeated miners’ strikes suggest that policy-makers lack will to reform the coal sector.
OIL-GAS COMPLEX

In the oil sector, a partial disaggregation of enterprises is required as well as enhancement of competition in those segments where it is expedient. For this to be achieved, the following measures are necessary:

- Domestic production should be carried out by an independent enterprise established under the holding company UkrNafta. This enterprise would buy services in this holding, for example, prospecting and drilling services. Ukrainian trade enterprises should be given the right to import oil at their expense and risk.

- It seems reasonable to establish an independent transport enterprise which would offer services related to transit traffic of oil.

- A large number of entrepreneurs should be given an opportunity to trade in oil products. Currently, oil-processing enterprises are formally free in choosing buyers for their goods. However, in practice they are forced to supply it primarily to budget-sustained establishments (such as ministries, customs offices, the army), though they are not ready to pay the same price as private buyers.

- Expansion of the oil terminal in the port of Pivdenny seems justified from the standpoint of power provision.

For reform of the gas sector, the following steps are needed:

- Regulation of imports should be cancelled and owners of high-pressure gas pipelines that occupy a monopoly position should be obliged to open access to the pipelines for third parties.

- All wholesale traders should have an opportunity to sell in all regions and large-scale buyers should be allowed to conclude agreements on gas supply with wholesale traders and oblasts as well as foreign suppliers.

- Transit operations require special treatment. The aim of establishing joint-stock companies is the creation of independent enterprises engaged in transit traffic of gas under authority of the National JSC Naftogaz Ukrainy. This is the only way to guarantee that tariffs for the transit of gas supplied by the Russian JSC GazProm will be established on the basis of cost.

In addition, between 1999-2001 measures should be taken to reform the gas sector, on which an agreement is achieved between The World Bank's working group and the Government of Ukraine. These measures include:

- arrangement of quarterly gas auctions, where gas traders and large-scale buyers would buy gas from UkrGasProm for cash. 7

- establishment of a state-owned joint-stock company for exploiting the network of transport gas pipelines, and assignment in 1999 of a consortium of Ukrainian and foreign companies to manage shares in this company for a period of at least 15 years. The state-owned interest of Ukraine in this would be limited to 25% plus one share.

- separation and privatization of productive activity of UkrGazProm and gas-prospecting activity of the State Committee for Geology.

- provision of incentives and criteria for gas-distributing companies to collect payments in 1999. In case of negative results, the rights to exploit the system of distribution and supplying non-industrial consumers would be transferred to experienced parties (Ukrainian or foreign).

- improvement of accounting, monitoring, and balancing gas flows, including implementation of contract procedures for settlements based on daily and monthly differences.

- imposition of a distance-based tariff for transportation and combined tariff for distribution as well as payment for storage in 1999.

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7 Ed. Experience to date with gas auctions in Ukraine indicates that, because they require payment in cash, they are less attractive to buyers than non-auction sales where cash payment is not required – where few penalties are imposed for barter payments or ever delays and non-payment. Improving gas auctions, which in an excellent idea, will therefore require simultaneous enforcement of payment discipline in energy markets outside of the auctions.
ELECTRIC POWER SECTOR

Significant possibilities to increase the efficiency of the electric power sector are mainly related to efficient consumption of electric power (95 percent of respondents consider that the legislative framework needs to be profit led in order to stimulate power saving by business entities.). The estimates of reserves for power-saving range between 20-25% (according to the Power Center of the European Union) to 40% (according to the Institute for Power-saving of the National Academy of Sciences). However, after 1993 the share of electric power consumption increased.

To implement structural reform in the power sector, both technical and regulatory measures are required. The former include provision of technical possibilities for disconnection from the Russian power supply network and reduced reliance on Russian deliveries of electric power. The entire Ukrainian network should be provided with means of control and regulation, which would connect electric power plants, power-generating association, the dispatcher center, as well as regional power-supplying companies. Large-scale consumers should be equipped with meters, which would register power consumption by time of day to facilitate peak-load pricing.

In addition, the following measures should be taken:

- the Antimonopoly Committee should control the behavior of those subjects of the market which restrict competition,
- privatization in the power sector,
- pricing policy should be a key aspect of structural reforms. Tariffs for electric power cover only current costs of production, transmission, and distribution of an additional unit of electric power and do not include amortization deductions.

COMPARATIVE TABLE OF THE ALTERNATIVE STRATEGIES

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Proposed by the authors: “Reform of the power sector”</th>
<th>Alternative: “Restoration of the administrative system in the fuel-power complex”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goals of the policy</td>
<td>Creation of an efficiently functioning market for fuel and power resources. Achievement of competitiveness through reduction of the power-intensity of GDP.</td>
<td>Provision of power security.</td>
</tr>
<tr>
<td>Problems to be solved</td>
<td>Inefficient redistribution of fuel and power resources.</td>
<td>Short-term satisfaction of the domestic needs and population in terms of fuel and power resources.</td>
</tr>
</tbody>
</table>
| Way to solve the problems | With a view to the efficient distribution of resources, prices for power should be deregulated to reflect existing market conditions, primarily through liquidation of all privileges and subsidies. Switch to contractual relations between power-generating and power-distributing companies. Power resources should be supplied by entities of all forms of ownership, and not be limited in number. Through establishing economic indicators | Intermediaries engaged in trade of power resources would be removed. Only companies authorized by the government would be allowed to supply power resources. The price for power resources and the volume of supply to consumers would be controlled and established by the government. Reciprocal subsidization of power consumption (when
<table>
<thead>
<tr>
<th>Strategy</th>
<th>Proposed by the authors: “Reform of the power sector”</th>
<th>Alternative: “Restoration of the administrative system in the fuel-power complex”</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>annual profits) the state should regulate monopolists,</td>
<td>industrial suppliers pay for power consumed by households) would continue.</td>
</tr>
<tr>
<td></td>
<td>All regulatory rights should be transferred to an independent body, the National Company for Regulation of the Electricity Market,</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Efficient mechanisms should be introduced for bankruptcy, liquidation, and change of ownership of enterprises that fail to pay for consumed power resources.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Accelerated privatization of enterprises engaged in the fuel-power sector.</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Anticipated outcomes:</strong></td>
<td></td>
</tr>
<tr>
<td>Short-term</td>
<td>A number of bankruptcies and restructuring of enterprises that are not able to pay their power bills.</td>
<td>Depressed investment climate through state intervention in pricing and setting the volume of supply of power resources to consumers.</td>
</tr>
<tr>
<td></td>
<td>Aggravation of social problems.</td>
<td>Increased external and internal debts for deliveries of fuel-power resources as a result of application of non-market prices.</td>
</tr>
<tr>
<td></td>
<td>Higher investment attractiveness of the fuel-power complex due to establishment of market relations in the power resource market.</td>
<td>Reduced number of business structures in the power resource market.</td>
</tr>
<tr>
<td></td>
<td>Legalization and boosting of business activity in the power sector.</td>
<td>Increased “shadowization” of relations in the power market as a result of non-transparent settlements (barter, mutual settlements).</td>
</tr>
<tr>
<td></td>
<td>Reduced volume of non-payments for consumed power resources.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Improvement of power-saving due to introduction of new technology.</td>
<td></td>
</tr>
<tr>
<td>Long-term</td>
<td>Steady provision of the national economy and population with power resources.</td>
<td>Irregularity of electric power supply to both industrial and communal enterprises.</td>
</tr>
<tr>
<td></td>
<td>Reduction of dependence on import of power resources.</td>
<td>Continued dependence on imported power resources.</td>
</tr>
<tr>
<td></td>
<td>Restructuring of the economy: liquidation of highly power-intensive productions using outdated technologies.</td>
<td>A need for the Governmental to solve the problems of supplying power resources to satisfy major requirements of the national economy: power plants, agriculture, etc.</td>
</tr>
</tbody>
</table>
IMPLEMENTATION OF THE PROSPECTIVE POLICY

The authors conducted a poll among governmental and non-governmental bodies in order to identify the differences in expert opinions regarding key issues of the power policy. When analyzing the poll's results, the authors focused on those issues which revealed the largest differences in expert opinion (the highest level of dispersion) and the largest agreement (very high rate of similar responses). The first group of issues, in our opinion, reveals those spheres where great efforts would be required to overcome obstacles, and first of all obstacles resulting from the lack of understanding. The second group includes those issues whose solution should be planned for short-term since expert shared view is obvious.

Table 4. The issues with the lowest degree of agreement (the highest level of dispersion in responses)

<table>
<thead>
<tr>
<th>dispersion Supported</th>
<th>Not supported</th>
<th>No opinion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governmental Total</td>
<td>Governmental Total</td>
<td>Governmental Total</td>
</tr>
<tr>
<td>The problem of non-payments for power resources may be solved by way of:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>strict sanctions for non-payments (closure, bankruptcy)</td>
<td>1.35</td>
<td>45</td>
</tr>
<tr>
<td>prohibition of non-cash payments for consumed power resources</td>
<td>1.00</td>
<td>35</td>
</tr>
<tr>
<td>Privatization in the fuel-power sector:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>should proceed at an accelerated rate; this would result in a considerable improvement of the financial stance of all enterprises</td>
<td>1.14</td>
<td>25</td>
</tr>
<tr>
<td>should be suspended in connection with the lack of real owners able to efficiently manage the assets</td>
<td>1.43</td>
<td>38</td>
</tr>
<tr>
<td>Cancellation of privileged treatment (zero VAT rate) of electric power, coal, and natural gas would worsen the financial position of enterprises</td>
<td>1.29</td>
<td>43</td>
</tr>
<tr>
<td>Structure of the wholesale market for electric power should be radically altered</td>
<td>1.18</td>
<td>40</td>
</tr>
</tbody>
</table>

Major differences in opinions

When analyzing expert responses, the authors concluded that the largest were the differences in opinions concerning the issues shown in Table 1. Differences in particular issues imply that these problems should be solved in the long-term. It should be added that the differences in opinions on strategic issues are attributable to the lack of a clear long-term program of economic development.

Governmental respondents have different opinions on the ways to solve the problems of non-payments for power resources. In particular, respondents have different opinions regarding expediency of tight sanctions to defaulters (closure, bankruptcy) and prohibition of non-cash forms
of payments for consumed power resources. This is a significant obstacle that may hinder restructuring of inefficient enterprises. In the opinion of experts, non-competitiveness is one fundamental reason for non-payment of consumed power resources.

Apart from this, there are differences in opinions regarding privatization in the fuel-power complex. Many governmental respondents have no opinion whether privatization should be accelerated (this will result in a significant improvement of the financial position of all enterprises), or should be suspended (in connection with the lack of real owners able to efficiently manage the assets). The differences in opinions of governmental experts may protract privatization in the fuel-power complex and affect the efficiency of their operation.

Expert disagreement regarding cancellation of privileged treatment of electric power, coal, and natural gas (in particular the VAT zero rate) suggests that setting market prices for power resources should be postponed.

Though the sector-by-sector structure of the electric power complex of Ukraine has lately improved, many experts consider that the existing structure is inefficient. Experts consider that this discord results from the lack of a progress in such key factors as reduction of government intervention and restructuring of enterprises (with bankruptcy of defaulters). As a result of this, the Power Market is essentially just an administrative way to distribute electric power.

**Issues that gathered large support**

The issues on which experts show unanimity mostly coincide with the strategy proposed by the authors and suggest that there is a need in a long-term strategic program of economic development.

The opinion that the level of Ukraine’s power security in the medium term (3-5 years) may be improved through extensive use of power-saving measures received most support.

In the opinion of the overwhelming majority of polled experts, the financial position of energy sector and investment potential of the sector may be improved through better collection of payments for energy (supported by 93% of experts), and structural reforms in the administration of the energy complex (85%). It is also important that 80% of respondents advocate separation of secondary kinds of activity, and 73% of polled experts support implementation of a new pricing policy in the electricity sector (in particular, balancing of the tariffs paid by industrial consumers and households) and bringing the tariffs closer to real costs of power-generating companies.

Regarding the problem of a legislative framework for the fuel-power complex, respondents unanimously agree that the legislative framework needs to be amended to create attractive conditions for foreign investment (supported by 83% of experts) and encourage power-saving efforts of businesses (95%).

**Table 5. Positive responses**

<table>
<thead>
<tr>
<th>Issue</th>
<th>Supported Total</th>
<th>Governmental</th>
<th>Not supported Total</th>
<th>Governmental</th>
<th>No opinion Total</th>
<th>Governmental</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-payment for consumed energy is one of the key problems of energy sector. Its resolution would stabilize situation in all sectors</td>
<td>90</td>
<td>97</td>
<td>3</td>
<td>7</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Under current circumstances, the level of Ukraine’s energy security in the medium term (3-5 years) may be increased through widespread power-saving measures</td>
<td>95</td>
<td>94</td>
<td>3</td>
<td>3</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Supported</td>
<td>Not supported</td>
<td>No opinion</td>
<td></td>
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<td><strong>Governmental</strong></td>
<td><strong>Total</strong></td>
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<td>Total</td>
<td>Governmental</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government energy arrears affect the financial position of energy enterprises</td>
<td>90</td>
<td>88</td>
<td>3</td>
<td>3</td>
<td>7</td>
<td>9</td>
</tr>
<tr>
<td>The low purchasing power is a reason for energy non-payments</td>
<td>85</td>
<td>85</td>
<td>3</td>
<td>3</td>
<td>12</td>
<td>12</td>
</tr>
<tr>
<td>Use of barter by energy sector is caused by current economic conditions (shortage of working capital, underdevelopment of the markets, etc.) and should be reduced</td>
<td>83</td>
<td>79</td>
<td>3</td>
<td>3</td>
<td>14</td>
<td>18</td>
</tr>
</tbody>
</table>

*Low level of investment by energy sector enterprises is caused by:*

<table>
<thead>
<tr>
<th>Supported</th>
<th>Not supported</th>
<th>No opinion</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Governmental</strong></td>
<td><strong>Total</strong></td>
<td><strong>Governmental</strong></td>
</tr>
<tr>
<td>Total</td>
<td>Governmental</td>
<td></td>
</tr>
<tr>
<td>high borrowing costs</td>
<td>85</td>
<td>85</td>
</tr>
<tr>
<td>widespread use of non-cash payments (barter, offsets) for consumed energy</td>
<td>93</td>
<td>94</td>
</tr>
</tbody>
</table>

*The problem of non-payments for energy may be solved by:*

<table>
<thead>
<tr>
<th>Supported</th>
<th>Not supported</th>
<th>No opinion</th>
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<tbody>
<tr>
<td><strong>Governmental</strong></td>
<td><strong>Total</strong></td>
<td><strong>Governmental</strong></td>
</tr>
<tr>
<td>Total</td>
<td>Governmental</td>
<td></td>
</tr>
<tr>
<td>restructuring the economy to cut the share of energy-intensive industries and the energy/output ratio in the economy in general</td>
<td>88</td>
<td>88</td>
</tr>
<tr>
<td>developing a national policy aimed at improving payment discipline. This policy should provide for both economic and administrative measures</td>
<td>83</td>
<td>85</td>
</tr>
</tbody>
</table>

*Energy sector can improve its financial position and increase investment if there is:*

<table>
<thead>
<tr>
<th>Supported</th>
<th>Not supported</th>
<th>No opinion</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Governmental</strong></td>
<td><strong>Total</strong></td>
<td><strong>Governmental</strong></td>
</tr>
<tr>
<td>Total</td>
<td>Governmental</td>
<td></td>
</tr>
<tr>
<td>better collection of payments</td>
<td>93</td>
<td>94</td>
</tr>
<tr>
<td>structural reform in the administration of the energy complex</td>
<td>85</td>
<td>85</td>
</tr>
<tr>
<td>more efficient management of enterprises with the state stake</td>
<td>83</td>
<td>82</td>
</tr>
</tbody>
</table>

*Existing legislation needs to be amended to:*

<table>
<thead>
<tr>
<th>Supported</th>
<th>Not supported</th>
<th>No opinion</th>
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<tbody>
<tr>
<td><strong>Governmental</strong></td>
<td><strong>Total</strong></td>
<td><strong>Governmental</strong></td>
</tr>
<tr>
<td>Total</td>
<td>Governmental</td>
<td></td>
</tr>
<tr>
<td>create attractive climate for foreign investment</td>
<td>83</td>
<td>82</td>
</tr>
<tr>
<td>encourage power-saving efforts of businesses</td>
<td>95</td>
<td>94</td>
</tr>
</tbody>
</table>
Recommended sequence of actions

The results of the poll suggest that the problems in the energy complex are caused by the economic crisis as well as incomplete reforms.

The poll results show that respondents essentially support strategy which would create an efficient market for fuel and energy. However, there are some differences in opinion regarding the strategy implementation, especially on such issues as privatization, bankruptcy, and cancellation of privileges.

Given the poll results, the authors believe that reforms in the energy sector should be implemented in the following order:

- liberalization of prices for energy.
- widespread implementation of power-saving measures.
- heavier penalties for delayed payments for consumed energy.
- implementation of the adopted plan of the gas sector reform.
- improvement of the legislative and regulatory framework to stimulate foreign investment.
- improvement of the wholesale electricity market operation and introduction of appropriate amendments to the Power Market Agreement.
- completion of administrative reform in the energy complex.

IV. CONCLUSIONS

Even though the government has recently made significant efforts to reform the energy sector and reduce energy consumption, these efforts did not make a significant economic impact because of weak control over decision implementation at the enterprise level.

Therefore, for reform of the energy sector to be successful, this sector should be reformed concurrently with other sectors of the Ukrainian economy, first and foremost, at the micro level.
4. FISCAL POLICY

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Currently the Ukrainian economy is at a difficult scale of development. The transition to market relations demands application of radically new methods of administration. For example, an important role is played by taxes and the budget, both of which depend on fiscal policy.

Tax and budget reform requires a transformation of society, property relations and the socio-economic structure towards a market economy. The main peculiarity of the current period is its transitional nature.

Considering existing economic problems and current transformations, the goals of fiscal policy should include: reversal of the fall in production, stabilization of the economy, stimulation of high-priority activities, and restructuring.

The goals of fiscal policy (such as curbing inflation, preventing rapid inflation, supporting business, production, and investment activities) can be contradictory. While anti-inflationary measures restrain business activity and provoke a fall in production, any measures to prevent a fall in production and stimulate its growth imply growth in demand, and this causes an increase in prices.

Fiscal policy should be based on the following principles:

- provision of a stable tax system,
- equal terms for taxation of producers, irrespective of sector and form of ownership,
- equality of tax burden for various categories of taxpayers with similar levels of income,

A significant reduction in the overall level of taxation by reducing tax rates and applying a progressive scale may be the first step in achieving such goals. Such measures would foster the establishment of a favorable investment climate and conditions for economic growth.

The most important goal of fiscal policy should be to:

- provide sufficient budget receipts to the budget for financing pressing social programs
- create a sharp structural shift in favor of those producers directly involved in satisfying the needs of the population
- create favorable conditions for stimulation of business activity.

The Structure of the Report. Existing Fiscal Policy" analyzes the tax and budget policies currently pursued that have resulted in increased tax arrears and arrears payable from the budget; the section entitled "Outlooks of Fiscal Policy" proposes a strategy which would foster economic growth, and provides a comparative analysis of this policy with an alternative one.

The report also presents results of a poll among representatives of governmental and non-governmental organizations. The section entitled "Implementation of a New Fiscal Policy" presents a brief analysis of the poll results and indicates the key obstacles to a prospective policy.

Data from the Ministry of Finance of Ukraine, the State Treasury of Ukraine, the State Committee of Ukraine for Statistics, the State Tax Administration of Ukraine, and the National Bank of Ukraine are used in the investigation.
II. ANALYSIS OF THE EXISTING FISCAL POLICY

CHARACTERISTICS OF THE CURRENT SITUATION

For a number of years, the budget has suffered from low cash receipts. Over the last two years, this situation has become worse. There was an initial impression that the problem was not so acute, attributable to the fact that official reporting does not include the indices that characterize the volume and extent of mutual settlements budget sector.

According to official reports, the level of overall consolidated budget receipts was 30.4% of GDP in 1997, in the first quarter 1998 it was 27.7% of GDP, the level of cash receipts in 1997 was UAH 12.2 billion (13.2% of GDP) lower than official levels, and in the first half of 1998 it was UAH 0.9 billion (9.4 % GDP) lower.

Some taxes were collected exclusively in the form of mutual settlements (for example, payment for transit of gas through the territory of Ukraine, and receipt of funds to the State Material Reserve). At the same time, there is some stability in cash receipts, which fluctuated within a very narrow range of 17.5-19.2% of GDP in 1997-1998. There is an impression that either taxes are set too high or that revenue authorities are not able to collect taxes.

It should be also noted that the level of tax receipts has dropped significantly over the last two years, as shown by significantly increased budget arrears. The volume of arrears increased by UAH 977 mln in 1997 and amounted to UAH 2.3 billion in late 1997, it increased by UAH 8.0 billion between January and December 1998 and amounted to UAH 10.3 billion at the end of 1998.

The policy of debt restructuring adopted by the Government as a measure to reduce arrears not only failed to produce anticipated results but even resulted in a widespread belief that unpaid taxes may be deferred. This essentially implies an interest-free loan from the budget, which has led to increased debts of budgetary establishments.

One more flaw in the fiscal policy pursued by Ukraine is a wide range and volume of tax exemptions. According to State Tax Administration of Ukraine estimates, budget losses related to zero rates and reduced rates as well as various tax exemptions amount to UAH 13-15 billion annually. As a rule, these exemptions are given to sectors or enterprises and are essentially unconditional subsidies. The growth of this practice leads to fragility of the competitive environment, where managers of enterprises are interested in securing these exemptions rather than in producing up-to-date goods in high demand.

EFFICIENCY OF TAX POLICY

The current tax policy pursued by the Government of Ukraine attempts to resolve the problem of budget replenishment primarily by way of increasing the tax burden on entities and individuals. Such measures can be successful only in the very short run.

The tax system has failed to satisfy the government’s requirement for a satisfactory level of revenue. It has also failed to perform the other function of tax, that is the regulatory function (including stimulation of production).

The opinion that the existing fiscal policy is inefficient is supported by 90% of polled government officials.

Uneven pressure of taxation

Though the pressure of taxation was about 37% as a share of official GDP (consolidated budget plus Pension Fund), this pressure is distributed unevenly. For example, the barter economy (which represents about 40% of GDP) has de facto been exempt from taxes. The shadow economy pays only a certain amount of some indirect taxes (for example, VAT and excise duties).

Within the official economy, the majority of agricultural, coal power and many state-owned enterprises comprise a “soft” segment which is supported through direct subsidies, tax exemptions, easy-term credits, and written-off tax arrears. The pressure on these enterprises is insignificant: according to experts from HIID/CASE, it is about 1/3 of their overall value added. As a result of this, normal market-based enterprises
that are subject to hard budget constraints and pay their taxes in full suffer, paying on average more than half of their value added in tax.

Significant “shadowization” of the economy

Excessive payroll taxes (including deductions to the Pension Fund, Social Insurance Fund, Employment Fund, and Chornobyl Relief Fund), which until recently collectively represented 48% of payroll fund, have contributed to the growth of the shadow economy.

Government policy is aimed at reducing these taxes. Beginning in 1999, with cancellation of deductions to the Chornobyl Relief Fund and reduction of social insurance, payroll taxes decreased to 37% of the payroll fund. It is unlikely that such a reduction in payroll taxes will significantly contribute to a decrease in the volume of unofficial wage payments. According to some estimates the inflow of shadow activity to the official economy may begin if payroll taxes decreased to 15-20%.

It should be noted that, in addition to inefficient fiscal policy, the growth of the shadow economy is influenced by inefficient monetary policy.

VAT as an example of imperfect tax legislation

Between 1997 and 1998 almost 200 amendments were made to the VAT Law. However, even after this, the law requires further amendment, as confirmed by many entrepreneurs.

The new procedure for VAT rebates (by way of direct payments to taxpayer accounts) implemented in Ukraine on 1 October 1997 resulted in reduced cash receipts to the budget in 1998.

In the first quarter of 1998, receipts decreased by almost 22% compared with the first quarter of 1997. During the first 9 months of 1998, taxpayers claimed rebates to the amount of UAH 3.3 billion to be paid from the State Budget, including UAH 859 million to be paid in cash to their accounts.

At the same time, while the State Budget must pay rebates claimed by taxpayers within the time limit defined by the Law (within one month of a tax return being filed), not all taxpayers pay due tax to the budget on time. The volume of delayed payments therefore increases.

For example, as of 1 October 1998, tax arrears amounted to more than UAH 2.9 billion, or 3.7 times as much as at the beginning of the year and rose to UAH 10.3 by the end of the year. The State budget, having not received taxes from certain taxpayers (e.g. retailers), must refund input VAT to other taxpayers (buyers). Therefore, there is actually a double loss—the budget fails to receive outstanding amounts of VAT and has to make VAT rebates.

At the same time, experience shows that some provisions of the VAT Law work to the benefit of those who try to illegally receive rebates. Various methods are applied to achieve this, for example:

- Special companies are established to carry out one or two transactions (typically export/import operations) within one accounting period. These companies are registered as VAT payers. Proceeds for received goods are paid to their accounts. After this, a company disappears (or is liquidated) without paying tax and the enterprise that bought the goods and exported them is entitled to a tax rebate from amounts not paid to the budget (this category of tax evaders represents the majority of 3.5 thousand taxpayers on trial)

- There are numerous misuses related to rebates (falsification of documents, operations, etc.); it has been proved that some suppliers of material and technical resources (at the first or second stage of the sale) which claimed rebates, were on trial, or had not reported to tax administrations since their registration, or even did not exist at all.

Checks performed between January and September 1998 revealed that one quarter of all taxpayers are violators. Tax bodies saved more than UAH 100 million in illegal VAT rebates as a result of these checks.

If the term for rebates were extended to three accounting periods, the establishment of such companies would make no sense and tax bodies would be able to discover such companies and the falsely claimed amounts. Three accounting
Box 1. An example of retroactive enactment of legislation

On 28 December 1994, Parliament passed a Law "On Taxation of Profits of Enterprises", which was to be enacted on 1 January 1995. This Law was not signed by the President and only published in mid-February 1995.

The delayed publication of the tax law caused many problems for enterprises that had to make advance payments no later than 25 January. The main cause of the delay in publication of the document was doubts of the Parliamentary legal department with regard to decentralization of power.

In keeping with the new law, profit tax receipts were to be paid to local budgets and not to the State budget as before. Therefore, the body authorized to settle tax disputes was a local court and not tax authorities as before. As a result, the Law was published in mid-1995, but was applied from 1 January 1995.

periods would be a sufficient term for taxpayers to sell the goods and services that resulted in a tax credit.

In general, rebate procedures similar to the procedure implemented in Ukraine on 1 October 1997 can only be applied in highly developed countries where tax has been in place for many years and where the system of levy is free of error and loopholes. At the same time, a number of Western European countries (for example, Finland, Italy, Spain, Greece) do not apply rebates for each accounting period and instead apply an annual rebate system (except for export operations). In Italy, for example, a rebate may be suspended for 3 or 4 years in case of tax misuses.

Mutual indebtedness of enterprises as an instrument of tax evasion

Though the non-payment problem in Ukraine dates back at least to 1991, active measures to counteract it were not initiated until late 1994. A number of Presidential Decrees, resolutions of the Cabinet of Ministers and directives of the National Bank were issued, all aimed at resolving this problem. Actually, all such efforts backfired. As suggested by statistics, in 1995 accounts receivable and accounts payable sharply increased in both nominal and real (index-linked) terms.

This struggle was accompanied by restrictive monetary policy. The economy’s monetization (ratio of the money supply to nominal GDP) decreased sharply from 80% in 1990 to 14% in 1997. As a result of the economy’s demonetization, slow restructuring, and unstable tax system, the working capital available to enterprises decreased. In this situation, enterprises are unable to pay taxes, which results in increased budget arrears. The Law On Bankruptcy (adopted as early as 1992) and anticipation of a write-off or restructurin of fiscal arrears reduces the burden of responsibility on enterprises to pay taxes, and contributes to increased fiscal arrears.

Graph 1. Level of mutual indebtedness, 1992 = 100

Currently, enterprises prefer implicitly tax arrears (payable to the budget) and wage arrears (payable to their employees) to credits in commercial banks. Thus, while the share of banking credits from overall borrowed resources is 12%,

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1 Experts from the Presidential Administration state, "It is incorrect to use monetarization data related to 1990 as a benchmark since it is inappropriate to refer to the time of the Ukrainian SSR.” [Ed. Also data from 1990 reflect the exceptionally large “monetary overhang” at the end of the Soviet Era when the supply of money greatly outstripped the supply of goals.]
the share of arrears payable to the budget, ear-
marked extra-budget funds, the Pension Fund,
the Social Insurance Fund and wage arrears is
21%.

Graph 2. Share of working capital, %

One outcome of the short supply of working
capital available to enterprises is the application
of the mechanism of mutual settlements to the
State Budget. In early 1998, the President signed
Decree # 41, which prohibits mutual settlements
to the State Budget, except for those permitted
by special decisions of the Cabinet of Ministers
of Ukraine. In fact, mutual settlements with both
the State Budget and local budgets continued in
1998: during the first 11 months of 1998 the
State Budget received UAH 1.7 billion (18% of
the overall receipts of the State Budget) in the
form of mutual settlements, and local budgets
received UAH 2.8 billion (28% of local budget
receipts).

A comparison of the ratio of mutual settlements
to consolidated budget revenues shows that this
ratio was about 28% in 1997 and about 20%
between January and November 1998. This im-
plies that the decreased share of mutual settle-
ments in consolidated revenues was modest, de-
spite the drastic action aimed at limiting them.

Until mutual settlements are stopped and enter-
prises begin to produce competitive goods, all
attempts to increase working capital through tax
exemptions are doomed to failure. This is con-
firmed by the fact that the UAH 1.8 billion
write-off and UAH 3.2 billion restructuring (for
10 years) of tax arrears implemented in 1997
failed to improve enterprises’ financial results.

BUDGET LEGISLATION

The budget process in Ukraine is regulated by a
number of legislative acts which lack cohesion
and coordination. These legislative acts include:

- On Amendment of the Criminal Code (in the
  part where criminal responsibility for violation
  of budget system legislation (1997) is dealt with.)
- On the State Tax Service, On Control-and-
audit Service, On the Accounting Chamber,
  etc.

These laws regulate only some budget proce-
dures.

The majority of provisions of the basic Budget
System Law adopted in 1996 are outdated and
do not regulate the budget process anymore.
Consequently, the budget is regulated by both
budget laws and laws on particular taxes and
fees. Such regulations have resulted in a set of
contradictions in budget procedures both at the
draft and execution stages of the budget. Ulti-
mately, this affects the accuracy of budget
indices.

For example, legislation fails to clearly define
either the limits to which the Verkhovna Rada
may change a draft State Budget submitted by
the Government for consideration or procedures
for introduction of such changes. As a result,
when passing the 1998 Budget, the Verkhovna
Rada requested that the Government increase
expenditure by UAH 4.6 billion (more than 20 %
of State Budget revenue) before passing the
budget. It failed, however, to determine the
source of revenue to cover such increased ex-
penditure. Revenues to the State Budget there-
fore proved to be overestimated (as confirmed in
practice) by at least UAH 3.2 billion. This sig-
ificantly disrupted the process of the 1999
budget. The passage of the 1999 State Budget
Law points to the same problem – the Verk-
khovna Rada required a 50% increase in the reve-
 nue side of the budget.

In addition, legislation does not define the status
of indices approved in budgets of different lev-
els. Traditionally, this is understood as a limit of
assignments a manager of funds can undertake.
This understanding and ambiguity of legislation
effect the condition of arrears. Of course, when
dealing with expenditure restriction this is un-
derstood not as reduction of commitment and
responsibility but as a lower amount of funds allocated. Actual expenses not covered by funds become growing arrears.

**ARREARS DUE TO AND PAYABLE FROM THE BUDGET**

*Unrealistic macroeconomic assumptions*

The unrealistic macroeconomic assumptions on which annual budgets are based were a major reason for increased budget arrears.

For example, when passing the 1993 budget, actual macroeconomic indices (inflation, GDP decline, falling production) differed significantly from macroeconomic assumptions underlying the budget. The actual level of revenue during the first months of the year also suggested that budget revenue targets were unrealistic. In the modified budget passed in June 1993, the deficit was 12.2% of GDP.

The 1994 budget was also based on unrealistic assumptions: the deficit of the consolidated budget was assumed to be 2.4% of GDP, target budget receipts were set at 70% of GDP.

Predicted indices of economic and social development underlying the 1996 State Budget of Ukraine provided for a 1.8% decrease in the real volume of gross domestic product and a 0.5% increase in the volume of industrial output.

In 1996 the volume of gross domestic product actually decreased by 10% in nominal terms and amounted to UAH 80.5 billion. Industrial output decreased by more than 5% and agricultural output by 9%. Production of consumables decreased by 20.2%.

In 1997, the situation was similar. Instead of the predicted increase, there was a decline (albeit less rapid) in both real GDP and industrial and agricultural output. For objective (and to a significant extent subjective) reasons, a deterioration of major macroeconomic indices was anticipated in 1998 as compared with the forecast. This would result in further reduction of budget revenues.

In 1999, a 1% decline in real GDP was predicted. Indeed, experience of other countries shows that an economy with 60% exchange rate devaluation has no realistic opportunity to grow. This is especially likely given the following:

- there was almost no progress in restructuring the economy’s real sector.
- more than 50% of enterprises are loss-making.
- 40% of all operations are implemented on a barter basis.
- the volume of mutual arrears of enterprises exceeds GDP.

It is likely that GDP will continue to decline in 1999. Since the 1999 Budget revenue target was approved at a higher level than actual revenue in 1998, the process of growth in tax arrears and accounts payable from the budget is likely to continue as a result of the unrealistic revenue projections.

**Shortfall on the revenue side**

Beginning in 1991, the revenue targets of the State Budget and the consolidated budget have never been fully met. Only local budgets, as a result of the interest of local governments to satisfy local budgets, exceeded their targets after 1995: in 1995 local budget revenues were 1.9% above target, in 1996 they rose to 3.1%, in 1997 to 21.4%, and in 1998 to 27.6%.

**Graph 3. Execution of the State Budget and local budgets**

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2 [Ed. On the other hand many economies have found that a substantial devaluation which makes domestically produce goods competitive on local and international markets is exactly what is needed to restore growth.]
What makes the budget situation even more dramatic is the continuous decline in GDP (see Graph). As a result of this, real budget revenue decreases even more than revenue as a share of GDP.

**Graph 4. Changes in GDP and industrial output, %**

![Graph showing changes in GDP and industrial output from 1992 to 1998.]

**Shortfall on the expenditure side**

Expenditure from the State Budget has never reached target. At the same time, local budget expenditure has exceeded targets in the last three years. Underexpenditure from the budget resulted in a steady trend of increasing arrears. The lack of clearly defined priorities and long-term budget planning results in imbalances in the expenditure side of the budget.

The expenditure side of the budget, overburdened with the social sector inherited by Ukraine from the Soviet times, remains unrestructured. For example, an international comparison of the number of doctors and teachers per 1,000 citizens shows that Ukraine rates among the highest in the world (see analytical reports on "EDUCATION" and "HEALTH CARE").

In real terms, budget outlays show a steady downward trend. The uneven yearly reduction of expenditure suggests the lack of a long-term policy to reform the expenditure side of the budget.\(^3\)

The cash method of financing the expenditure side of the budget results in a disproportion between actual and planned expenditure. The only excuse for this method of financing expenditure is the ability to control the cash budget deficit.

**Graph 5. Real Expenditure and GDP, 1992=100**

![Graph showing real expenditure and GDP from 1992 to 1998.]

All aspects of the budget are out of balance, but the most salient feature of this imbalance is in the execution of the expenditure side of the State Budget. For example, in 1997 the expenditure side of the State Budget was executed to a level of 84.3%. The following programs received funding at lower than average levels:

- science 79.1%
- housing and communal services 75.6%
- socio-cultural establishments 73.1%
- national economy 69.6%
- repayment of arrears related to depreciated cash savings of citizens 15%.

At the same time, government consumption and operational costs of the governments as well as law enforcement bodies and national defense were funded to levels far higher than average (98% and 91.0% respectively).

In 1998, this trend in the execution of the expenditure side of the budget continued. Over the period between January-December 1998, the expenditure side was executed 72.7%. The execution of spending on government consumption was 85.5%, law-enforcement activity and national defense 82.2%, social protection and social security 82.4%, and construction a staggering 240%. At the same time, spending on hous-

\(^3\) [Ed. The more rapid decline of expenditures than GDP since 1992 may create the impression of excessively conservative fiscal policy. In fact, the budget deficit in 1992 was extraordinary large (12% of GDP on a cash basis and 24% of GDP on an accruals basis) and the compression of expenditures since then has never been sufficient to produce a balanced budget.]
ing and communal services was 27.4% below target.

**Main causes of increased budget arrears**

Ever increasing arrears (tax arrears of business entities payable to the budget) and poorly regulated inter-governmental financial relations resulted in a chronic shortfall in budget revenue (low actual revenues in comparison to targets).

As of 1 January 1999, arrears of enterprises and organizations to the budget continued to accrue and amounted to UAH 10.3 billion, that is, increased 4.5 times relative to the beginning of the year.

**Graph 6. Budget arrears, thousand UAH**

The graph shows that the problem of budget arrears worsened significantly in 1998. This sharp increase was caused by a changed VAT procedure, short supply of resources on taxpayers' accounts, significant inventories in warehouses, barter, lack of demand for goods, and large arrears for goods shipped and services provided. As discussed below, moral hazard created by earlier tax write-offs was also a factor.

One major reason for increased arrears is the sharp reduction in enterprises' solvency. Relative to 1990, the structure of enterprises' working capital deteriorated significantly. For example, in 1997 relative to 1990 the share of cash working capital decreased more than tenfold, from 15.6% to 1.5%.

**Graph 7. Share of budget arrears in budget revenues**

One hundred and twenty five thousand enterprises of various forms of ownership were in arrears as of 1 November 1998. Actual data indicates that share of the non-state arrears has risen relative to that of the state and constitutes 72% of the overall arrears. In a number of regions, collectively owned enterprises (joint-stock companies of various kinds, collective enterprises, joint ventures, and limited liability companies) account for the majority of arrears.

Relative to the beginning of 1998, significant arrears of open joint-stock companies established on the basis of former state-owned enterprises increased two-fold (to UAH 3.6 billion), inter-sector associations, consortiums, associations, joint-stock companies, trading houses doubled (UAH 2 billion), and enterprises with a stake of state ownership by 240% (UAH 73.3 million).

Tax bodies try to resolve the problem of arrears by taking purely administrative measures. Thus, during the first 10 months of 1998 the state tax administration attempted to collect outstanding payments amounting to UAH 5.7 billion, which is about one third of the overall revenue of the consolidated budget. This fact once again confirms the purely fiscal orientation of Ukrainian tax policy.

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4 Experts from the Ministry of Finance state, “If this amount (UAH 5.7 billion) was collected “in cash”, then we must praise rather than criticize tax officers for their “purely fiscal orientation. The STA should be fiscal by nature”.
High expectation of write-off and restructuring of arrears

One factor that contributed to the increase in fiscal arrears is the high expectation of future write-off and/or restructuring of tax arrears.

During the last 18 months, fiscal debts were either restructured or completely written off four times. For example, in pursuance of the Law of Ukraine On Writing off and Restructuring Tax Arrears as of 31 March 1997 adopted on 5 June 1997, VAT arrears, enterprise profit tax, land tax, deductions to the State Innovation Fund, deductions to the Chornobyl Relief Fund, fine arrears, penalties, and financial sanctions, including those payable to the Pension Fund and Social Insurance Fund, were written off as bad debts.

Debt write-off and restructuring amounted to about UAH 5 billion. Payment of restructured budget arrears commenced on the 1st of January 1998. Actually, only a small percentage of the restructured amount was paid; so arrears rise.


The Presidential Decree On Write-off and Restructuring of Tax Arrears of Taxpayers that are Agricultural Enterprises and Sugar Factories (Kombinats) as of 1 January 1998, signed on 18 June 1998, envisages the cancellation of fines, penalties, and financial sanctions payable to the State budget, Pension Fund, and Social Insurance Fund as of 1 January 1998 and restructuring of tax arrears as of the same date.

It is clear, however, that penalties and financial sanctions were applied to violators of tax legislation. It appears that those who violated tax legislation but paid penalties and financial sanctions to the budget proved to be short-sighted since their counterparts who did not observe legislation were exonerated.

The Cabinet of Ministers Resolution # 662 of 11 March approved a list of enterprises of the military-industrial complex whose arrears for 1997 were written off.

Ultimately, responsible taxpayers who pay all the taxes and make settlements with the budget according to the law, sometimes to the detriment of their business and employees, end up in financial difficulty.

Regarding tax concessions, the majority of managers get the impression that fiscal debts of large-scale enterprises and agricultural good producers would sooner or later be written off or restructured anyway; therefore non-payment is expedient.

Structure of arrears

The structure of payment arrears to the budget coincides generally with the structure of receipts of those taxes to the budget. This fact suggests that the fundamental cause of arrears is related not to the imperfection of one or another tax but to the inability of enterprises to pay all tax liabilities. Otherwise, the structure of arrears and receipts of the budget would differ significantly.

It is notable that the share of VAT arrears in overall arrears is almost stable at about 40% throughout the period 1995-98.

Furthermore, VAT as a proportion of gross domestic product is also stable at about 8-10% (based on this trend VAT receipts for 1999 were calculated). Numerous amendments to VAT legislation affected neither actual budget receipts nor compliance of enterprises.

Graph 8. Structure of arrears by tax, 1995-1998

Budget arrears

There is no standard definition of budget arrears. Usually, they include only wage and social payment arrears. In fact, they must also include
other arrears including housing and communal services, grants to the national economy, etc.

In the first half of 1998, the Government increased wage and social arrears from UAH 2.7 billion to UAH 3.4 billion, despite the fact that in keeping with the EFF Memorandum with the IMF the Government was obliged to start a stage-by-stage repayment of these arrears after 1 July. Without doubt, the budget passed by the Parliament in December of 1998 was unrealistic: revenues were significantly overestimated, and hence expenditure was overestimated as well.

In the expert opinion of analysts, the 1998 budget modified by the Presidential Decree and submitted to the Parliament for consideration in July was also unrealistic. It is hardly possible that after first-half average revenues of UAH 600-800 mln, in the second half revenues would increase to UAH 1,250 mln. What causes anxiety is the continuing trend towards accumulation of other budget arrears. Given the significant shortfall of budget receipts, they are likely to increase in the future.

Unfortunately, delays in budget reform do not allow Ukraine to monitor debts of budget establishments and, according to information from regions, these debts continue to increase. Debts for gas, electric power, and heating increased by UAH 657 mln from the beginning of 1998 and amounted to UAH 3.4 billion. Just these two kinds of budget arrears amounted by mid year to about UAH 7 billion, and their rise since the beginning of the year amounted to UAH 1.4 billion.

The Government has repeatedly declared its intention to repay budget arrears, but in practice this concerns mainly arrears due to the coal sector, which receives budget resources regularly, especially after repeated strikes. The repayment is implemented both by way of direct financing of the coal sector and by procurement of coal by the State Committee for Material Reserves or through targeted budget financing of individual ministries and departments conditioned to spending money on the procurement of coal. In general, the volume of such expenditure is twice or even more as high as direct expenditure on financing of the coal sector and are nothing but subsidies to this sector. The annual volume of direct and indirect subsidy to this sector is estimated at about UAH 2 billion.

A similar situation exists in agriculture. There are numerous privileges related to fiscal payments, these payments are paid to separate accounts in the Ministry of Agro-industrial Complex and the latter spends these funds on providing grants to enterprises in the sector. According to expert estimates, these indirect subsidies amount to UAH 700-800 million per year.

Unsettled intergovernmental financial relations

The notion of mutual responsibility in the relations between a taxpayer and the budget is lacking in existing legislation. Only the VAT Law regulates stipulates mutual responsibility.

This problem is reflected in the procedure for mutual settlements. An explicit and fundamental paradox exists—the budget can be in arrears to an enterprise for any period of time, but enterprise must repay arrears to the budget after a period of 45 days. At the same time, a fine of about 15% of the total debt is automatically charged.5

Theoretically, it is possible for a firm to have this 45 day period and fines charged on arrears abolished. For this to be achieved, the director must go to Kyiv and initiate a Cabinet of Ministers resolution. It is clear that only large-scale or well-connected enterprises can afford this.

BUDGET DEFICIT

The budget deficit and state debt

The Annual budget deficit causes increased state debt. Depending on the method of financing the budget deficit, internal or external debts increase.

5 Experts from the Ministry of Finance state, “This is a weak example. The taxpayer is a subject involved in business activity at his discretion and risk. Debtors are budgetary establishments, which conclude agreements on this subject. The time limit of “45 days” is a way of restraining the increase of mutual settlements by restricting them to bad debts. Therefore, the aim of this thesis is not understandable. Do we want mutual settlements to increase? This contradicts other sections.”
As a result of the permanent budget deficit the external debt totaled more than UAH 35 billion ($10.9 billion), and the internal debt amounts to about UAH 13.4 billion in late 1998 for a total of UAH 48.4 billion.

**Graph 9. Budget deficit as a share of GDP, %**

A comparison of the volume of current cash tax receipts and the volume of funds that must be spent on funding wages and social payments suggests that the latter represents almost 85%, and only 15% of current cash receipts (about UAH 2.2 billion) is available for other programs. When the amount required for servicing the state debt (UAH 1.7 billion in 1997 and UAH 2.9 billion in 1998) is factored in, the aggregate volume of these two sections of budget expenditure is equal to budget cash receipts.

Of course, there is an option: either to raise funds by borrowing on capital markets or by implementing significant reforms in the fiscal-budget policy.

During the last two years, Ukraine pursued a policy of raising cash funds to finance current expenditure in the internal and external markets. As a result, the state debt as a share of GDP increased to 30%, and the budget deficit continues to be inadmissibly high.

In addition, a crisis in the financial markets has led to a significant rise in the cost of borrowing and reduction of its maturity. The policy pursued resulted in the situation when the share of loans in the volume of State budget resources in the first half of 1998 relative to the same period of 1997 increased by 8 percentage points and reached 62%.

As a result of attempts to resolve the problem of cash shortages in the budget through ever more expensive borrowing, without searching for an efficient mechanism for reduction of fiscal arrears, the problem of budget expenditure has grown. This results in a crisis in the budget sector.

In the first half of 1998 relative to the same period of 1997, the share of budget cash resources (cash tax receipts plus borrowing) spent on servicing and repayment of the state debt increased by 16% to reach 54%. This implies that out of UAH 100 of general expenditure of the State Budget, UAH 54 is spent on Government debt, and the volume of current cash tax receipts is insufficient to fund current wages, social payments, and servicing the public debt. (The state budget provided UAH 4.38 bn for public debt and amortization payments while budget cash receipts amounted to UAH 4.35 bn over the same period).

**Budget deficit and interest rates**

As a result of a higher demand for money, financing the budget deficit from internal (not inflationary) sources lead to higher interest rates (tightened credit to the private sector). In 1997, 67% of the budget deficit was financed using funds raised through T-bills (OVDP). Due to the high return on state securities, banks re-oriented their resources to the OVDP market. This is evidenced by the fact that the share of OVDP in the asset portfolio of commercial banks is almost ten times as high as the volume of credits to the real sector of the economy. The need to decrease the budget deficit is obvious.

The 1999 State Budget Law provides for a 1% deficit as a share of GDP. This is the lowest deficit since independence. The low budget deficit was anticipated to result in lower interest rates, including in the real sector.

However, this mechanism, which works in developed market economies, unfortunately does not work in the Ukrainian economy or rather may be offset by additional factors, more specifically, cost of credits to the real sector of the economy is mainly determined by the risk of non-repayment of credits. Thus, the Ukrainian economy still lacks legislative regulation of the issues related to ownership (an inefficient system of bankruptcy, lack of private ownership of land, etc.) and the risk of non-repayment is too high. Therefore, a low level of deficit may not result in a marked decrease in the interest rate. There is
There is a need for structural reforms which are beyond the scope of this fiscal study and which, to a significant extent, are outside the competence of Verkhovna Rada.

Graph 10. Structure of financing of the budget deficit

INTERGOVERNMENTAL FISCAL RELATIONS

The existing system of inter-governmental financial relations and preparation of local budgets is essentially based on a tight centralization of functions and assignments and extensive redistribution of resources. However, the existing legislation on local self-government and budget system is one of the most liberal in Europe from the standpoint of independence of local governments. Thus, the existing system is in direct contradiction to the legal framework of financial relationships between central and local government.

Relations between local and state budgets

Before 1997, there were five regulating taxes including the value-added tax, excise tax, enterprise profit tax, personal income tax, and land tax. At the same time, according to norms, more than 20 taxes and charges were distributed between all the levels of the budget system, resulting in dispersion of financial resources and looser control over their use.

The division of financial functions between the central and local governments in the period under review was subject to many changes. Detailed definition of responsibilities was done every year through negotiations in parliament during passage of the budget.

Since receipts from local taxes were insufficient to balance local budgets (the share of local taxes and charges in local budgets was only 2.6% in 1996, 2.4% in 1997, and 2.6% in 1998), Local budgets were allocated a share of the overall volume of national tax, mainly from the enterprise profit tax (prior to 1997 this tax was completely assigned to local budgets) and personal income tax. The size of this share is established by annual budget law and depends on the region. This results in a differentiation of the share across regions of Ukraine. It should be noted that, apart from the causes mentioned, the limited share of local tax and charges is also related to the fact that collected revenues are usually paid to extra-budgetary funds and, therefore, are not included in the budget.

The system that differentiates the use of national taxes by individual regions creates unrestricted opportunities for lobbying and so the size of revenue sources are subject to change over very short periods of time. Changes to expenditure limits and revenues available to local governments does not stimulate long-term budget planning at local level.

Though in recent years Ukraine has managed to abolish the practice of annual adoption of differentiated normatives of sharing taxes with local budgets (see table), the division of responsibilities between central and local government is still unsatisfactory.

For example, local budgets fund a number of important national social programs such as housing subsidies, privileges for veterans, and underprivileged family allowances. However, local governments are not authorized to grant or adjust these privileges. Moreover, differentiated sharing rates were restored in 1999.

As a result of these and other causes, negotiations between the Ministry of Finance and local governments about local budgets for the next
year are based not on the principles financing programs and distribution of transfers, but rather deal with sums for oblast or city. These, at the same time, can radically change when respective local budgets are being approved.

**Formation of intergovernmental transfers**

A major problem of inter-governmental financial relations is inter-governmental transfers. There is only one kind of general transfer that covers the difference between planned local expenditure and revenue negotiated with the Ministry of Finance. At the same time, at least five oblasts and the city of Kyiv have a revenue surplus, which the Government failed to attract into the central government budget as per Budget Law. For example, in 1998, when modifying the State budget, grants to local budgets were cut from UAH 2.5 billion to UAH 1.1 billion. At the same time, measures for attracting more than UAH 1 billion from donor oblasts were not taken. Intergovernmental debts during recent years have never been properly accounted at the end of fiscal years.

**Table 1. Tax sharing: deductions to the State Budget**

<table>
<thead>
<tr>
<th>Year</th>
<th>VAT</th>
<th>Excise tax</th>
<th>Profit tax</th>
<th>Land tax</th>
<th>Personal income tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>As per Law On the Budget System</td>
<td>Share defined by the State Budget</td>
<td>Share defined by the State Budget</td>
<td>Law for the respective year</td>
<td>30%</td>
<td>30%</td>
</tr>
<tr>
<td>1995</td>
<td>80%</td>
<td>30%</td>
<td>30%</td>
<td>50%</td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td>80%</td>
<td>30%</td>
<td>30%</td>
<td>50%</td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>100%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td>100%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td></td>
</tr>
</tbody>
</table>

**Box 2. As a result of the shortage if financing, Ukraine forms direct budget transfers (DBTs) from budget allocations**

DBT may take the form of:

- partial deductions from one or more taxes payable to the state budget,
- annual allocations of the state budget,
- changes in the volume of local expenditure.

It is generally accepted that the most stable DBT is when it is tied to budget revenue, though this approach does not provide for full stability. In our opinion, is the global grant functioning in France. In stable economies (Germany, France, Poland), DBTs are budget grants by nature and are funded from this kind of source. Russia attempts to follow this approach as well. As regards conditional DBTs, the most suitable source for them is budget outlay depending on the volume of local outlay.

As one can see, transition economies (Latvia, Lithuania, Ukraine) are not able to provide a stable source for DBT and, therefore, prefer budget allocations, whose volume depends on the size of the budget and political factors.
Table 2. Sources for DBT in various countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Types of DBT</th>
<th>Sources for DBT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>Additional grants</td>
<td>2% of VAT</td>
</tr>
<tr>
<td></td>
<td>Assistance for investment</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Grants for joint programs</td>
<td>Depending on local outlays</td>
</tr>
<tr>
<td></td>
<td>Structural fund</td>
<td></td>
</tr>
<tr>
<td>Russia</td>
<td>Budget grant</td>
<td>Budget allocations</td>
</tr>
<tr>
<td></td>
<td>Budget subventions</td>
<td>15% of the State Budget revenues</td>
</tr>
<tr>
<td></td>
<td>Federal transfer</td>
<td>Depending on local outlays</td>
</tr>
<tr>
<td></td>
<td>Pure mutual settlements</td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>Global functioning grant</td>
<td>Annually adjusted VAT share</td>
</tr>
<tr>
<td></td>
<td>Grants to offset additional privileges</td>
<td>Budget allocation</td>
</tr>
<tr>
<td></td>
<td>Global grant for decentralization</td>
<td>CIT share depending on local outlays</td>
</tr>
<tr>
<td></td>
<td>Global grant for equipment</td>
<td>VAT share</td>
</tr>
<tr>
<td></td>
<td>VAT compensation</td>
<td>Budget allocations depending on local outlays</td>
</tr>
<tr>
<td></td>
<td>Special subventions</td>
<td></td>
</tr>
<tr>
<td>Poland</td>
<td>General subventions</td>
<td>Share of state budget outlays</td>
</tr>
<tr>
<td></td>
<td>targeted grants</td>
<td>Budget allocations</td>
</tr>
<tr>
<td>Latvia</td>
<td>Budget subsidies</td>
<td>Budget allocations</td>
</tr>
<tr>
<td></td>
<td>Subsidies from the equalization fund</td>
<td>CIT share</td>
</tr>
<tr>
<td></td>
<td>Targeted grants</td>
<td></td>
</tr>
<tr>
<td>Lithuania</td>
<td>Budget grants</td>
<td>Budget allocations</td>
</tr>
<tr>
<td></td>
<td>Special subsidies</td>
<td></td>
</tr>
<tr>
<td>Ukraine</td>
<td>Budget grants</td>
<td>Budget allocations</td>
</tr>
</tbody>
</table>

A trend towards an increase in the number of subsidized oblasts

For years, the number of subsidized oblasts has been increasing. For example, in 1996, 11 oblasts were grant recipients, in 1997 – 18, in 1998 this number increased to 22. In 1999 all oblasts, except for Kyiv, will be grant-dependent. The volume of planned grants is also increasing.

In addition, a clear-cut mechanism of subsidization is absent. This results in uneven distribution. For example, between January and September 1998, the annual target was only 33.5% realized. At the same time, 8 local governments were funded at a level significantly lower than average. While the budget of the city of Sevastopol received 57% of the annual target, the Kirovohrad oblast got 48%, the Kherson oblast 45%, the budgets of the Odesa, Lviv, and Mykolaiv oblasts received only 8%, 16%, and 17% respectively.

Table 3. Transfers from the State Budget, billion

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>As approved in</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Budget Law</td>
<td>0.8</td>
<td>2.1</td>
<td>2.5</td>
</tr>
<tr>
<td>Bn UAH of 1996</td>
<td>0.8</td>
<td>1.8</td>
<td>2.0</td>
</tr>
</tbody>
</table>

At the same time, the State Budget of Ukraine, in turn, receives insufficient official transfers from donor oblasts. In 1996, the State Budget failed to receive UAH 149.2 mln, in 1997—UAH 249.9 mln. A similar trend continued in 1998.
III. FISCAL POLICY OUTLOOK

Global non-payments and permanently increasing fiscal and budget arrears are impossible to eliminate without radical measures in tax and budget policy.

The most adverse feature of arrears is longevity. Businesses have adjusted themselves to the existence of arrears and in many cases use them for doubtful financial operations. This factor complicates any efforts of the Government to solve the problem of non-payments in the short term since there will be significant opposition from enterprises that gain superprofits as a result of various kinds of mutual settlements and barter operations.

REFORM OF TAX POLICY
Principles of tax policy formulation

Tax policy is formulated on the basis of two interrelated methodological prerequisites:

- use of tax payments for the formation of budgets and execution of the fiscal tasks of the State,
- use of tax instruments as an indirect method to regulate economic activity.

Formulation of tax policy and creation of a tax system should take place simultaneously with reforms in the system of ownership, pricing, the banking system, monetary policy, etc. Therefore, in any given period of time, each next step towards the establishment of the tax system should be to a significant extent defined by the adoption of decisions in other directions of reform.

Decision-making in the field of tax policy is influenced by the following factors:

- general economic situation as characterized by fluctuations in production,
- rate of inflation,
- monetary policy,
- relationships between state-controlled production sector and the private sector.

Abolishing the purely fiscal function of tax policy

Reality has shown the untenability of the purely fiscal function of tax policy. This policy has resulted in a reduced tax base and reduced budget receipts. Urgent measures are required to shift emphasis from the fiscal function of taxes. Changes are needed to stimulate manufacturers, to foster and encourage production. For this to be achieved, the tax burden should be reduced and the system of tax assessment should be simplified.

A strategic way of solving the above problems is, first and foremost, the reduction of the tax burden on payroll fund to 15%. This would result in a release of financial resources needed for timely payments of wages, foster legalization of incomes and increase budget receipts.

The main obstacle hindering a solution to the issue of reducing the burden on the payroll fund is the low probability that such a law is unlikely to be adopted by the Verkhovna Rada of Ukraine.

Therefore, the following measures are required:

- decrease tax pressure on the official economy through a reduction of tax rates (especially the rates of taxation of personal incomes and payroll tax rates) and extend the tax base through taxation of the shadow economy,
- discontinue the practice of writing off tax arrears due to the budget and implement a mechanism of deferred payment through promissory notes from taxpayers to concerned tax bodies,
- liquidate the so-called “Card File # 2” and the restriction on the number of accounts of business entities; this should be accompanied by enhancement of responsibility for timely settlements,

According to participants of the poll, the removal of the existing privileges should be the main direction of fiscal policy.
reduce the maximum duration of the procedure for filing a petition for bankruptcy and simplify bankruptcy procedure,

suspend the levy of taxes payable to the State Budget and local budgets and penalty sanctions on businesses if State and local budgets fail to carry out their obligations,

improve the mechanism of assessment and payment of VAT,

implement tax differentiation on individual property,

extend the practice of lump sum tax payment and restrict the frequency of payments to once or twice a year,

reduce the number of national taxes,

to solve the above problems, a Tax Code must be adopted in 1999 and a moratorium on amendments to tax legislation must be introduced for 3-5 years.

Abolition of mutual settlements and the practice of writing off and restructuring debts

In addition, mutual settlements against arrears must be prohibited completely or partially in the near future. The right to provide tax credits or tax deferments must be canceled as well as write-off or restructuring of debts, since this leads to increased arrears.

Currently, the complete prohibition of mutual settlements during the existing payment crisis would immediately result in increased arrears. Given this, prohibition of mutual settlements must be implemented stage-by-stage (over one or two years) and in concurrence with monetary policy.

Sector ministries, whose enterprises use mutual settlements as a way of repaying their debts to the budget or disposing of low-quality and non-competitive goods, will oppose the imposition of gradual and later full prohibition of mutual settlements and will lobby for retention of the existing mutual settlement system through the Cabinet of Ministers and Verkhovna Rada of Ukraine. Commercial intermediaries are likely to lend support sector ministries.

As regards debt restructuring, there are also many parties interested in preserving this instrument for reducing of debt liabilities. These include the so-called "problem" sectors – agriculture and coal industry, whose debts to the budget and state extra-budget funds have been written off many times. Indeed, the representatives of these sectors in the Government and Verkhovna Rada and political make the abolition of tax debt restructuring unlikely.

Another important step is to cancel all existing tax exemptions and substitute them with budget subsidies where socially important. These changes will make the budget more transparent.

The cancellation of tax exemptions is the most complicated problem since it affects many vested interests both on a regional and national level. The ability of Government and Verkhovna Rada State to make legislative decisions on these issues is clearly insufficient.

REFORM OF BUDGET POLICY

Optimizing public expenditure

In order to optimize budget outlays, a careful reconsideration of all programs funded at the expense of budget resources is needed (according to Ministry of Finance estimates, UAH 80 billion is needed to fund all the programs, which is 2.5 times as much as the annual budget) as well as a significant reduction in the number of employees in budgetary organizations, including law-enforcement bodies.

There is a need to initiate restructuring of large redistribution systems.

There will be opposition both from the Government, especially individual sector ministries, whose programs will be cut, and their representatives and vested interests in the Verkhovna Rada.

Cuts in central government expenditure on the national economy will especially feature the coal industry and agriculture. They have the most powerful lobbies in Verkhovna Rada and are in urgent need of radical reform.

9 Experts from the Ministry of Finance consider that this direction is fraught with danger.
**Improvement of the budget process**

The problems related to the budget process may be resolved by immediately adopting the Budget System Law developed by the Ministry of Finance followed by adopting a number of other regulatory acts which would create a program of legislation essential for a balanced budget.

The following measures are also required:

- transfer accounts of all budgetary organizations to the Treasury
- switch to making budget expenditure through a State Treasury system,
- implement a mechanism of medium-term and long-term budget planning specifying stable sources of revenues for local governments,
- abolish the targeted character of the State Budget revenues and refrain from earmarking revenue to budget outlays,
- switch over from a cash management system of budget expenditure to management of liabilities with budgetary organizations,
- devolve state budget execution to oblasts so that state budget resources collected in oblasts fund outlays in those oblasts,
- improve forecasting macroeconomic indicators for the state budget,
- reduce the list of managers in state budget organisations so as to optimize the network of budgetary organizations and increase the role and responsibility of ministers,
- revert to local budget execution via the Treasury
- enact legislative provision that defines that the amount of the State Budget deficit cannot exceed the volume of investment from the State Budget.

It should be noted that implementing a mechanism for medium and long-term budget planning (which implies abolition of daily fund distribution) would prevent conflict between budget-sustained establishments.

**Box 3. When allocating grants, the majority of countries prefer a formula-based approach.**

*World experience shows that there are the following methods of DBT distribution:*

1) proportional to the financial capacity (revenues) of a local community
2) complicated formula
3) compensation of actual outlays of local communities;
4) as a share of the annual budget of a local community.

*For allocation of budget grants, the second method and fourth method are applied most frequently. For conditional DBT the most common are the first and the third method.*

*As one can see from the table, in allocating grants, the majority of countries prefer formulas, since they allow a more objective assessment of the need for a local government in centralized support. The formula itself, however, does not resolve the problem since the set of criteria built in it and their weight are of great importance.*

*Except for France and Switzerland, all the countries reconsider and modify their formulas almost every year. In France and Switzerland, however, there are debates regarding the appropriateness of the inclusion of some indices in the formula.*
Table 4. Methods for distribution of budget grants

<table>
<thead>
<tr>
<th>Country</th>
<th>Types of grants</th>
<th>Methods for allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>Additional grants</td>
<td>A portion of the annual budget to the amount of funds needed to adjust the revenue base to the average level and as lump sums</td>
</tr>
<tr>
<td>Russia</td>
<td>Budget grant</td>
<td>A proportion of the annual budget</td>
</tr>
<tr>
<td></td>
<td>Federal transfer</td>
<td>Formula</td>
</tr>
<tr>
<td>France</td>
<td>Global grant for functioning</td>
<td>Formula</td>
</tr>
<tr>
<td></td>
<td>Grants to offset additional privileges</td>
<td>Formula</td>
</tr>
<tr>
<td></td>
<td>VAT compensation fund</td>
<td>Depending on the actual amount of losses (compensation)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Compensation of a proportion of spending for capital investment</td>
</tr>
<tr>
<td>Poland</td>
<td>General subventions</td>
<td>Formula</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Unconditional subsidy</td>
<td>Formula</td>
</tr>
<tr>
<td>Latvia</td>
<td>Budget subsidies</td>
<td>Formula</td>
</tr>
<tr>
<td></td>
<td>Subsidies from the equalization fund</td>
<td>Formula</td>
</tr>
<tr>
<td>Lithuania</td>
<td>Grants</td>
<td>A proportion of the annual budget</td>
</tr>
<tr>
<td>Ukraine</td>
<td>Budget grants</td>
<td>A proportion of the annual budget</td>
</tr>
</tbody>
</table>

At the same time, not everybody involved in the adoption of legislation is sufficiently aware of the need for the Budget System Law. A significant obstacle to adoption of the law is that it does not resolve the issue of deep regulation of inter-governmental budget relations and formulation of local budgets.

Normalization of inter-governmental financial relations

Unsettled inter-governmental financial relations affect budget balancing and arrears reduction. A way of balancing the local budget is a legislative and practical solution of issues concerning delimitation of responsibilities between the central, regional, and local budgets.

The central government budget must:

- **either** take all the responsibility for providing social services by local government and concentrate all the resources in this area, despite the legislatively determined principles of local government independence.

- or appropriately delimit the responsibilities and resources defining a system of intergovernmental financial regulation based on mutually agreed and appropriately fixed principles – transparent and clear for all participants.

We advocate the latter approach. In these terms, negotiations must deal not with set amounts or kinds of expenditure for given areas but rather with the establishment of principles (for example, see the Box on page 32) that equally influence all local budgets.

Such an approach may give the impression that the central Government loses control over the distribution of resources among local governments (though this is not the case) and this may hinder resolution of the issue.

It is required that centers of power are deprived of the right to redistribute fiscal authorities assigned to local self-governments and provide bodies of local self-government with the right to independently borrow and manage their debentures without additional agreement (except for
agreeing with the State Commission on Securities and Stock Market) of the central government or local bodies of power. (Experts from the Ministry of Finance argue that this is a mistake. “Control is inevitable. Their failure will negatively affect Ukraine’s rating.”) Conditions should be created for the development of the debenture market of both the central and local governments by excluding them from the tax base (tax exemptions for investors, sale-and-purchase operations, etc.)

**COMPARATIVE TABLE OF THE PROPOSED STRATEGY AND AN ALTERNATIVE STRATEGY**

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Reforming of the fiscal policy</th>
<th>Increase of budget revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goals</td>
<td>To stimulate economic growth and use of taxpayers’ resources effectively</td>
<td>To increase budget receipts and fully finance the expenditure side of the budget</td>
</tr>
<tr>
<td>What problems are resolved by the strategy?</td>
<td>Establishes prerequisites for expansion of production and development of legal entrepreneurship.</td>
<td>Removes the need for drastic unpopular decisions regarding reform of the expenditure side of the budget.</td>
</tr>
<tr>
<td></td>
<td>Liquidates the causes of increasing arrears and non-payments.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Creates stimuli for investment and re-investment.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Decreases state intervention in economic activity.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Ensures targeted use of budget resources.</td>
<td></td>
</tr>
<tr>
<td>How does the strategy address the problem?</td>
<td>Taxes</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Reducing the burden of taxation on the official economy by decreasing tax rates (especially the rates of personal income tax and payroll taxes) and expanding the tax base through bringing the shadow economy into tax structures.</td>
<td>Taxes</td>
</tr>
<tr>
<td></td>
<td>Simplifying the mechanisms of assessment and payment of taxes, especially with respect to small and medium businesses.</td>
<td>Increase of tax rates.</td>
</tr>
<tr>
<td></td>
<td>Canceling economically unreasonable privileges.</td>
<td>Implementation of new kinds of taxes and charges.</td>
</tr>
<tr>
<td></td>
<td><strong>Budget</strong> Transition to medium and long-term budget planning and concurrent implementation of the program principle in the formulation of the expenditure side of the budget.</td>
<td>Granting the tax administration wide authority, including regulatory authorities.</td>
</tr>
<tr>
<td></td>
<td><strong>Budget</strong></td>
<td>Wide application of penalties and administrative measures.</td>
</tr>
<tr>
<td></td>
<td><strong>Budget</strong></td>
<td>Confiscation of property of payers in arrears.</td>
</tr>
<tr>
<td></td>
<td><strong>Budget</strong></td>
<td>Legal action for non-payment of taxes.</td>
</tr>
<tr>
<td></td>
<td><strong>Budget</strong></td>
<td>Centralization of budget resources in the State Budget.</td>
</tr>
<tr>
<td></td>
<td><strong>Budget</strong></td>
<td>“Hand-operated” execution of the budget.</td>
</tr>
<tr>
<td></td>
<td><strong>Budget</strong></td>
<td>Preservation of the existing principles in financing of education, health, and social protection.</td>
</tr>
<tr>
<td>Strategy</td>
<td>Reforming of the fiscal policy</td>
<td>Increase of budget revenues</td>
</tr>
<tr>
<td>----------</td>
<td>-------------------------------</td>
<td>----------------------------</td>
</tr>
<tr>
<td>Reform of monopoly redistribution systems (education, health, social protection).</td>
<td>Principles for formation of inter-governmental financial relations: establishment of equal principles of formation of inter-governmental financial relations by implementing a formula-based approach centers of power are legislatively deprived of the right to redistribute fiscal authorities assigned to bodies of local self-government.</td>
<td>Keeping the planned budget deficit through increasing expenditure arrears. Financing the budget deficit through internal credit resources of the economy.</td>
</tr>
<tr>
<td>Short-term (1-2 years) Possible temporary reduction of the revenue side of the budget. Dissolution of areas of conflict between budget-sustained organizations. Business recovery. Creation of a favorable investment climate.</td>
<td>Implementation of a new tax or charge or taking administrative measures will produce a moderate short-term effect (for 1-2 months). Increased volume of arrears. Increased number of loss-making enterprises. Outflow of working capital available to enterprises. Increased volume of the shadow economy. Low processing of domestic raw materials resulting in a significant reduction of value added. Increased number of anti-dumping lawsuits against Ukrainian exporters.</td>
<td></td>
</tr>
</tbody>
</table>

**IV. IMPLEMENTATION OF A NEW FISCAL POLICY**

Governmental and non-governmental agencies were polled to find out the differences in expert opinion on the key fiscal policy issues. When analyzing the outcomes of the poll, investigators focused on those issues on which there was the smallest agreement in expert opinion (the highest level of dispersion in responses) and the largest consensus (the highest level of similar responses). The first set of questions, in our opinion, reflects those issues whose resolution would meet the largest obstacles, first and foremost, obstacles related to the lack of understanding. The second set of questions represents those questions that may be planned in the short-term, since there is obvious agreement in the positions of the advisors to policymakers.

**Major differences**

When analyzing responses to the questions included in the questionnaire, researchers came to the conclusion that the largest were the differences concerning the questions shown in Table 1. The lack of consensus regarding some questions implies that the solution to these problems should be long term. The lack of consensus among government officials is mainly attribut
Table 5. Issues on which the agreement was at a low level (as evidenced by a high level of dispersion in responses)

<table>
<thead>
<tr>
<th>Dispersion</th>
<th>Supported</th>
<th>Not supported</th>
<th>No opinion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>Government officials</td>
<td>Total</td>
<td>Government officials</td>
</tr>
<tr>
<td>Fiscal policy should be primarily oriented at supporting agriculture and the coal sector</td>
<td>1.63</td>
<td>44%</td>
<td>44%</td>
</tr>
<tr>
<td>The revenue side of the budget may be increased by extending the tax base</td>
<td>1.52</td>
<td>56%</td>
<td>60%</td>
</tr>
<tr>
<td>The problem of non-payments to the budget may be resolved by improving the methods of macroeconomic forecasting and planning</td>
<td>1.46</td>
<td>38%</td>
<td>36%</td>
</tr>
</tbody>
</table>

Respondents had no opinion on the question of how to resolve the problem of non-payments to the budget by improving the methods of macroeconomic forecasting and planning. The lack of consensus on this issue is a significant obstacle to the formulation of a realistic budget and economically reasonable governmental programs.

**Positions receiving considerable support**

The issues on which there was a large consensus mainly coincide with the proposed strategy and suggest a need to create a long-term strategic governmental economic development program.

The largest consensus was on the need to establish favorable conditions for business development. It is understood that the development of business may both resolve the problems in the revenue side of the budget and ease social tension.

As regards the issue of increasing efficient monetary management, 96% of governmental respondents supported this standpoint. This implies that everybody is aware of the urgent need to switch over to the system of Treasury budget management.

The respondents support the cancellation of numerous social allowances and ensure the targeted character of social programs. Cancellation of unrealistic privileges was supported by 92% of
**Table 6. Positive responses**

<table>
<thead>
<tr>
<th>Supported</th>
<th>Noi supported</th>
<th>No opinion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>Government officials</td>
<td>Total</td>
</tr>
<tr>
<td>-----------</td>
<td>------------------</td>
<td>-----------</td>
</tr>
<tr>
<td>It is time to create favorable conditions for business development</td>
<td>97%</td>
<td>100%</td>
</tr>
<tr>
<td>Increased efficiency of resource management is required</td>
<td>97%</td>
<td>96%</td>
</tr>
<tr>
<td>Normalization of systems of privileges is required</td>
<td>93%</td>
<td>89%</td>
</tr>
<tr>
<td>Cancellation of numerous social allowances and ensure targeting of social programs</td>
<td>92%</td>
<td>92%</td>
</tr>
<tr>
<td>Normalize the system of social allowances and reconcile the expenditure side of the budget with the state’s means</td>
<td>92%</td>
<td>88%</td>
</tr>
<tr>
<td>Implement clear-cut system of expenditure priorities</td>
<td>87%</td>
<td>88%</td>
</tr>
<tr>
<td>Public investment should be directed to the development of competitive sectors</td>
<td>87%</td>
<td>84%</td>
</tr>
<tr>
<td>Simplification of the taxation system and imposition of a moratorium on amending the system</td>
<td>86%</td>
<td>89%</td>
</tr>
<tr>
<td>The problem of non-payment may be resolved by simplifying the system of taxation and imposition of a moratorium on amending this system</td>
<td>85%</td>
<td>88%</td>
</tr>
<tr>
<td>Budget receipts may be increased by involving the shadow sector in taxation</td>
<td>83%</td>
<td>89%</td>
</tr>
</tbody>
</table>
polled government officials. In addition, the majority of respondents consider that the system of social privileges should be normalized and the expenditure side of the budget should concur with state capacity. The expenditure side of the budget may be normalized by formulating a clear system of expenditure priorities. This opinion was supported by 88% of polled officials.

It is possible to resolve, in the short term, the issues of simplification of the taxation system and introduction of a moratorium on amendments to this system. This is suggested by the fact that this opinion was supported by 88% of the polled officials.

As considered by 84% of government officials, state investment should be directed to develop competitive sectors of the economy. This implies that there is an understanding that state investment should be efficient.

V. CONCLUSIONS

The poll’s outcomes lead us to the conclusion that the strategy of fiscal policy proposed by the authors is supported by both governmental and non-governmental experts. Measures to remove economically unreasonable privileges and financing for loss-making sectors are anticipated to cause the most significant opposition.

It is proposed that policymakers take key measures to implement the proposed fiscal policy in the following order:

<table>
<thead>
<tr>
<th>Short term</th>
<th>Long term</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Normalize the system of tax exemptions and social allowances.</td>
<td>• Simplify the system of taxation and shift the accent from the purely fiscal function of taxes to the function of regulating the economy.</td>
</tr>
<tr>
<td>• Develop a mechanism for efficient management of available financial resources and enhance the Treasury’s role in this process.</td>
<td>• Cancel of the practice of “non-cash settlements to the budget.</td>
</tr>
<tr>
<td>• Introduce a moratorium on amending the taxation system (regarding taxation of entities) until the Tax Code is approved.</td>
<td>• Reform the redistribution systems of education, health, and social protection.</td>
</tr>
<tr>
<td>• Develop and implement a personal income tax law consistent with international practices.</td>
<td>• Implement medium and long-term planning of the budget in accordance with the goals of the economic policy.</td>
</tr>
</tbody>
</table>
5. HEALTH CARE POLICY

Y. Vitrenko
Head of Department
Ministry of Health Care

A. Nagorna
Deputy Director
Ukrainian Institute for Public Health

Ukrainian and foreign experts participating in investigation: R. Bogatyryova, Minister of Health Care of Ukraine; T. Baranova, Head of the Main Department of Economy, Ministry of Health Care of Ukraine; L. Gryrovych, Deputy Head Committee on Health Care, Maternity and Childhood Protection, Parliament of Ukraine; I. Demchenko, Advisor to the Minister of Health Care of Ukraine; V. Zukhin, Member of the Association of Administrators of Private Medicine; B. Kryshtopa, Honored Doctor of Ukraine, Ph.D., Head of the Department of Health Care, Kyiv Medical Post-graduate Academy; O. Lukianova, Director of the Institute of Pediatrics, Obstetrics and Gynecology; Julia O’Nonnel, research assistant, World Bank; O. Poladko, Deputy Head of the Main Department for Medical and Preventive Treatment, the Ministry of Health Care of Ukraine; V. Rudyi, Head of the Secretariat of the Committee for Health Care, Maternity and Childhood Protection, Parliament of Ukraine; V. Sayenko, Director of the Institute of Clinic and Experimental Surgery; O. Smyrnova, Deputy Head of Kyiv Oblast State Administration for Education, Culture and Health Care; Yuriy Sibotin, Head of the Bureau of World Health Protection Organisation on Coordination and Relations with Ukraine; M. Khobzey, Head of the Department for Health Care, Lviv Oblast State Administration
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IV. CONCLUSIONS ..................................................................... 99
1. INTRODUCTION

Almost all industrially developed countries spend considerable budget and non-budget funds on maintaining and effective national health care system. There are ongoing discussions concerning the availability of adequate health care to all levels of society as well as the cost of medical services. Economic development should increase life span and the level of health, but can only do so in a manner consistent with a country's ability to pay. Each developed country has to provide the conditions for this, with financing of prime importance.

As seen in Chapter II, the Ukrainian health care system employs about 1.2 mln people, or almost 7% of the working population. The network of health care institutions is funded by 4% of GDP and 10-11% of the consolidated budget. The purpose of analysis is to find means of more effectively allocating human, material, technical and financial resources needed for the national health service.

II. ANALYSIS OF THE CURRENT STATE POLICY

Health is a precious commodity, and individuals are prepared to spend their own incomes on medical treatment, but would often prefer to rely on state-provided healthcare service. Even in more developed countries there are inadequate financial resources in government coffers to give effective medical treatment for every citizen. Consequently, discriminatory choices must be made on the most effective allocation of funds. During a period of economic transition the difficulties in making choices are exacerbated. Whatever arguments it takes to justify funding alternatives there are, by implication, dissatisfied parties. The current level of health of the population of Ukraine is a paradigm of this situation.

EVALUATION OF THE UKRAINIAN NATIONAL HEALTH SERVICE.

A major indicator used to evaluate the standard health of the population is life expectancy.

According to the objectives of Health for Everyone policy, which was adopted in 1984 by the European Regional Bureau of the World Health Organization, average life span should be not less than 75 years by the year 2000.

In 1992 Ukraine placed 34th in this indicator (69 years) among European countries. In 1995 life expectancy in Ukraine fell back further by 2 years and was less than the average in Europe by 5.3 years and the EU by 7.3 years. (see Table 1)

<table>
<thead>
<tr>
<th></th>
<th>1992</th>
<th>1995</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ukraine</td>
<td>69.1</td>
<td>67.1</td>
</tr>
<tr>
<td>Europe</td>
<td>73</td>
<td>72.4</td>
</tr>
<tr>
<td>EU countries</td>
<td>77</td>
<td>77.4</td>
</tr>
<tr>
<td>CEE countries</td>
<td>70.9</td>
<td>71.4</td>
</tr>
<tr>
<td>NIS</td>
<td>68.4</td>
<td>66</td>
</tr>
</tbody>
</table>

Life expectancy is proportional to the mortality rate which is heavily influenced by the following factors: blood diseases, cancer, injury and poisoning, and breathing system diseases. The mortality rates in comparison with those of the European countries are shown in Table 2.
According to this data, the general mortality rate in Ukraine increased by 14.7% during 1992-1995 against an increase in Europe of 6.6% and a 0.1% fall in the EU. This is due to the following increases in causes of death:

- **blood diseases**: 39.7%
- **cancer**: 4.5%
- **injury and poisoning**: 23.2%
- **breathing system diseases**: 32.1%

In 1995 the mortality rate in Ukraine was 36.4% higher than in Europe and 54.3% higher than in the EU; mortality caused by blood diseases 72.4% and three times higher respectively; cancer 3.1% and 1.1%; by injury and poisoning 59.3% and 3.7 times higher; breathing system diseases 32.7% and 57.7%.

Despite general stability, infant mortality (an infant being defined as up to 1 year old) in Ukraine is 2 times higher than the EU average (in Ukraine this rate was 14.7 per 1,000 newlyborns in 1995 compared to 6 in the EU), while early neonatal mortality (age 0-6) was 2-2.6 times higher than in Europe and the EU (in Ukraine 7.6 cases compared to 3.7 and 2.9 correspondingly per 1,000 non-stillborn children). Maternity mortality is two times higher than the marginal level defined by Health for Everybody Policy for 2000, 1.5 times higher than in Europe and 5 times higher than in the EU.

### Table 2. Mortality rates in Ukraine and Europe

<table>
<thead>
<tr>
<th></th>
<th>Ukraine</th>
<th>Europe</th>
<th>The EU</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>General mortality rate</strong> (per 100 of the population)</td>
<td>13.43</td>
<td>10.59</td>
<td>9.99</td>
</tr>
<tr>
<td><strong>Blood diseases</strong> (per 1,000 of the population)</td>
<td>625.68</td>
<td>476.24</td>
<td>307.03</td>
</tr>
<tr>
<td><strong>Cancer</strong> (per 100,000 of the population)</td>
<td>188.17</td>
<td>195.22</td>
<td>199.63</td>
</tr>
<tr>
<td><strong>Injury and poisoning</strong> (per 100,000 of the population)</td>
<td>130.23</td>
<td>88.87</td>
<td>47.05</td>
</tr>
<tr>
<td><strong>Breathing system diseases</strong> (per 100,000 of the population)</td>
<td>67.74</td>
<td>61.05</td>
<td>52.25</td>
</tr>
</tbody>
</table>
Table 3. Sickness rate by major diseases (number of first registered cases)

<table>
<thead>
<tr>
<th>Disease</th>
<th>Thousands 1990</th>
<th>Thousands 1996</th>
<th>Thousands 1997</th>
<th>Per 100,000 of the population 1990</th>
<th>Per 100,000 of the population 1996</th>
<th>Per 100,000 of the population 1997</th>
</tr>
</thead>
<tbody>
<tr>
<td>All diseases</td>
<td>32188</td>
<td>30169</td>
<td>31158</td>
<td>62335</td>
<td>59319</td>
<td>61769</td>
</tr>
<tr>
<td>(1990=100)</td>
<td>100</td>
<td>93.7</td>
<td>96.8</td>
<td>100</td>
<td>95.2</td>
<td>99.1</td>
</tr>
<tr>
<td>Blood system diseases</td>
<td>1149</td>
<td>1412</td>
<td>1497</td>
<td>2225</td>
<td>2776</td>
<td>2967</td>
</tr>
<tr>
<td>(1990=100)</td>
<td>100</td>
<td>122.9</td>
<td>130.3</td>
<td>100</td>
<td>124.8</td>
<td>133.3</td>
</tr>
<tr>
<td>Cancer</td>
<td>310</td>
<td>335</td>
<td>348</td>
<td>601</td>
<td>659</td>
<td>690</td>
</tr>
<tr>
<td>(1990=100)</td>
<td>100</td>
<td>108.1</td>
<td>112.3</td>
<td>100</td>
<td>109.7</td>
<td>114.8</td>
</tr>
<tr>
<td>Injury and poisoning</td>
<td>2866</td>
<td>2603</td>
<td>2484</td>
<td>5550</td>
<td>5118</td>
<td>4925</td>
</tr>
<tr>
<td>(1990=100)</td>
<td>100</td>
<td>90.8</td>
<td>86.7</td>
<td>100</td>
<td>92.2</td>
<td>88.7</td>
</tr>
<tr>
<td>Breathing system diseases</td>
<td>17021</td>
<td>13221</td>
<td>14129</td>
<td>32962</td>
<td>25995</td>
<td>28011</td>
</tr>
<tr>
<td>(1990=100)</td>
<td>100</td>
<td>77.7</td>
<td>83.0</td>
<td>100</td>
<td>78.9</td>
<td>85.0</td>
</tr>
<tr>
<td>Active tuberculosis</td>
<td>16500</td>
<td>23400</td>
<td>24900</td>
<td>31900</td>
<td>46000</td>
<td>49300</td>
</tr>
<tr>
<td>(1990=100)</td>
<td>100</td>
<td>141.8</td>
<td>150.9</td>
<td>100</td>
<td>144.2</td>
<td>154.5</td>
</tr>
<tr>
<td>Syphilis</td>
<td>3100</td>
<td>77100</td>
<td>74500</td>
<td>6000</td>
<td>151600</td>
<td>147700</td>
</tr>
<tr>
<td>(1990=100)</td>
<td>100</td>
<td>25 times higher</td>
<td>24 times higher</td>
<td>100</td>
<td>25 times higher</td>
<td>24 times higher</td>
</tr>
<tr>
<td>Viral hepatitis</td>
<td>147600</td>
<td>144400</td>
<td>80100</td>
<td>285800</td>
<td>283900</td>
<td>158800</td>
</tr>
<tr>
<td>(1990=100)</td>
<td>100</td>
<td>97.8</td>
<td>54.3</td>
<td>100</td>
<td>99.3</td>
<td>55.6</td>
</tr>
</tbody>
</table>

It is necessary to note here that the sickness rate decreased both in absolute figures (by 3.2%) and per 100,000 of the population by 0.9%. However, according to the majority of experts this is caused not by general improvement in the standard of health of the population but by decreasing number of people who turn to medical institutions for treatment. Such a conclusion is based on the fact that the sickness rate decreased in those diseases that can be treated without professional medical personnel. For instance, the breathing system sickness rate decreased on average by 15-20%, the injury and poisoning sickness rate decreased by 10-15%. At the same time blood system and cancer sickness rates increased. Increasing tuberculosis and syphilis (over 50% and over 25% correspondingly) are areas of particular concern. According to 1995 data, the tuberculosis sickness rate was 26.3% higher than in Europe and 2.8 times higher than in the EU, while the syphilis sickness rate was 82.3% and 74 times higher correspondingly.

National health service: network, human resources and financing

By the beginning of 1998 in Ukraine there were 3.4 thousand medical institutions with a total capacity of 503.2 thousand beds; 7.1 thousand hospitals with 964.1 thousand attending per shift; over 1,000 of first aid posts. Compared to 1985 the number of medical institutions decreased by 10.1%; that of hospitals by 12.7% and that of first aid posts by 22.6%.

The number of beds per 10,000 of the population in Ukraine of was 39.4% higher than in Europe and 66.8% higher than in the EU. These data prove that during the years of independence the network of health care institutions did not change and even increased according to some indicators. It is necessary to note here that compared to some European countries Ukraine has better indicators. For instance, in 1995 in Ukraine the ratio of beds per 10,000 of the population was 118.9, while it was 85.3 in
Table 4. Network of medical institutions (at the end of the year stated)

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>1990</th>
<th>1996</th>
<th>1997</th>
<th>1997 % to</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1985</td>
</tr>
<tr>
<td>Number of medical institutions, thousands.</td>
<td>3.8</td>
<td>3.9</td>
<td>3.7</td>
<td>3.4</td>
<td>80.5</td>
</tr>
<tr>
<td>Number of beds, thousands of beds</td>
<td>669</td>
<td>700</td>
<td>580</td>
<td>503</td>
<td>75.2</td>
</tr>
<tr>
<td>by 10,000 of the population</td>
<td>131.2</td>
<td>135.5</td>
<td>114.6</td>
<td>100.2</td>
<td>76.4</td>
</tr>
<tr>
<td>Number of hospitals, thousands.</td>
<td>6.3</td>
<td>6.9</td>
<td>7.1</td>
<td>7.1</td>
<td>112.7</td>
</tr>
<tr>
<td>Capacity of hospitals:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Thousands of visits per shift per 10,000 of the population</td>
<td>756</td>
<td>895</td>
<td>960</td>
<td>964</td>
<td>127.5</td>
</tr>
<tr>
<td>per 10,000 of the population</td>
<td>148.2</td>
<td>173.1</td>
<td>189.7</td>
<td>191.9</td>
<td>129.5</td>
</tr>
</tbody>
</table>

Table 5. The number of doctors and nurses (at the end of the year)

<table>
<thead>
<tr>
<th></th>
<th>1985</th>
<th>1990</th>
<th>1996</th>
<th>1997</th>
<th>1997 % to</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1985</td>
</tr>
<tr>
<td>Total number of doctors. thousands</td>
<td>211</td>
<td>227</td>
<td>229</td>
<td>227</td>
<td>107.6</td>
</tr>
<tr>
<td>by 10,000 of the population</td>
<td>41.3</td>
<td>44.0</td>
<td>45.2</td>
<td>45.1</td>
<td>109.2</td>
</tr>
<tr>
<td>Population per doctor ratio</td>
<td>245</td>
<td>228</td>
<td>224</td>
<td>222</td>
<td>90.6</td>
</tr>
<tr>
<td>Total headcount of medical institutions thousands</td>
<td>567</td>
<td>607</td>
<td>583</td>
<td>566.4</td>
<td>99.9</td>
</tr>
<tr>
<td>per 10,000 of the population</td>
<td>111.1</td>
<td>117.5</td>
<td>115.0</td>
<td>112.7</td>
<td>101.4</td>
</tr>
</tbody>
</table>

Europe and 71.3 in the EU. Thus Ukraine’s indicator is 39.4% higher than the European ones and 66.8% higher than the EU. Ukraine places 3rd in Europe (after Monaco and Moldova) by this measure.1

Compared to 1995 the network is better provided with human resources. (table 5.)

Compared to 1985 the number of doctors in Ukraine increased by 7.6% and the number of doctors per 10,000 of the population increased by 9.2%. The number of doctor assistants has almost not changed but if calculated per 10,000 of the population, it increased by 1.4%. All of these figures exceed those of European countries. The number of doctors per 10,000 of the population in Europe in 1995 was 32.4; in the EU 29.7, and in Ukraine 44.0, so it was 35.8% higher than in Europe and 48.1% higher than in the EU. The number of medical assistants per 10,000 of the population in Ukraine in 1995 was 53.6% higher than in Europe 99.7% higher than in the EU. Ukraine places 2nd by the number of doctors per 10,000 of the population and 5th by the number of medical assistants.2

1 Ed. In this area quantity doesn’t not necessarily mean quality of overall healthcare. In fact, if too much money spent on maintaining too many hospital beds, there will not be enough money to pay for the diagnostic equipment, medicines and other supplies, need to deliver the highest standards of healthcare. This is clearly a problem in Ukraine.

2 Ed. Here are again, excessive quantity may reduce quality. Substantial scope exists for improved efficiency that would make it possible for Ukraine to
Current budget expenditures for health care in 1992-1997 reached approximately 4% of GDP and 10% of consolidated budget (see Table 6).

GDP and in Germany were 10.7%, Switzerland 9.8%, France 9.4%. In Ukraine current budget expenditures on the health care system in 1995 were 4.6% of GDP (the general figure for the NIS is 3%).

The share of expenditures on health care from the consolidated budget has tended to grow (9.8% in 1992 compared to 11.4% in 1997). However, since GDP has been falling, the absolute level of funding for health care has decreased. In other words, even though the share of health care expenditures as part of GDP increased from 3.9% in 1992 to 4.2% in 1997, real funding decreased by 60-70% during 5 years. In 1992, 41% of funding was used to pay salaries; in 1997 it was necessary to allocate 60%. While the salary share increased by 20%, the share allocated for bandages and medicine dropped by half. Expenditures on food similarly decreased. During 1997 only 0.2% of all funding was spent on equipment and supplies.

Although quantitative characteristics of the healthcare system (i.e. the number of doctors per 10,000 of the population) increased, real funding decreased. In our opinion, this is the key cause of the inefficient national health service contributing to low life expectancy, high sickness rates and socially dangerous diseases such as syphilis, AIDS and tuberculosis.

Economic problems affect the quality of medical treatment. Problems such as wage arrears, indebtedness of medical institutions to communal service suppliers, lack of equipment and medical supplies, and the lack of any infrastructural repairs and exacerbate the problem.

Not all economic problems can be solved in the next few years, since the budget cannot sustain such expenditures. Therefore, it is necessary to look for radical ways of reforming this sector.

Evaluation of the current policy

State responsibilities are established in Clause 49 of the Constitution of Ukraine which states:

“Every individual shall have the right to medical treatment and medical insurance. Health care is provided by state funding of relevant social, economic, preventive, sanitary and medical programs. The State shall create conditions for effective and freely available medical treatment. State and municipal medical institutions provide medical services free of charge. The existing network of medical institutions shall not be reduced. The state shall promote development of medical institutions of all forms of ownership. The state shall support physical education, sport and fitness. The state shall provide sanitary and epidemiological safety.”

The statement on provision of free medical services by state and municipal medical institutions as well as a prohibition on reducing the existing network of medical establishments are noteworthy. These statements perpetuate all the disadvantages of the existing system and hinder reform. The economic mechanism used here is absolutely ineffective in the context of the current economic situation. Provisions allowing levies for services in state and municipal institutions adopted by the Cabinet of Ministers were annulled in 1998 by the Constitutional Court for being in breach of the Constitution of Ukraine.

The specific legislative framework of health care is defined by Basic Legislation for Health Care adopted in 1992, which particularly states: “... basic state health care policy is established by the Parliament of Ukraine through establishing Constitutional and legislative norms, principles, objectives of budget financing, establishing a system of relevant credit and financial, tax, customs and other regulators, approving complex and targeted state programs of health care.” Executive power has a restricted field of activities. However, over 60 issues have been regulated by Presidential Decrees and over 100 provisions of the Cabinet of Ministers and other departmental acts.

The declining state of public health proves that declared goals cannot be fulfilled and require complete revision.
Table 6. Current budget expenditures for health care in Ukraine

<table>
<thead>
<tr>
<th>Years</th>
<th>Total</th>
<th>Including</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Hospitals</td>
</tr>
<tr>
<td>1992, krbln</td>
<td>187.6</td>
<td>169.6</td>
</tr>
<tr>
<td>% of: GDP</td>
<td>3.9</td>
<td>3.52</td>
</tr>
<tr>
<td>Consolidated budget</td>
<td>9.8</td>
<td>8.70</td>
</tr>
<tr>
<td>1995, UAH, mln</td>
<td>2536.7</td>
<td>2364.6</td>
</tr>
<tr>
<td>% of: GDP</td>
<td>4.65</td>
<td>4.34</td>
</tr>
<tr>
<td>Consolidated budget</td>
<td>10.4</td>
<td>9.7</td>
</tr>
<tr>
<td>1996, UAH, mln</td>
<td>3151.3</td>
<td>2971.9</td>
</tr>
<tr>
<td>% of: GDP</td>
<td>3.9</td>
<td>3.65</td>
</tr>
<tr>
<td>Consolidated budget</td>
<td>9.2</td>
<td>8.70</td>
</tr>
<tr>
<td>1997, UAH, mln</td>
<td>3908.6</td>
<td>3676.2</td>
</tr>
<tr>
<td>% of: GDP</td>
<td>4.2</td>
<td>3.97</td>
</tr>
<tr>
<td>Consolidated budget</td>
<td>11.4</td>
<td>10.7</td>
</tr>
</tbody>
</table>

- Lack of medicine, equipment and technical supplies for medical institutions;
- Irrational organization of the current national health service, misbalance of primary, secondary and tertiary levels of medical treatment;
- Lack of modern medical technology;
- Insufficient informational support for modern medical technology;
- Ineffective state policy on promoting health and fitness;
- Lack of financial, particularly budget, resources for effective functioning of the health care system;
- Lack of effective marketing;
- Insufficient legislative basis that influences public health and effective administration of the health service; ineffective allocation of human, material, technical and financial resources.

III. FRAMEWORK FOR A NEW POLICY

OVERALL OBJECTIVES AND WAYS OF IMPLEMENTING THE NEW POLICY

One of the major objectives of any civilized state is to provide social and humanitarian development for its citizens based on economic growth. One of the strategic goals of any state is to increase life expectancy and support public health. Fulfillment of this goal depends not only on health service and its funding. The majority of experts agree that other factors such as standards of living, per capita incomes, fitness, and environmental protection are also important. Therefore, other objectives of state health care policy include the following:

- to promote fitness and preventive measures through educating population, developing a network of fitness institutions (sports centers, fitness clubs, etc.), and carrying out anti-bad-habit campaigns;
- to develop an effective national health service;
- to allocate material, technical and human resources effectively;
- to develop an effective system of environmental protection through penalizing enterprises that pollute the environment.
In order to fulfill the aforementioned strategic goals and solve the problems of health care in Ukraine, it is necessary to carry out the following measures:

Legal regulation of health care:

- revise regulatory acts which define state health care policy (in accordance with EU standards);
- develop measures for legal protection of patients and medical workers;
- introduce and develop modern medical technologies; effective diagnosis methods; preventive, treatment and rehabilitation methods;

Restructuring of the sector:

- Give priority to family practice doctors at primary health care level;
- Separate establishments providing primary, secondary and tertiary medical and sanitary treatment;
- Decentralize and privatize medical institutions;
- Encourage development of private medical practices;
- Encourage competitiveness among different medical practices, which would promote availability and quality of medical treatment;

Financing of the sector:

- Introduce a system of multi-source funding of health care based on obligatory social medical insurance;
- Promote private medicine and legalize the shadow sector for medical services.

Regulation of the market of medical services:

- Develop and improve the system of accreditation and licensing, which would promote different types of medical treatment;
- Develop a system of control over quality of medical treatment based on existing standards;
- Develop a system providing computer information; unify methods of work with information; develop informational network; and reform medical and statistical services;

- Improve healthcare administration at state, regional and local levels.

Preventive measures and promotion of fitness:

- Organize clinical examination centers that prevent and treat diseases and carry out preventive work in medical institutions;
- Protect rights, improve organization and effectiveness of the work of sanitary and epidemiological services;
- Improve the level public awareness and promote fitness.

Other measures:

- Train qualified specialists in the administration of health care who are able to reform the sector; organize training courses in the President’s Academy of State Administration as well as social medicine studies in the Academy of Post-graduate Education;
- Improve the system of medical education by training family doctors and their assistants;
- Develop healthcare systems in maternity, childhood, teenage health, elderly, disabled and victims of the Chornobyl disaster;
- Promote reforms in social security for different social groups, including; medical workers, policy makers, administrators and business people.

Some of the proposed measures will have a more significant effect than others, especially revising current legislation and establishing a system of multi-source financing of the health service. In more developed countries this sector is financed from the five following sources:

- Individual savings;
- Private insurance companies;
- Obligatory medical insurance funds;
- Budget funding
- Others such as charity contributions, foreign aid, etc.

Taking into account world experience, it is possible to maintain the existing system of financing from budget and insurance funds whilst reform-
Introducing a system of medical treatment. It is also essential to:

- Introduce a system of obligatory social medical insurance;
- Develop private medical insurance;
- Develop a system of paid medical services.

Inadequate state funding of medical treatment in the recent years has been caused by the high cost of some medical equipment. Neither the established Fund of obligatory medical insurance, nor private insurance companies are able to finance this treatment. It is possible only for the state when it allocates target funds.

Furthermore, it is necessary to implement key reforms in healthcare funding from the budget:

- Introduce methods of administration and new sources of financing for hospitals and other medical institutions;
- Promote a more effective allocation of resources.

Maintaining this as the main principle, it is necessary to use the most effective methods of payment for different types of medical treatment.

For instance:

- Payment for each first-patient and payment for each medical service provided in a clinic;
- Payment following treatment in hospital.

In the next few years it would be necessary to introduce a system of incentives for highly qualified medical workers who perform the most difficult functions. They could be taxation privileges, credits on purchasing a flat, a vehicle or medical equipment, etc. Among those medical workers are those who work in rural areas, first aid posts, infectious treatment centers, etc. 3

Prioritizing primary, secondary and tertiary medical treatment would greatly affect the functioning of the health service (especially in allocating budget funds).

For many years, specialization has been considered the means of increasing effectiveness and quality of medical treatment. For instance, in 1997 only 11% of the total professional headcount were medical therapists, compared to 30-40% in more developed countries. Hospitals which provide medical treatment for over 80% of all clients are funded from only 20% of all funds, including primary medical aid posts, which provide a major share of all treatment with only 5-7% of overall funding. As a result, some of the most qualified doctors provide services to clients who do not require such treatment.

Beds are allocated ineffectively. For instance, in 1995 the ratio of beds in hospitals was 21.9 per 100 people (the corresponding European ratio is 17.9, which is 18% less); in short-term clinics the bed ratio was 20.8 compared to 17.7 in Europe and 16.5 in the EU (15%-20% less). The average term of treatment in a hospital was 14.6 days compared to 10.6 days in Europe (27.6% less than in Ukraine) and 8.6 days in the EU (41% less). However, in 1991-1997 the level of hospitalization decreased substantially (from 25.5% in 1991 to 19.1% in 1997, which is 25% less). Every fifth person in Ukraine was treated in a hospital, even though some Ukrainian experts think that it was necessary for one in every three.

It is essential for the level of public health to initiate fitness promotion. Ukraine is beset by a lot of factors, which have negative effect on the health of its population compared to those in Europe. Some of them are abuse of alcohol (often of very low quality), drugs and bad nutrition. Further, very few people take part in physical activity such as sport. The other measures which would have the greatest effect are anti-pollution programs and environmental protection.

3 [Ed. While a case can be made for some in-kind privileges and incentives (e.g. car for doctors doing house calls in rural areas), it is generally better to provide direct budgeted financial monetary incentives, for these are more transparent less subject to abuse.]
### COMPARATIVE TABLE OF ALTERNATIVE PROSPECTIVE STRATEGIES

<table>
<thead>
<tr>
<th>Objectives</th>
<th>“Reforming the health care system and its financing”</th>
<th>“Improvement of the current health care system and legislative guarantees for its financing”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increase life expectancy and health</td>
<td>According to the provisions of the Constitution of Ukraine (Clause 49):</td>
<td>Provide free-of-charge medical treatment in state and municipal medical institutions</td>
</tr>
<tr>
<td>Promote fitness</td>
<td>Develop effective and freely-available medical treatment</td>
<td>Maintain the existing network of medical institutions</td>
</tr>
<tr>
<td>Promote environmental protection</td>
<td></td>
<td>Promote development of medical institutions of all forms of ownership</td>
</tr>
<tr>
<td>Develop effective market mechanisms for functioning of health care system</td>
<td></td>
<td>Promote physical education and sports</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Provide sanitary and epidemiological safety</td>
</tr>
<tr>
<td>What problem it solves</td>
<td>Insufficient state of public health</td>
<td>Unequal possibilities to receive high-quality medical treatment</td>
</tr>
<tr>
<td>Misbalance of demand and supply of medical services (i.e., amounts of medical services and funding available)</td>
<td>Misbalance of demand and supply of medical services (i.e., amounts of medical services and funding available)</td>
<td>Social protection for health care system workers (particularly, unemployment protection)</td>
</tr>
<tr>
<td>Key measures</td>
<td>Revise legislative basis for health care system.</td>
<td>Increase budget funding for medical institutions</td>
</tr>
<tr>
<td>Prioritize primary medical and sanitary aid based on family practice.</td>
<td>Restructure health care system. Retrain healthcare managers.</td>
<td>Strengthen control over allocation of budget funding for health care</td>
</tr>
<tr>
<td>Restructure health care system.</td>
<td>Develop multi-level funding based on obligatory medical insurance. Gradually develop a market for medical services</td>
<td>Introduce private practices with state support</td>
</tr>
<tr>
<td>Retrain healthcare managers.</td>
<td>Develop programs for fitness promotion and preventive measures</td>
<td>Regulate prices for health care services</td>
</tr>
</tbody>
</table>
"Reforming the health care system and its financing"      "Improvement of the current health care system and legislative guarantees for its financing"

<table>
<thead>
<tr>
<th>Possible outcomes</th>
<th>Short-term outcomes (up to 2 years):</th>
<th>Short-term outcomes (up to 2 years):</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Improved quality of medical services:</td>
<td>Increase of budget debts to health care institutions</td>
</tr>
<tr>
<td></td>
<td>Higher availability of quality services.</td>
<td>Lower quality of medical services</td>
</tr>
<tr>
<td></td>
<td>Efficient market for medical services.</td>
<td>Increased share of shadow medical services</td>
</tr>
<tr>
<td></td>
<td>Lower budget expenditure for health care.</td>
<td>Insufficient provision of medical services to the population</td>
</tr>
<tr>
<td></td>
<td>Gradual legalization of the &quot;shadow market&quot; for medical services.</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Long-term outcomes (over 3 years):</strong></td>
<td><strong>Long-term outcomes (over 3 years):</strong></td>
</tr>
<tr>
<td></td>
<td>Better state of public health</td>
<td>Lower overall state of public health</td>
</tr>
<tr>
<td></td>
<td>Effective health care system.</td>
<td>Decay of material and technical resources</td>
</tr>
<tr>
<td></td>
<td>Development of medical services market.</td>
<td>Misbalance of medical services provided and funding required</td>
</tr>
</tbody>
</table>

**IMPLEMENTATION OF THE NEW POLICY**

**Obstacles**

One of the main obstacles to implementing the new policy is the Constitutional provision stipulating free medical treatment in state and municipal medical institutions and prohibiting the decrease of existing medical networks. The most effective measure would be to revise the Constitution of Ukraine. However, it would be more realistic to implement recommendations of the Constitutional Court of Ukraine, establishing free-of-charge services provided by state and municipal health care institutions, with additional paid services.

73.7% of experts that took part in the survey said that current healthcare legislation requires major revision.

One of the main obstacles is public opinion on sources of financing of public health care:

- over 80% of expert in government and non-government agencies consider that it is necessary to attract funding from state and local budgets;
- over 70% of experts propose the introduction of paid services for people that are not considered part of low-income population.

Thus it is necessary to gradually introduce multi-source funding for the national health system and develop a public awareness campaign.

**Recommended Plan of Activities**

Considering results of the survey, experts proposed the following plan of activities:

Short-term activities (for 1999 – 2000):

- Develop and introduce a list of free medical services provided free of charge by budget funded medical institutions;
- Develop and introduce a mechanism of compulsory social medical insurance for the population;
- Develop and carry out anti-tobacco, anti-drug and anti-alcohol public awareness campaigns;
- Develop a preventive measures program in accordance with the Law of Ukraine "On Sanitary and Epidemiological Safety of the Population";
- Justify budget-funded quotas of beds and medical institutions;
- Develop a self-supporting medical environment in some regions of Ukraine;
- Prioritize allocation of human resources in hospitals and other medical institutions to promote first aid based on good family practice;
- Balance the number of medical workers trained in accordance with demand;
- Prioritize medical research and develop a competitive basis for funding scientific research;

Long-term activities (over 3 years):

- Revise and improve the network of medical institutions;
- Improve organization and structure of sanitary and epidemiological systems;
- Bring the number of medical workers in compliance with that of more developed countries;
- Support the domestic pharmaceutical and medical equipment industry;
- Introduce international standards for training of medical workers;
- Improve infrastructure;
- Develop a market for medical services with partial medical regulation (different forms of ownership, price-making, tax privileges, etc.);
- Regulate state guaranteed medical services;
- Introduce an effective system of monitoring the environmental and disseminating this information to the public.

IV. CONCLUSIONS

The Ukrainian health care system has almost not changed during the years of independence. In some ways it improved, especially in terms of capacity of medical institutions, the number of people per doctor, etc.). At the same time some indicators such as life expectancy, sickness rate, etc show dangerous declines. This is caused by the lack of state financing in this sphere, insufficient equipment and technology, and the lack of a physical fitness culture. Economic problems such as wage arrears to medical workers, debts to suppliers of heating and electricity, and suspension of renovation works also worsen the general state of the health care system.

All of this requires a radical revision of current state healthcare policies, development and implementation of very specific measures aimed at improving the state of public health and increasing effectiveness in allocating human, material and technical resources, which are attracted in this sphere.
6. INDUSTRIAL AND FOREIGN TRADE POLICY

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I. INTRODUCTION

Industry is one of the most important sectors of the national economy and a basis for meeting vital interests such as economic security and social and cultural development. Even now, when the Ukrainian economy is in the depths of an economic crisis which acutely effects industry, one third of GDP and more than three quarters of all goods consumed by the population are produced by the industrial sector.

Furthermore, industry performs an essential social function − it employs more than a quarter of all workers and provides more than a half of the population with their means of living. Industry is also an important factor in Ukraine’s integration into the world economy. Ukraine receives two thirds of all currency proceeds from the export of industrial goods.

Judicious industrial and foreign economic policies can create a radically new base for economic growth through promoting higher efficiency and competitiveness of industrial production, and exploiting the advantages of international division of labor. In Ukraine industrial and foreign economic policies determine major trends in socio-economic development and play a decisive role in economic reform.

Systematic analysis of strategic goals, key problems, legislative support and effective ways of carrying out industrial and foreign trade policies has helped to more precisely identify key problems in industrial development and provide alternative solutions. Such an analysis enables the formation of prospective economic models based on improving living standards through the effective use of national resources.

This report focuses on the fact that, during a period of falling demand for industrial products on internal markets, industrial production needs increasingly to be oriented towards exports.

The following factors are of key importance for successful economic reform: institutional reform, creation of efficient business ownership, and an improved legislative framework that would promote competition and business.

Successful implementation of proposals aimed at improving efficiency and competitiveness of domestic production would help Ukraine to enter world commodity markets, establish currency reserves required for modernization and restructuring of production, and foster economic prosperity.

The report is based on materials of various research and development institutions, comments of Ukrainian and international experts, and expert discussions. Of special importance for the preparation of this document were results of the investigation entitled Differences in Opinions of Experts (based on a poll of 42 experts from 13 governmental and 7 non-governmental institutions and organizations).

Results of this analysis will contribute greatly to practical work of the Government in accelerating market reforms and improving economic effectiveness. Furthermore, it will contribute to policies that create a positive image of Ukraine internationally, and stimulate Ukraine’s successful integration into the world economic community.

II. ANALYSIS OF THE EXISTING INDUSTRIAL AND FOREIGN ECONOMIC POLICIES

STRUCTURAL CHANGES

Analyses of the efficiency of existing industrial and foreign economic policies point to a significant evolution in approaches to economic reform between 1991-1998.

Two stages in this evolution can be noted:

- From 1991-94.

The search for market transformation models took place, by trial and error, through accelerated liberalization of economic relations both within the country and in external markets - and without sufficient assessment of internal conditions and peculiarities in the national economy.
The result was a significant loss of control over economic processes, inflation, and a dramatic decline in production.

- From 1995-98.

This was a stage of reflection on earlier experiences, leading to intensive efforts to counteract crisis phenomena, and initiation of more consistent and considered steps to adapt industrial enterprises to market conditions.

Measures taken by the Government during recent years have contributed to the stability of industrial production and export growth. However, the decline in industrial production has not yet been reversed.

Between 1991-1998, the volume of industrial output decreased: gross output decreased by 52%; gross value added fell by 63%.

**Graph 1. Dynamics of gross output of industrial production**

![Graph 1](image)

Output has declined at very different rates across sectors. Consequently, the share of the fuel and raw material sector (engaged mainly in production of primary products and semi-finished goods) increased from 33.3% in 1990 to 64% in 1998. In the same period, finished goods experienced considerable structural problems: the share of machine building and metal works decreased by almost 50%, the share of light industry by a factor of 7.2.

**Graph 3. Changes in the sector-by-sector structure of industrial production, 1990-1998**

![Graph 3](image)

The structure of production of materials continues to deteriorate. The share of the sector producing unfinished materials (chemical and oil-chemical industry, timber and pulp-and-paper industry) tends to decrease while the share of ferrous metallurgy increases.

**Graph 4. Changes in the structure of material production, 1990-9**

![Graph 4](image)
Especially acute structural problems arose in production of consumer goods. The share of consumer goods in total industrial output decreased from 31.3% in 1991 to 19.7% in 1998, in other words by one third. Provided the industrial output itself halved, consumer goods output has decreased in three times. Light industry has shown the greatest losses. While in 1990 light industry represented 10.8% of total industrial production and 10.2% of production of consumables, in 1997 these levels decreased to 1.5% and 5.1% respectively.

Similarly, technological decline in industry continues. Financing of research and development decreased from 3.1% of GDP in 1990 to 1.1% in 1998. Allowing for the general decline of GDP, real financing of science fell by a factor of 5. The number of specialists engaged in science and technology was 130.8 in 1998, almost 2.4 times less than in 1990.

The output of the most important types of high-quality unfinished products also decreased, in particular:
- basic oxygen steel
- arc-furnace steel
- sheet products
- heat-treated reinforced products
- casing tubes
- synthetic resins and polyvinyl
- chloride-based plastics and copolymers
- polystyrene-based plastics and copolymers
- rotary and rotary-conveyor lines and complexes

The depreciation and obsolescence of industrial fixed assets is significant. In the majority of sectors, depreciation reached up to 60%. According to expert estimates, this level has exceeded the 70% threshold in ferrous metallurgy sectors, the chemical and oil-chemical industry, and the food industry.
FOREIGN ECONOMIC ACTIVITY

Against the backdrop of decreased internal demand, foreign trade could be an important factor in future economic prosperity. This idea is increasingly supported by Government officials. However, practical realization of this idea has as positive as negative impacts.

Fortunately, that a relatively high share of exports has been maintained, despite the deepening production crisis. Between 1995 and 1998, industrial production dropped by 19.2% while export volume increased by 24.0%. In general, orientation of the industrial production of Ukraine to export increased from 31.9% to 34.6%.

The volume of exports increased due to further expansion into market economies such as Austria, Greece, Egypt, Iran, Spain, Syria, Turkey, and others.

A drawback of Ukraine's foreign strategy is the low production of capital goods and finished products. Primarily these have been products of high-tech sectors such as machine building. It is also a source of some embarrassment that Ukraine imports a significant volume of power resources, and then uses them mainly for production of primary raw materials and semifinished goods that generate almost no profit for the national economy.

The structure of foreign economic relations fails to improve. Ukraine's economic potential for increased exports is not fully realized through export of raw materials and semifinished goods. The share of mineral products, ferrous metals, products of the chemical industry and related sectors in total exports increased from 57% in 1995 to 59% in 1996 and 64% in 1998. At the same time the export potential of high-tech sectors particularly those of machine building, is used ineffectively. The share in total industrial exports of machines, equipment, transport vehicles, and devices decreased from 16% in 1995 to 14% in 1998.

Graph 8. Commodity structure of industrial exports and imports

Graph 7. Changes in the volume of industrial output and export, % 1994=100

The low competitiveness of domestic goods and the gradual loss of traditional markets for Ukrainian exports is the main cause of this trend. The share of the former USSR in the structure of commodity exports decreased from 55% in 1995 to 35.1% in 1998. The negative balance of trade in commodities was 24% in 1997 covered by export of services, in particular, transport ones.

The domestic market does not have a legal and organizational framework that promotes fair competition. The level of monopolization continues to be high in many national and regional commodity markets. At January 1, 1998, monopolistic enterprises numbered 410. On domestic markets, the highest degree of monopolization is in industries producing capital products, agricultural machinery in particular, as well as...
the chemical and oil-chemical industry, and metallurgy.

About 200 machine-building enterprises monopolize the production of 233 types of product. One third of all metallurgy enterprises and one half of chemical and oil-chemical industries producing 89 and 126 products respectively are monopolistic.

The lack of competition on domestic markets makes domestic industry more vulnerable to external competition. Additionally, there is no state strategy to support and encourage manufacturers of domestic goods, and imperfect information regarding the economy and development of competition in commodity markets. The problems in creating a competitive environment are significant, for example:

- Inefficient small, medium, and venture business, and imperfect mechanisms for their restructuring or liquidation; low pace of accumulation and concentration of legal capital; low professional level of domestic entrepreneurs.
- The lack of financial, credit, insurance, and share markets, and a deficient commodity exchange; poor regulation and unpredictability of such bodies; a lack of market information.
- A high tax burden on business; inconsistent and irrational policy of economic priorities; frequent changes in the "rules of the game"; the lack of reasonable protectionism for domestic manufacturers who have the potential to build up competitive advantages.

For example, the Law On Entrepreneurship of February 1991 was amended by 25 Laws of Ukraine and one Decree of the Cabinet of Ministers. As a result, the list of entrepreneurial activities subject to licensing grew from 11 in 1991 to 102 in 1997. The rules for issuing licenses are regulated by 3 Codes, 28 Laws of Ukraine, 23 Decrees of the President of Ukraine, 23 Resolutions of the Cabinet of Ministers of Ukraine, and 67 instructions.

**MARKET TRANSFORMATION**

Institutional reform has not yet developed of entrepreneurship and improved competitiveness. About 79.8 percent of enterprises employing 66.5 percent of workers and producing 68 percent of overall industrial output have changed their form of ownership from state to private. Unfortunately the change in form of ownership has not been followed by the establishment of an efficient layer of owners.

Though the main form of ownership in the non-state sector is that of collective form, the share of workers' collectives in "destatized" and privatized enterprises does not exceed 20 percent. The efficiency of collective enterprises increases very slowly. This results from flaws in tax, amortization, and credit policies, which stifle the profitability of collective ownership. In other words, conditions are created where the one form of workers' dependence, administrative, is replaced by another one – economic.

Small-scale enterprises (SSE) are becoming an essential factor in ownership reform. Their number increased by a factor of 5 relative to 1991, and SSE employees represent 6% of all the employable population of Ukraine.

**Graph 10. Changes in the structure of SSEs' forms of ownership by number of enterprises**

According to estimates, about 50% of operating SSEs evade taxes. In some sectors, almost one half of registered SSE either failed to commence operation or operate in a very irregular manner. Furthermore, unfair competition develops and actual material output fall. As a result, an ever-higher proportion of entrepreneurial capital is concentrated on non-productive and intermediary activities.

During the process of "de-statization" and privatization, owners often receive profits, not from producing and marketing goods, but from purchasing movable public sector assets like transport vehicles, material reserves, equipment, etc
at understated prices and selling them at much higher market prices.

Monetary policies have curbed inflation, but, at the same time, have suppressed investment in the real economic sector. The shortage of working capital forces enterprises to apply pseudo-market forms of settlement such as barter, give-and-take raw materials, mutual settlements, and other forms of shadow activity. This further restricts financial possibilities of businesses and budgets at all levels.

Graph 12. The rate of "barterization" in sectors of industry in 1998

According to estimates, industrial enterprises had loss from barter sales amounting to UAH 32 billion in 1998. Of this amount, almost UAH 4.6 billion would have been spent on wages. More than UAH 2 billion of amortization deductions and UAH 1.9 billion of profit was receivable.

As a result of lower cash profits, the State Budget failed to receive UAH 0.6 billion of tax revenue.

III. STRATEGIC VECTORS OF THE NEW POLICY

Strategic goals

Strategic goals of a prospective industrial policy include:

- stimulate business activity aimed at restoring industrial production through optimization of ownership and strategic investment, and implementation of tax reform accompanied by enhancement of the stimulatory role in fostering production and investment;

- plan and implement development priorities focusing on those centers of activity which are most likely to provide economic revival: science-intensive and high-tech sectors;

- introduce new technology, stimulate research and development activity aimed at improving technical and economic characteristics.

- reduce resource consumption and improve energy/output ratio by introducing resource-saving technologies, restructuring power and resource-intensive productions and converting to a more efficient sectoral structure;

- improve competitiveness and sales revenue by entering world markets; boosting the internal market through enhancing the level of equilibration of production; establishing technological cycles producing final goods; re-orientating machine building, metallurgy and chemical sectors to a better satisfaction of needs of inter-sector cooperation;

- social orientation to safe environmental practices to provide a significant increase in the standard of living, reduction of ecological cost, and a more efficient and equitable use of natural resources.
**Main tasks of industrial policy**

To achieve strategic goals, the Government should concentrate its efforts on the following major tasks:

- implement anti-crisis measures aimed at releasing the stagnation in financial and monetary-credit systems, and improvement of money turnover;

- accelerate institutional reforms that are essential for increasing the efficient functioning of a market economy, guaranteeing efficient management and use of ownership rights, anti-monopoly regulation, as well as development of competition.

- improve the management of state-owned enterprises and deregulate public sector management through application of bankruptcy procedures, restructuring of inefficient enterprises and adopting corporate management models;

- implement tax reform that simplify and stabilize the tax system and ease the pressure of taxation on entrepreneurs;

- reduce pseudo-market forms of economic relations, such as barter, use of give-and-take raw materials, mutual settlements, and other substitutes for business transactions;

- stimulate development of those sectors and types of production which have or may secure competitive advantages in the world market and provide real export growth;

- accelerate development of market infrastructure, including commodity exchange markets, free economic zones, transport terminals, banking and non-banking financial-credit establishments, modern communication systems, a market for information products, and integration with international information systems;

- establish a favorable investment climate, increase in the level of saving in the economy, especially the share of investment in fixed assets, encouraging technological innovation and increasing the efficiency and competitiveness of domestic production.

Assessing the current state of Ukraine's economy, it should be noted that mistakes in the formation and implementation of industrial and foreign economic policy are key factors that have resulted in halting development and the economic crisis.

**IMPROVING THE LEVEL OF COMPETITIVENESS**

**Prospective policy alternatives**

When discussing the variants of a prospective strategy for industrial and trade policy, two basic strategies are proposed:

- the first one implies state control (protectionism) over individual sectors;

- the other one advocates free market competition and hence market-determined implicit support of the high-priority sectors.

Competition-based strategy as a basic direction of the new policy has gained the support of the majority of Ukrainian and international experts. It was also noted that protection and competition are not radical antagonists. These two directions may interact and support each other and reduce exclusive reliance on the "invisible hand" of the market.¹

A search for, and application of, areas of interaction is especially important at the initial stage of market transformations, when the market-based sector, its infrastructure and legislative framework are underdeveloped.

**Tasks of a competition-based policy**

Creation and implementation of a competition-based strategy must be based on:

- assessment of competitive conditions in domestic and international market;

- implementation of economic restructuring to encourage accelerated development of competitive sectors and enterprises;

- improved use of national resources, first and foremost, reduction of the power and material intensity of production as a prerequisite for increased competitiveness;

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¹ Ed. A similar view is found in Hansen and Cook (1999), Chapter 8. "Handled properly, modest protection can facilitate the transition in carefully chosen cases to a fully competitive environment".
• accelerated institutional reforms;
• coordinated state and business efforts in developing of the economy’s competitive sectors;
• developing market infrastructure, establishing a training system and advanced training of experts in competition;
• improving and stabilizing the regulatory and legislative framework for competition and integration into the competitive world environment.

A competition-based strategy, in terms of an open economy, would allow enterprises to become more efficient and enter external markets.

**Obstacles to a competition-based strategy**

Participants of the poll reasonably pointed to obstacles that may hinder a competition-based strategy. These include:

- reliance of the majority of managers on state protectionism;
- danger of reckless liberalization of foreign economic relations, when the majority of business entities are not prepared to work in a competitive environment;
- excessively high interest rates, which render futile all entrepreneurial efforts aimed at modernization, technical investment, and restructuring of production;
- social problems of market-oriented transformations of the economy resulting from increased unemployment in regions.

The policy that would establish a competitive environment should be viewed not in the light of sectors but in the light of subjects of business activity. It is necessary to do away with the practice of explicit and implicit state subsidy of the economy. Special attention should be paid to establishing a favorable investment climate. Pricing and tax policies should create conditions for accumulation of capital not in the primary but in the high-tech sectors and sectors with a rapid capital turnover.

**Efficient use of national resources**

Relative to the world’s most developed economies, Ukraine ranks rather high in certain resource areas: agricultural land, labor force, and research potential. This provides Ukrainian manufacturers with the opportunity to secure competitive advantages in the world market.

But exploitation of these advantages is highly unsatisfactory at this point. In terms of efficient use of productive resources, Ukraine ranks far below developed economies. For example, in France the ratio of use of agricultural land is 11 times higher than that of Ukraine, labor forces – 15 times, fixed assets – 3 times, and research potential – more than 20 times higher.

Even allowing for the approximate nature of such comparisons, the shortfall is so large that it is essential to take it into account when formulating industrial policy. The low level of resource use is to a significant extent attributable to the crisis in the Ukrainian economy. Though there are some discrepancies in the use of productive forces in more stable economies, they are mainly determined by differences in the structure of production in those countries.

For Ukraine, whose economy is in a period of transition, measures of industrial policy aimed at improving the competitiveness should include identification of an optimum direction of structural changes as a high-priority measure. If the main criterion is competitiveness, the task would be to define high-priority sectors and productions which are able to provide competitive advantages in the short or medium term.

**Priorities of the competition-based policy**

Special attention should be paid to those sectors where Ukraine enjoys significant scientific knowledge and technological potential, including aircraft and aerospace rocket construction, power and agricultural machine building, ship building, instrument-making, and so on. These sectors may occupy favorable competitive positions in the world market and drive the development of other sectors.

Of high priority are:

- many sectors of the light industry (especially flax-processing, sewing and knitting)
- food industry (production of sugar, oil, fat, alcohol, meat, and dairy products)
- construction materials (production of cement, glass, marble, granites and related goods).
Table 1. Provision of selected economies with productive factors and efficiency of their use

<table>
<thead>
<tr>
<th>Economy</th>
<th>Arable area</th>
<th>Labor force**</th>
<th>Fixed assets</th>
<th>Research potential***</th>
<th>GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Great Britain</td>
<td>1.9</td>
<td>6.5</td>
<td>5.4</td>
<td>4.5</td>
<td>8.0</td>
</tr>
<tr>
<td></td>
<td>4.3</td>
<td>1.2</td>
<td>1.5</td>
<td>1.8</td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>15.6</td>
<td>3.4</td>
<td>4.7</td>
<td>1.0</td>
<td>4.2</td>
</tr>
<tr>
<td></td>
<td>0.3</td>
<td>1.2</td>
<td>0.9</td>
<td>74.4</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>1.2</td>
<td>9.3</td>
<td>9.2</td>
<td>5.3</td>
<td>9.6</td>
</tr>
<tr>
<td></td>
<td>7.8</td>
<td>1.0</td>
<td>1.1</td>
<td>1.8</td>
<td></td>
</tr>
<tr>
<td>Russia</td>
<td>22.3</td>
<td>21.1</td>
<td>10.8</td>
<td>39.5</td>
<td>4.0</td>
</tr>
<tr>
<td></td>
<td>0.2</td>
<td>0.2</td>
<td>0.4</td>
<td>0.1</td>
<td></td>
</tr>
<tr>
<td>USA</td>
<td>50.5</td>
<td>31.1</td>
<td>40.4</td>
<td>26.9</td>
<td>46.1</td>
</tr>
<tr>
<td></td>
<td>0.9</td>
<td>1.5</td>
<td>1.2</td>
<td>1.7</td>
<td></td>
</tr>
<tr>
<td>Ukraine</td>
<td>4.3</td>
<td>7.4</td>
<td>2.5</td>
<td>7.5</td>
<td>0.7</td>
</tr>
<tr>
<td></td>
<td>0.2</td>
<td>0.1</td>
<td>0.3</td>
<td>0.1</td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>3.5</td>
<td>5.6</td>
<td>9.0</td>
<td>3.2</td>
<td>8.2</td>
</tr>
<tr>
<td></td>
<td>2.3</td>
<td>1.5</td>
<td>0.9</td>
<td>2.6</td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>0.6</td>
<td>15.6</td>
<td>18.6</td>
<td>12.1</td>
<td>19.2</td>
</tr>
<tr>
<td></td>
<td>33.3</td>
<td>1.2</td>
<td>1.1</td>
<td>1.6</td>
<td></td>
</tr>
</tbody>
</table>

*In numerator - provision with the factor as % to the total; in denominator - ratio of efficiency of use calculated as GDP per unit of the factor relative to the average level.

** Based on population employed in all sectors of the economy.

*** Based on the number of the employed in the research sector.

Source: “Science and scientific services”

The above products strongly rely on agricultural resources, labor resources and natural deposits of non-ore materials. In addition, capital turnover in these sectors is rapid and the sectors provide significant budget receipts.

Basic sectors of Ukraine’s industrial complex (electric power production, ferrous metallurgy, chemical and oil-chemical industry, whose export orientation is rather high) continue to be a key vector of the competition-based strategy. However, for them to preserve their export orientation, technological renovation, diversification, and improvement of performance are essential.

Key problems of the competition-based strategy

In transitional economies, apart from purely material conditions for successful competition, the basis advantages through competition depends significantly on the state of institutional reforms in the economy.

In Ukraine, unresolved problems include:

- the limited number of efficient business entities.
- undeveloped market infrastructure.
- unstable and unbalanced legislative framework for competition.
Industrial policy should take a more effective and pragmatic position in creating conditions fostering solution of these problems.

**ACCELERATION OF INSTITUTIONAL TRANSFORMATION**

The main vehicles of competitive strategy are manufacturers and sellers of goods. In Ukraine, despite active reforms in the structure of ownership, a layer of efficient owners capable of successfully tackling the competitive problems is still lacking. This is to a significant extent determined by the inefficient structure of ownership rights. Though almost 4/5 of industrial enterprises have changed form of ownership, the share of workers' collectives in “destatized” and privatized enterprises is only 20%. Only 1.7% of fixed assets are privately owned.

**Graph 13. Structure of forms of ownership**

The establishment of a layer of efficient owners, and hence the basis of an efficient competition-based strategy, is also restricted by low savings and low concentration of capital in the form of efficient corporate business structures. One more factor is the low professional level of managers.

**Development of efficient owners**

In order to accelerate the process of efficient ownership, the following policy measures should be undertaken:

- to improve legislation dealing with restructuring and privatization of enterprises and provide more effective support to small and medium-sized and venture business,
- to foster financial-industrial integration through improving existing legislation dealing with industrial and financial groups in Ukraine; to extend the rights of corporate associations to meet world standards.

In the course of discussions, some differences in opinions were revealed. In particular, some critics did not agree with our position that the state should stop granting special privileges to selected enterprises or that it should stop establishing government-supported financial-industrial groups. With all due respect to the views of our critics, we can not agree that such policies are justified give the realities of Ukraine's transition today to a market-oriented economy.

**Development of small and medium-sized business**

Special attention should be paid to small and medium-sized and venture business. The framework of a new industrial and foreign-economic policy should provide for the extension of the regulatory and legislative framework and increase of financial opportunities available to entrepreneurs.

Ukraine should deregulate entrepreneurial activity and exempt from taxation the portion of corporate incomes used for investment and reinvestment in business. In the future, any state intervention in the right of enterprises to use amortization funds should discontinue, and a regime of accelerated amortization should be implemented.

To encourage export orientation, the government should implement a mechanism of pre-export guarantees for to manufacturers of competitive goods against contracts with foreign customers. Another measure would be to use all the issued money to provide long-term credits of competitive export-oriented projects through a process of tender.

It is reasonable to more widely levy tax on business activity and switch from a restrictive tax policy to a policy supporting and encouraging production by reducing of the rate of VAT, extending the tax base, and re-considering the exemption system.
Small enterprises should apply a simplified accounting system and International Accounting Standards.

Bankruptcy legislation needs improving to simplify and accelerate bankruptcy procedures and restructuring of inefficient business entities, including those having outstanding credit indebtedness.

**DEVELOPMENT OF MARKET INFRASTRUCTURE**

A prerequisite for successful market economies in general and development of fair competition is a developed market infrastructure. In Ukraine, however, the financial-credit, insurance, and share markets are underdeveloped. A similarly undeveloped infrastructure for production (commodity exchange markets, trade houses, chambers of industry and commerce, business centers, regional funds to support entrepreneurship) and restricted information available to entrepreneurs to both concerning internal and external markets contribute to this problem.

Efficient competition is hindered by the lack of a concept identifying the priorities of the national economy in the international division of labor, and the lack of a system of measures to support manufacturers who are able to increase the efficiency of production, secure competitive advantages, and compete in the marketplace. Excessive liberalization and vulnerability of the Ukrainian economy to imports makes the situation even more complicated, especially given the fact that the majority of manufacturers are not in a position to operate in a competitive environment.

We consider that conditions should be created to increase the number of various consulting centers rendering services to enterprises and the government. Foreign banks, insurance companies, and investment funds should have easier access to the Ukrainian market. Special attention should be paid to the establishment of a system of training and advanced training of experts in the problems of competition and management.

A comprehensive state program “Increasing the Competitiveness of the Ukrainian Economy,” would combine restructuring, investment, and industrial policies and have a positive long-term affect on production.

In the near future, material encouragement should be given to the infrastructure sector, in particular, the following should be tax exempt:

- bank yields from long-term (5 years and longer periods) credits;
- securities (subject to operation of the National Depository);
- income from deposit accounts with those banks whose controlling interest is held by non-residents;
- profits of commodity exchanges, insurance companies, investment funds, etc.

A National Agency supporting state industrial strategy such as those in the USA, Canada, South Korea and some other countries would foster competitiveness in production. This type of organization was created in countries where the environment had always been competitive.

**IMPROVEMENT AND STABILIZATION OF THE REGULATORY AND LEGISLATIVE FRAMEWORK**

The poor economic logic behind laws and regulatory acts dealing with taxation, tariffs and currency regulation, and the system of benefits all combine to undermine the stability of the legislative framework. Numerous changes in the “rules of the game” on the commodity and service markets interfere with successful competition not only from domestic but also from foreign participants in the market.

As a result, improving the legislative framework for competition and economic relations in general must become a key challenge in the comprehensive system of measures to be developed and implemented. In particular it would be expedient to:

- introduce a 5-year moratorium on any changes in existing legislation, except for those fostering competitiveness of business entities and economy in general;
- remove obstacles hindering Ukraine’s membership of GATT and the WTO and free trade agreements with the European Union;
- discontinue any intervention in the legislative framework for competition without an
A common problem for the newly independent states is that almost all of them, when developing their industrial policy and competition-based strategies, must address the issue of measures aimed at investment in productive capacity and improvement of competitiveness.

There are not only common problems but also common solutions. Along with internal mobilization of financial resources (development of the financial and share markets and relevant tax and credit policies), it is possible to find at least a partial solution to the problem of foreign investment by making use of the economic potential of CIS member states.

We do not mean only mutual financial subsidies, but also by creating a beneficial international climate. In other words, it is necessary to coordinate tariff and non-tariff regulation policies, political and diplomatic support to exports, support to joint ventures producing export goods for domestic and foreign markets.

The significance of this particular aspect of the problem has increased because Ukraine’s share of export among other post-Soviet countries has decreased substantially, from 55.2% in 1995 to 35.1% in 1998.

When enterprises are in competition, the state must not be a mere spectator.

An economy is to succeed only when:

- the state creates a competitive environment,
- when particular enterprises and industries feel state pressure to carry out a competitive strategy,
- when state policies foster development and support of stable political and economic relations with potential partners and competitors in world markets.
## Comparative Analysis of Alternative Strategies of the Industrial Policy

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Liberalization</th>
<th>Competitiveness (proposed by authors)</th>
<th>Protectionism</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Goals</strong></td>
<td>Improved efficiency and competitiveness of the economy through efficient use of available resources</td>
<td>Increase in the number of subjects and sectors of Ukraine’s economy competitive in the world market</td>
<td>Stage-by-stage increase of competitiveness of internal (domestic) manufacturers</td>
</tr>
<tr>
<td><strong>Problems to be solved</strong></td>
<td>“Hand management” of the economy</td>
<td>Poor adaptation to market conditions</td>
<td>Pressure of foreign competitors on domestic manufacturers</td>
</tr>
<tr>
<td></td>
<td>Sector and price disproportion</td>
<td>Limited integration into the world market</td>
<td>Loss of market share to imports</td>
</tr>
<tr>
<td></td>
<td>Losses of enterprises and non-competitiveness in many sectors</td>
<td>Increase in the number of non-competitive sectors</td>
<td>Preservation of existing enterprises in the internal market</td>
</tr>
<tr>
<td></td>
<td>Need to subsidize individuals sectors and enterprises</td>
<td>Low efficiency of exports</td>
<td>Outflow of capital abroad</td>
</tr>
<tr>
<td></td>
<td>“Shadow” capital</td>
<td>Lack of competitive Ukrainian capital</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Low attractiveness of the economy to investors</td>
<td>Reluctance of domestic and foreign capital investors to invest</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Uncertainty on the side of competitive enterprises and sectors</td>
<td>Low internal demand for national scientific and technological potential</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Lack of rapid concentration of capital in the profitable sectors</td>
<td>Lack of conditions for development of competitive small and medium-sized business</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Underdevelopment of small and medium-sized businesses</td>
<td>Significant number of critical imports</td>
<td></td>
</tr>
<tr>
<td><strong>Way to solve the problems</strong></td>
<td>Decrease in tax pressure</td>
<td>Tax pressure would be reduced by way of exemptions on profits used for investment</td>
<td>Budget subsidies for the economic security to be kept</td>
</tr>
<tr>
<td></td>
<td>Liquidation of tax exemptions</td>
<td>Legislative implementation of the right of ownership to land plots under enterprises</td>
<td>Provision of tax exemptions and state guarantees of loans for enterprises engaged in high-priority sectors of the economy</td>
</tr>
<tr>
<td></td>
<td>Deregulation of business activity</td>
<td>Stimulated development of market-oriented, financial-credit and exchange-market infrastructure, including though exemptions conditioned by re-investment of funds</td>
<td>Extension of protectionist customs duties and application of quotas to imports that may be produced by non-monopolized domestic producers</td>
</tr>
<tr>
<td></td>
<td>Discontinuance of any explicit and implicit budget subsidization of privatized enterprises and sectors</td>
<td>Encouraged concentration of national capital through establishment of industrial-financial groups and trans-</td>
<td>Liquidation of tax exemptions for imports</td>
</tr>
<tr>
<td></td>
<td>Implementation of cash-driven privatization (against investment commitments) of all state-owned enterprises, except for public enterprises</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Implementation of mortgage rights, unconditional liquidation of inefficient enter</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strategy</td>
<td>Liberalization</td>
<td>Competitiveness (proposed by authors)</td>
<td>Protectionism</td>
</tr>
<tr>
<td>----------</td>
<td>----------------</td>
<td>---------------------------------------</td>
<td>---------------</td>
</tr>
<tr>
<td>Maximal liberalization of foreign economic activity</td>
<td>Implementation of a regulatory policy in the currency market with a view to making it attractive for exporters</td>
<td>Implementation of a tight regulatory policy in the currency market with use of a fixed currency corridor and compulsory sale of currency proceeds</td>
<td></td>
</tr>
<tr>
<td>Liberalization of administrative restrictions in the currency market and implementation of a floating exchange rate</td>
<td>Discontinuation of explicit and implicit subsidization of non-profitable sectors and unconditional liquidation of inefficient enterprises</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Introduction of private ownership to land</td>
<td>Deregulation and simplification of the tax and accounting system for small and medium-sized business</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Discontinuation of retroactive amendments in the “rules of the game”; new provisions may be enacted only after a set period of time (6 to 12 months) after their publication</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Consequences of implementation:**

<table>
<thead>
<tr>
<th>Short-term (first 2 years)</th>
<th>Increase in imports</th>
<th>Establishment of a favorable investment climate</th>
<th>Boosted internal production</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reduction of internal production in non-competitive sectors</td>
<td>Acceleration of restructuring and technological renovation of production</td>
<td>Preservation of jobs</td>
</tr>
<tr>
<td></td>
<td>Numerous bankruptcies of enterprises and liquidation of entire sectors of the economy</td>
<td>Limitation of pseudo-market forms of economic relations</td>
<td>Increased budget revenues from taxes and import duties</td>
</tr>
<tr>
<td></td>
<td>Increased unemployment</td>
<td>Establishment of Ukrainian industrial-financial groups and trans-national corporations and</td>
<td>Possible increase in investment, including foreign, that wish to “penetrate tariff barriers”</td>
</tr>
<tr>
<td></td>
<td>Increased pressure on the budget resulting from lower tax revenues.</td>
<td>Swift increase in the number of new small and</td>
<td></td>
</tr>
<tr>
<td>Strategy</td>
<td>Liberalization</td>
<td>Competitiveness (proposed by authors)</td>
<td>Protectionism</td>
</tr>
<tr>
<td>----------</td>
<td>----------------</td>
<td>---------------------------------------</td>
<td>---------------</td>
</tr>
<tr>
<td>Long-term (more than 3 years)</td>
<td>medium-sized enterprises and their bankruptcies and liquidation</td>
<td>competition in the Ukrainian market</td>
<td>Extension of the duration of market adaptation and increased competitiveness of the economy</td>
</tr>
<tr>
<td></td>
<td>Aggravation of social problems</td>
<td>“Soft landing” solution of social problems related to adaptation of the economy to market term</td>
<td>Aggravation of budget problems as a result of insufficient investment attractiveness of the economy</td>
</tr>
<tr>
<td></td>
<td>Swift reduction of the number of loss-making enterprises and sectors</td>
<td>Swift reduction of the number of loss-making enterprises and sectors</td>
<td>Loss of state leverage over competition and efficient use of natural resources</td>
</tr>
<tr>
<td></td>
<td>Significant inflow of investment capital</td>
<td>Increased investment and financial attractiveness of the economy</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Economic growth on account of individual most competitive productions engaged in the existing sectors and new sectors, which would arise due to inflow of internal and external investment</td>
<td>Separation of competitive clusters of the economy</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Membership of GATT – WTO and entrance into world markets</td>
<td>Deep integration of Ukrainian industrial-financial groups and transnational corporations in the world economy</td>
<td></td>
</tr>
</tbody>
</table>

**IMPLEMENTATION OF A PROSPECTIVE POLICY**

*In general, the industrial policy proposed by the authors gained large support from experts from both governmental and non-governmental establishments and organizations.*

**Major differences in opinion**

Even concerning issues where differences in opinions are the greatest (Table 2), the share of those supporting proposed measures exceeds the 50 percent threshold. However, the existence of opposite opinions requires a more careful and considered approach to measures related to implementation of the prospective policy.

The largest disagreement concerns the issue of increasing industrial competitiveness through enhanced state regulation. Lack of consensus on this issue may hinder the implementation of a competition-based strategy and, therefore, requires additional reconciliation of opposing positions.

There is also a lack of unanimity as to the approaches to creation and concentration of legal capital as a basis for internal investment. This concerns the restriction of the state’s rights in establishment of efficient business structures of a corporate type. The lack of agreement on this would interfere with creating “locomotives” of restructuring, that is, large-scale enterprises able to concentrate significant investment capital and foster the establishment of a competitive layer of business structures in many sectors of global competition.

A significant aspect of estimating the efficiency of financial and business activity of enterprises is the attitude to the “human factor.” An obstacle to increasing the efficiency of financial and business activity of enterprises and developing consulting companies may be the disagreement on the question about sufficiency of the level of professional training of state officials and entrepreneurs and the system for advanced training of specialists in market-based economy.
Table 2. The issues with the lowest degree of agreement

<table>
<thead>
<tr>
<th>Question</th>
<th>Supported, %</th>
<th>Not supported, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Competitiveness of industry may be increased by way of:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>increasing exports and decreasing imports</td>
<td>59.5</td>
<td>54.5</td>
</tr>
<tr>
<td>state regulation of industry and foreign economic policy</td>
<td>50</td>
<td>31</td>
</tr>
<tr>
<td>Inefficiency of financial and business activity of enterprises is determined by:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>level of professional training of state officials and entrepreneurs</td>
<td>57.1</td>
<td>45.5</td>
</tr>
<tr>
<td>lack of practical experience of operation in market conditions</td>
<td>45.2</td>
<td>45.5</td>
</tr>
<tr>
<td>lack of a system of advanced training of specialists in market economics</td>
<td>59.5</td>
<td>36.4</td>
</tr>
<tr>
<td>Low rate of accumulation and concentration of legal capital results from:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>significant restrictions in the legislative framework dealing with establishment of corporate-type business structures</td>
<td>54.8</td>
<td>45.5</td>
</tr>
<tr>
<td>restriction of the rights of corporate associations to the benefit of the state</td>
<td>52.4</td>
<td>63.6</td>
</tr>
<tr>
<td>underdevelopment of the financial-credit, insurance, and share markets is caused by insufficient state support to formation of market infrastructure</td>
<td>69</td>
<td>90.9</td>
</tr>
</tbody>
</table>

1 GO - representatives of government organizations,
2 NGO - representatives of non-state organizations

The issues on which a high level of consensus was revealed

The issues on which a high level of consensus was revealed actually coincide with the strategy proposed by the authors (see Table 3).

This concerns, first of all, the strategic goal – to increase economic competitiveness by way of creating favorable conditions for the development of entrepreneurship, irrespective of the form of ownership. That is, there is consensus that development of entrepreneurial activity may significantly influence the development of the Ukrainian economy and thereby solve pressing social problems.

Respondents (both governmental and nongovernmental) fully support proposals related to improving the mechanisms of bankruptcy, restructuring inefficient business entities, and mechanisms of responsibility of owners for unsatisfactory management.

Issues having a high degree of consensus also outline the ways to solve the key problems proposed by the authors.
Table 3. The issues with the highest degree of agreement

<table>
<thead>
<tr>
<th>Question</th>
<th>Support, %</th>
<th>Not supported, %</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>GO</td>
</tr>
<tr>
<td>Competitiveness of industry depends on:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>creation and introduction of innovations in production</td>
<td>95.2</td>
<td>96.8</td>
</tr>
<tr>
<td>creation of a stable and considered legislative framework</td>
<td>92.9</td>
<td>93.6</td>
</tr>
<tr>
<td>Development of small, medium-sized, and venture business will be fostered by simplification and improvement of tax system and enhancement of its stimulatory functions</td>
<td>90.5</td>
<td>90.3</td>
</tr>
<tr>
<td>Imperfection of mechanisms of restructuring and bankruptcy of inefficient business entities results from the lack of:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>responsibility for unsatisfactory management of assets</td>
<td>97.6</td>
<td>96.8</td>
</tr>
<tr>
<td>experience of bankruptcy and restructuring problems</td>
<td>69</td>
<td>67.4</td>
</tr>
<tr>
<td>Underdevelopment of financial-credit, insurance, and share markets is determined by the unstable economic situation and unstable national currency</td>
<td>88.1</td>
<td>87.1</td>
</tr>
<tr>
<td>Underdevelopment of the market for means of production in industry manifests itself in:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>high risks for possible investors</td>
<td>88.1</td>
<td>87.1</td>
</tr>
<tr>
<td>limited scope of domestic market information and consulting infrastructure</td>
<td>66.7</td>
<td>64.5</td>
</tr>
<tr>
<td>insufficient marketing activity of business entities</td>
<td>81</td>
<td>83.9</td>
</tr>
<tr>
<td>High tax pressure on business subjects is caused by:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>inefficient tax policy, whose main function is fiscal (enforcement-aimed) rather than stimulatory</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>existence of numerous charges and legally required payments that increase the prime cost of products and decrease their competitiveness</td>
<td>95.2</td>
<td>96.8</td>
</tr>
<tr>
<td>Instability of the legislative framework (&quot;rules of the game&quot;) is caused by insufficient economic substantiation of laws and regulatory acts dealing with taxation, tariff, and currency regulation and provision of benefits</td>
<td>88.1</td>
<td>90.3</td>
</tr>
</tbody>
</table>
Obstacles to implementation

Based on the poll’s results, one can conclude that the strategy proposed by authors enjoys general support of both governmental and non-governmental experts. Some opposition to the proposed strategy may be anticipated on the following issues:

- the role of the state in implementing export/import policy;
- system of training and necessity of advanced training of specialists (both government officials and entrepreneurs) in the issues of competition;
- deregulation aimed at creating and concentrating legal capital as a basis for internal investment;
- establishment of efficient corporate structures and reduction of state interest in them.

Recommended sequence of actions

Results of the poll suggest that all experts from both governmental and non-governmental organizations support proposals aimed at further improvements in industrial and foreign economic policy as developed by the authors.

The following aspects industrial policy may be reckoned as promising:

- development of small, medium-sized and venture business;
- development of financial and consulting infrastructure;
- stabilization of the legislative framework to support competition.

IV. CONCLUSIONS

A strategy aimed at improving competitiveness as a high-priority of industrial policy is comprehensive by nature. Its advantages are eventually realized through trade. The basis of competitive advantages is created at all stages of production and involves a wide circle of economic relations regulated by economic policy.

Preferring a comprehensive system-based approach to solving central economic problems faced by Ukraine, the authors consider it necessary to focus attention on the following key problems:

- expanding the number of efficient business subjects with initial focus on the development of small, medium-sized and venture businesses;
- transition from fiscal (enforcement-oriented) policy to the policy which supports and fosters production by reducing and differentiating of VAT rates,
- practical application of bankruptcy procedures and improvement of existing legislation on the basis of this experience,
- further deregulation of entrepreneurial activity,
- implementation of accelerated amortization and cancellation of any state intervention into the right of entrepreneurs to use amortization funds at their discretion,
- tax exempt corporate profits used for investment and re-investment
- tax exempt bank profits gained from provision of long-term credits of more than 5 years to manufacturers
- tax exempt profits in commodity exchange markets, insurance companies, investment funds, etc.,
- establishment of a National Agency for research and methodological development of the state strategy aimed at improving economic competitiveness,
- cessation of intervention in the existing legislative framework without comprehensive substantiation of economic expediency, in particular, from the standpoint of a favorable influence on the economy’s competitiveness.
- developing market infrastructure, mainly financial and consulting facilities;
- providing stability of the legislative framework fostering competition, that is, "equal rules of the game".

For this to be achieved, relatively small investment resources are needed but solving this problem will give a considerable stimulus for domestic producers to compete efficiently.

The authors duly respect comments and proposals of the opponents related to:

- reform of the tax system – reduction of the level of taxes and introduction of additional incentives for capital-intensive enterprises;
- modernization and technical investment – reduction of power and material intensity of Ukrainian goods and improvement of their competitiveness;
- expansion of the capacity of the internal market through increased levels of wages and salaries and normalization of the financial and credits system.
7. SHADOW ECONOMY POLICY

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I. INTRODUCTION

The shadow economy exerts a significant influence on the socio-economic and political condition of a country. According to experts, shadow economic activity is increasing throughout the world. Adverse effects of the shadow economy include leakage from the circular flow of national income, significant growth of shadow capital, illegal export of capital to other countries, loss of investment resources, reduction of tax receipts, imbalance in state budgets, increased inflationary pressures, differences in income levels, etc.

One of the most dangerous effects of the shadow economy is the growth of criminal activity: an increased crime rate, misdemeanors in office, and economic offences, and large-scale growth of organized crime, which leads to loss of government regulatory control.

Accumulation of significant shadow capital allows certain groups to monopolize entrepreneurial activity and exert influence on all types of economic activity, including state and regional authorities, members of parliament, political parties, the mass media, and so on. This leads to an increase in crime based on the struggle for wealth and the attempt to gain control over any profitable entity. The shadow economy is also a basis for anti-government and unconstitutional acts, and for corruption.

In Ukraine, the size and influence of the shadow economy is especially large. According to various estimates, it equals that of the official sector. Due to this, investigations of the problems related to the shadow economy and its influence on all the spheres of political and socio-economic life are of special importance.

Problems related to the growth of the shadow economy are the focus of government officials and scientists in many countries. Despite the rapid growth of the shadow economy in Ukraine, neither researchers nor state officials have displayed much interest in this phenomenon. Individual scientific papers or presentations in the mass-media as well as ad-hoc decisions made by bodies of power have not been able to change a passive acceptance of the shadow economy.

Results of investigations and analysis of the shadow economy in Ukraine suggest that underestimating such a complicated phenomenon as the shadow economy results in miscalculations and errors in policy formulation where economic indices are used as a basis for calculation.

Considering that the shadow economy and the official economy are comparable in terms of size, investigating the shadow economy and developing policy proposals aimed at controlling it is a pressing challenge.

The main tasks of this investigation were to:

- identify the main types of growth in the shadow economy,
- identify the benefits of shadow business and adverse effects of the shadow economy,
- identify the causes of shadow economy growth,
- define the main directions of activity aimed at restricting the shadow economy, which may and should be developed in future projects and programs.
- present measures aimed bringing the shadow economy into the legal sphere and restricting its scale and volume.

This report is based on materials of various governmental and research and development institutions, comments of Ukrainian and international experts and expert discussions. Of special importance in preparing this document were the results of an investigation of differences in expert opinion as revealed in a poll involving 51 experts from governmental and non-governmental organizations and businesses.

The report defines peculiarities and causes of growth and transformation of the shadow economy in Ukraine, and how it affects the political and socio-economic condition of the state. We give a definition of the shadow economy and list the main types of shadow economic activity requiring practical restrictive measures. The dynamics of shadow economy activity in Ukraine between 1990-1997 are given. The report gives evidence of the adverse effects of large-scale
shadow economy growth. Short and long-term tasks and activity of power authorities aimed at reducing the shadow economy are discussed. It also describes the economic benefits which may be achieved by reducing the shadow sector and legalizing it.

The authors of this report are grateful to all experts who responded to the questionnaire and specialists who participated in assessment of the materials of this project and provided their recommendations and proposals regarding individual sections, issues, and estimates. We consider that the work related to the problems of the shadow economy must continue on a permanent basis if the Government’s interest in seriously addressing this problem is real.

II. THE SHADOW ECONOMY IN UKRAINE

CHARACTERISTIC OF THE CURRENT SITUATION

The heavy tax burden established in Ukraine as well as a significant number of restrictions, bans, obstacles to business, and lack of a clear perspective for the development of the private sector, in guaranteed irreversibility of economic reforms, inviolability of private property and private capital have all resulted in a significant growth of the shadow economy in Ukraine.

37% of experts consider that there are no entrepreneurial structures in Ukraine not in some way involved in shadow economic activity.

In Ukraine, investment activity has decreased dramatically. Shadow capital has become the main form of investment. However, the complexity of shadow capital legalization, which is a prerequisite for the use of shadow capital as an investment resource, was the main cause of falling capital investment in the Ukrainian economy. The volume of capital investment displayed a fourfold decrease from 1990 to 1997.

Against this background, the trend towards illegal capital export stabilized. According to expert estimates, USD 20–25 billion was illegally exported from Ukraine in the last 7 years.

A significant tax burden on wages (in some periods up to 90%, though the average wage was around $40) and excessive payroll taxes encouraged commercial managers to pay only a minimum official wage and pay real wages in foreign currency, thereby circumventing the tax system.

The practice of payments in cash extended to involve the sphere of contracts and agreements. The need for a significant cash resources circulating outside the banking system has resulted in various schemes and structures to obtain them.

Currently, almost 50% of the money supply (more than UAH 6.1 billion as of early 1998) is circulating outside the banking system. As a result, new kinds of shadow activity evolved in production, distribution systems, financial structures, banking, and other spheres.

It should be also mentioned that despite the low level of official wages and salaries (the salary of a government minister was only a little more than USD 100 in late 1998) and social payments, Ukraine has significant wage and social arrears. This problem cannot be solved without economic growth.

State institutions and their employees failed to efficiently respond to these challenges, whose scale and volume is increasing rapidly. The inability to do this is attributable to the reluctance of state officials to seriously address the problem, and the lack of expertise to do so.

The lack of resources to solve economic problems has forced the government to secure loans from world financial organizations. This has resulted in increased foreign debt, which currently exceeds USD 10.5 billion, or almost 40% of estimated GDP for 1999. Internal debts and Ukraine’s dependence on other countries also tends to increase.

Therefore, the economy finds itself in a state of crisis and can provide neither an environment for development nor social guarantees to the population. This endangers political and economic independence. A peculiarity of Ukraine is that nobody bears responsibility for economic problems. The principle of collective irresponsibility continues to work, but in new conditions.
DEFINITION OF THE SHADOW ECONOMY

Despite active discussions dealing with problems related to the shadow economy in the early nineties, a commonly acceptable definition of the shadow economy does not exist. This complicates the phenomenon and efficient decision-making. To some extent, this is attributable to the fact that many different specialists (economists, lawyers, law-enforcement and tax officials, etc.) deal with such problems. Each of them gives a definition of the shadow economy which reflects their particular situation, and the majority of these definitions do not coincide. Opinions of economists and experts differ not only in defining the notion of shadow economy, but also in assessment of factors that brought it about and allow it to proliferate.

**Constituents of a shadow economy**

To understand the nature of the shadow economy and create prerequisites for effective ways of restricting it, a definition of the shadow economy should embrace the whole range of possible constituents and types of activity related to it. A definition should include the following constituents:

- Economic activity which is not concealed from state authorities but for various reasons

...is not accounted, controlled and taxed by the state.

- Legal economic activity where full or partial evasion of tax levies, and other legally required payments takes place or state regulations are violated.

- Illegal economic activity which is deliberately concealed from state authorities.

- Activity aimed at gaining profits through crime or fostering crime.

**TYPES AND VOLUMES OF THE SHADOW ECONOMY**

The shadow economy was a feature of socialist Ukraine. At that time, shadow economic activity was common. It manifested itself in false reporting, large-scale plundering of material, technical, and financial resources, and clandestine business activity.

During the period of economic reform (1991-1998), some transformations occurred in the structure of the shadow economy. On the basis of analytical expert estimates and definition of the shadow economy, 10 major types of shadow economic activity were identified (Table 1).

---

**Box 1. Definition of shadow economy**

*In the investigation, the following definitions of the shadow economy were included in the questionnaire:*

1. *economic activity not accounted and controlled by official state bodies and/or aimed at gaining profit through violating existing legislation.*

2. *unofficial economic activity outside the legislative framework or violating Ukrainian law and not generating tax receipts for the state.*

3. *economic activity implemented within the framework of legislation but not registered with state bodies; activity which is criminal in essence and involves illegal types of activity; as well as activity which is legal but is implemented illegally.*

*As a result of expert discussions and the majority response to the poll, we define the shadow economy as follows:*

"Shadow activity is economic activity which is not reflected in accounting and reporting of enterprises, is not accounted and controlled by official state bodies and/or is aimed at gaining profits through violating existing legislation, and whose profits are neither controlled nor taxed by the state."
Table 1. Major types of shadow economic activity characteristic of the socialist and current stage

<table>
<thead>
<tr>
<th>Types of shadow economic activity under socialism</th>
<th>Types of current shadow economic activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Overreporting.</td>
<td>1. Concealment of real profits by enterprises and entrepreneurial structures to avoid taxation.</td>
</tr>
<tr>
<td>2. Plundering of state-owned material, technical, and financial resources.</td>
<td>2. Illegal foreign and internal economic operations, contraband.</td>
</tr>
<tr>
<td>3. Small-scale misappropriations in state and cooperative sectors.</td>
<td>3. “Shadowization” of the budget.</td>
</tr>
<tr>
<td>5. Transgressions in trade and public services.</td>
<td>5. Illegal currency operations and export of capital.</td>
</tr>
<tr>
<td>6. Resale of household appliances and food-stuffs outside the framework of the state (speculation).</td>
<td>6. Illegal privatization of state-owned assets.</td>
</tr>
<tr>
<td>10. Criminal lines of business and other criminal activity</td>
<td>10. Criminal lines of business and other criminal activity</td>
</tr>
</tbody>
</table>

According to expert estimates, items 1 to 6 embrace the main kinds of shadow economic activity in Ukraine at the current stage.

The dynamics and volume of the shadow economy

An assessment of the shadow economy in Ukraine suggests that it is increasing rapidly and penetrates all spheres of economic life.

According to our calculations, the share of the shadow economy in real gross domestic product was 41.7% in 1997 and the volume of shadow GDP more than doubled relative to 1990 (Table 2).

Assessment of volume based on levels of consumption

Some statistical assessments and indices may indicate the volume and scale of the shadow economy in Ukraine. Despite a twofold decline in GDP and multifold reduction in real incomes of the population, the number of privately owned cars increased by more than 1.3 mln in 1996 relative to 1990 (in 1990 relative to 1985, the number of cars increased by 1.2 mln). Among cars purchased, cars produced in Western European countries, USA, and Japan prevailed, including expensive and prestigious types. The output of cars manufactured in Ukraine decreased from 155.6 thousand in 1990 to 1.8 thousand in 1997. The increase in output in 1998 is not significant, as the majority of these cars remain unsold.

The sale of the following luxury items has also increased: TVs, computers, radios, videos, office machinery, refrigerators, washing machines, vacuum cleaners, footwear, clothes, building goods, and food products.

In a country with a more than 50% decline of production and multifold decrease in public income, there are clearly clandestine market forces at work. Otherwise there would be smaller markets for clothes, foods, services, culture, education, etc.

There is clearly additional potential which keeps the standard of living higher than reflected in official statistics. This potential is shadow income, which is earned by the majority of population in businesses and on an individual basis.
Table 2. Indices of "shadowization" of Ukraine’s economy between 1992-1997

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Index: 1990 = 100</td>
<td>100.0</td>
<td>81.8</td>
<td>69.7</td>
<td>54.5</td>
<td>48.5</td>
<td>43.6</td>
<td>42.4</td>
</tr>
<tr>
<td>Official GDP (GDP_o)</td>
<td>100.0</td>
<td>147.8</td>
<td>176.1</td>
<td>200.0</td>
<td>217.4</td>
<td>219.6</td>
<td>217.4</td>
</tr>
<tr>
<td>Shadow GDP (GDP_s)</td>
<td>100.0</td>
<td>89.9</td>
<td>82.7</td>
<td>72.3</td>
<td>69.1</td>
<td>65.2</td>
<td>63.8</td>
</tr>
<tr>
<td>Real GDP (GDP_r)</td>
<td>100.0</td>
<td>14.0</td>
<td>25.4</td>
<td>35.2</td>
<td>51.1</td>
<td>62.5</td>
<td>70.1</td>
</tr>
<tr>
<td>Ratios (%)</td>
<td>14.0</td>
<td>25.4</td>
<td>35.2</td>
<td>51.1</td>
<td>62.5</td>
<td>70.1</td>
<td>71.4</td>
</tr>
<tr>
<td>GDP_s/GDP_o</td>
<td>12.3</td>
<td>20.1</td>
<td>26.0</td>
<td>33.8</td>
<td>38.5</td>
<td>41.2</td>
<td>41.7</td>
</tr>
</tbody>
</table>

The scale of shadow economic growth is suggested by the fact that almost 40% of the working population have income from the shadow economy, according to some estimates. The above data suggest that since the volume of the shadow economy is not officially part of GDP (while it actually represents about 50% of the volume of GDP), decisions made by state authorities and managers are not based on real data. Therefore, these decisions cannot be optimal.

The level of "shadowization" of the economy

When analyzing and assessing the development of the shadow economy in a country, the level of "shadowization" is of great importance. To assess the level of "shadowization," a general coefficient of "shadowization" can be applied (C_s). It is calculated as a ratio of gross domestic product produced in the shadow economy (GDP_s) to the overall volume of gross domestic product (GDP_r). It should be noted that GDP_r includes both the official gross domestic product (GDP_o) and GDP_s:

$$C_s = \frac{GDP_s}{GDP_r}$$

In recent years, Ukraine has gone through all the stages of "shadowization". Restructuring of the shadow sector of the economy without first clearly defining and even locating it, as well as the self-interest of some officials and a proportion of population, has resulted lately in a full "shadowization" of the economy. The peculiarities of this include:

- an extremely high tax burden on entities and individuals with concomitant mass tax evasion,
- shadowisation of all spheres of economic activity,
- increasing large-scale export of capital,
- blurred distinction between the official and shadow economy,
- increased legislative nihilism and informal relations,
- impoverishment of the population,
- growth of organized crime,
- public vulnerability to organized crime,
- increased crime in shadow economic activity,
- intensification of struggle between informal groups for economic and political domination,
- orientation of some political and economic powers to the establishment of a totalitarian regime to resist the chaos,
- negative attitude to symbols and structures of power, exacerbated by public disaffection.

The majority (84%) of polled experts argue that if no measures are taken to restrict stem the growth of the shadow economy in Ukraine, it will develop further. In the opinion of 82% of experts, this worsens the socio-economic situation. Only 24% of experts, however, consider that a social upheaval may occur in Ukraine.
Box 2. Shadow economies internationally

It should be noted that shadow economies exist throughout the world. They differ only in volume, structure, and operation.

According to The World Bank, the share of the shadow economy in post-industrial economies is 10-15%; in Italy and Latin America - 30%; in African economies - 30%; in the Czech Republic - 18%; in other post-socialist economies - 40-65% GDP (13% in Uzbekistan, 47% in Ukraine, 64% in Georgia). The volume of the shadow economy in the USA is 8-12%; Canada and France - 5-8%; Norway and Sweden - 6-7% of GDP.

In Russia the shadow economy represents more than 40% of GDP. According to various estimates, shadow capital amounting to USD 20-60 billion is accumulated in and USD 150-300 billion is exported from the Russian economy.

CAUSES OF SHADOW ECONOMY DEVELOPMENT

Incentives

Incentives to operate in the shadow economic include:

- economic interests,
- economic necessity and expediency based on individual and group efforts to make profits to satisfy personal needs,
- higher standards of personal and family life,
- survival in the marketplace,
- rapid accumulation of capital for solution of economic, political, and other problems and achievement of other goals during the crisis and a low level of remuneration.

The main causes of growth in the shadow economy are:

- Imperfect tax policy since independence; the high tax burden (including the payroll fund) leading to a reduction in official wages and salaries and additional cash payments; a system of penalties which does not foster entrepreneurial success.

Canvassed experts (53%) consider that high corporate taxes cause the shadow economy to grow.

At the same time, 65% of experts believe that conditions existing in Ukraine make tax evasion and avoiding punishment easy (71% of responses) and encourage shadow activity and violation of laws.

- low levels of personal income in the state sector, low pensions and other benefits; the high prices of consumer goods and services (relative to official incomes); wage, pension, and social arrears,
- low standard of living and benefits enjoyed by the majority of the population; a high level of official and unofficial unemployment which forces members of the working population to look for additional sources of income,
- lack of capital needed to realize business interests, forcing entrepreneurs to accumulate profits through illegal actions; lack of alternatives for investment of shadow capital; the need to dedicate accumulated capital to achieving political rather than economic goals,

The number of business structures registered in Ukraine has not changed over the last few years. Due to a heavy and protracted economic and non-payment crisis, existing businesses are forced to develop a strategy of survival rather than development.1

- inefficient implementation of legislation; low worker qualifications; an insufficient level of instruction and informational regulatory, supervisory, and law-enforcement bodies; vested interests of state officials when reforming economic relations; the suf-

1 [Ed. A 1999 survey by USAID indicates, however, the emergence of a very large group of small and medium private enterprises in recent years; a large share apparently not formally registered.]
focating bureaucratic procedures involved in running businesses; inefficient control over economic activity and state activity.

49% of experts consider that, in present conditions, business activity is impossible without bribes; 41% of experts believe that business is only partly possible without bribes.

- The commercialization of budget, targeted and extra-budget funds; imperfect budget legislation; lack of explicit restrictions on the untargeted use of budget resources.
- the high level of corruption among regulatory officials, supervisory and law-enforcement bodies, and political and economic elites; state patronage; venal officialdom in all spheres of executive power.
- corrupt officials at all levels of power who act exclusively in their own interests, prevent possible losses of accumulated capital and power, and disregard anti-state activity.

Experts (86%) consider that in only a few cases may illegal acts of state officials be contested or their impeachment enacted.

- the rapid growth of organized criminal groups, their impunity and domination of commerce; internationalization of organized crime; increased criminality of central and local government officials, their collaboration with shadow and criminal structures,
- the legal vulnerability of citizens and businesses to criminal groups and illegal actions of corrupt state officials,
- the lack of political will to restrict the shadow economy,
- inefficient economic policy, poor quality state economic programs and general inefficiency and uncoordinated legislative framework; lack of legislative regulation of a number of economic processes; unreasonable legislative restrictions of economic and business activity, which are usually underpinned by personal, group, and corporate interests.

69% of experts agree that it is possible to avoid compliance with laws that regulate economic activity in Ukraine.

- Loss of public confidence in economic programs, state economic policy, and power structures in general. Since independence, no official program aimed at overcoming shadow activity has been developed and implemented (though there were more than 10 such programs “in progress”). Official statements are perceived as declarations made “to redeem the position”.
- decline of social and personal morals resulting from actions of state officials,
- shifting traditions and norms of private ownership and entrepreneurial activity,
- the essential corruptibility of people,
- the disposition of some categories of citizens to organized fraud,
- publicized examples of illegal profiteering of top state officials and other office-holders,
- the adverse effect of Western culture and morals,
- enforced criminal activity,

In the opinion of experts, the main causes of shadow economic growth include:

- Imperfect tax policy and a high tax burden on businesses,
- Inefficient economic policy and poor quality of state economic programs,
- Significant restrictions and bans interfering with entrepreneurial economic activity.

**CONSTRUCTIVE AND DESTRUCTIVE ROLES OF THE SHADOW ECONOMY**

The analysis of causes, peculiarities, and growth of the shadow economy allows for generalizations about the destructive and constructive effects of the Ukrainian shadow economy.

**Constructive role**

During a protracted economic crisis, the shadow economy acts as a kind of economic stabilizer. It features a larger flexibility and dynamism, is able to rapidly satisfy demand and create additional jobs.

This renders some relative stability to the entire national economy.
Shadow economic activity has become a means of self-preservation and survival for many individuals. As a result of this, Ukraine has managed to avoid social upheavals during a ruinous economic crisis.

Generally, the "constructive" effect of the shadow economy manifests itself in a stabilizing and compensating function, whose effects include provision of goods and services, increased disposable income, a better standard of living, competition in the market, a source of investment in the official economy, lower unemployment, and improved national security.

According to polled experts, the shadow economy provides:

1. a means of survival and development (supported by 71% of the polled experts),
2. the ability to maintain economic activity (69%),
3. the ability to pay unofficial wages to employees (51%),
4. a means of accumulating shadow capital required for economic activity (45%).

Destructive role

The increase in the volume of the shadow economy brings about a number of adverse consequences. The most significant are as follows:

1. reduced budget receipts and increased external and internal debts,
2. increased shadow capital and weakened investment climate,
3. increased crime in society,
4. loss of state regulatory function.

Loss of economic control

Polled experts believe that the most harmful effects of the shadow economy are:

- reduced tax receipts and inability to balance the budget (78%),
- loss of state regulatory capacity (71%),
- moral and mental degradation of society (59%),
- outflow of investment resources (59%),
- increased crime in state and society (57%),
- threat to economic and national security (51%),
- emergence of financial channels for influencing state officials, the mass-media, and elected officials (43%),
- increased organized crime (37%).

III. NEW SHADOW ECONOMY POLICY

GOALS AND PREREQUISITES

In terms of the total "shadowization" of Ukraine's economy, the growing socio-economic crisis is inevitable unless measures are taken to reduce and restrict shadow economic activity, so it should be a priority of the Ukrainian government.

Two political and economic ways of preventing total economic "shadowization" are possible. The first is radical reform of the entire range of economic and social relations, removing factors contributing to the expansion of the shadow sector. The second way out is establishment of a political and economic monopoly and subjugation of all activity.

In order to support economic development, economic policy should be formulated strategically and in a way that can be understood by society.

It is proposed to base this strategy on:

- creating conditions for business development, especially small businesses,
- removing restrictions on business,
- increasing production potential through domestic and foreign investment resources.

At the same time, general conditions fostering restriction of the shadow economy should be created in Ukraine.
The most important of these are the following (these proposals are supported by polled experts):

1. Restructured economy and real economic growth, thereby increasing the standard of living,
2. State guarantees on irreversibility of economic reforms, existence of unlimited private ownership, and a ban on confiscation of capital,
3. Strong and uncorrupted central and local executive branches able to implement adopted laws and decisions,
4. Measures restricting the shadow economy and legalization of shadow capital, popular understanding and support.

When defining the directions of activity aimed at reducing the shadow economy, it should be taken into account that one-off measures or individual laws or presidential decrees cannot resolve this problem.

It also cannot be resolved by means of force as suggested by the experiences the socialist period.

Reducing the shadow economy is a stage-by-stage process, which begins from defining general directions of activity (specified in this project), followed by developing and implementing national and regional programs specifying concrete legislative measures. Further legislative acts at all the levels of power are also required (this requires additional research projects). This approach is the only way to achieve real success.

Only 35% of polled experts believe that there is a real possibility of reducing the shadow sector; 65% of experts consider it impossible.

A strategic direction of activity

A strategic policy of reducing shadow economy activity requires a reasonable, substantiated deregulation program.

This strategy is supported by 92% of polled experts. They agree that liberalization of economic activity is the right strategic direction.

Based on the general policy aim of reducing the shadow economy, long-term (5 years or more) and short-term tasks (to be implemented in 1999-2000) are defined.

**LONG-TERM TASKS**

The analysis of poll results suggests that a set of long-term tasks should be implemented. These tasks must be aimed at:

- making use of productive potential and restructuring the economy on the basis of both domestic and foreign resources,
- initiating economic growth through programs initiated by the government,
- unifying political will amongst top state leadership to ensure reduction of the shadow economy,
- ensuring implementation of laws of Ukraine and decisions adopted at national and regional level,
- creating favorable conditions for entrepreneurs, especially for small and medium-sized business,
- counteracting organized crime and corruption through governmental influence.

**SHORT-TERM TASKS**

Problems exist that must be solved in the short term.

It is crucial to provide, with help of research institutions and state organizations, continuous scientific investigation and analysis of the role played by state and political elites and state officials in the shadow sector. This investigation must be initiated in 1999 and requires certain allocation of finances. Financial resources for this research and investigation may be released through interim suspension of low-priority investigations.

The majority of experts, who responded to the questionnaire, consider that investigation of the shadow economy must be extended. Special government departments, law-enforcement bodies, research institutions, and specially established groups should perform it.

In the opinion of experts, the primary subjects of investigation should be:

- shadow sector mechanisms (71%),
- actions and activities of the state-political elite and state officials (37%).
• *Types of shadow economic activity (33%).*

It is essential to develop and approve techniques for assessing the scope of the shadow economy, order both the Ministry of Economy of Ukraine and the State Committee for Statistics to conduct ongoing research into the scope, dynamics, and structure of the shadow economy. Findings must be taken into account when calculating the real volume of GDP and other macroeconomic indicators and in other areas of policy formulation.

Examination of existing laws, acts and other regulatory documents to assess their impact on the development and functioning of the shadow economy and criminal activity must be conducted along with independent expert examination of new draft laws to assess their impact on the shadow economy.

*The majority (73%) of experts consider it possible for Ukraine to partially restrict shadow economic activity through legislation; 24% of experts consider it impossible.*

- Regulate uncertain economic processes,
- Develop the Laws of Ukraine to regulate economic activity in a direct manner, without the need to develop additional regulatory documents.
- Prevent economic regulation through by-laws that are developed by state officials who provide for their private or group interests.
- Provide control over the implementation of Laws of Ukraine, Presidential Decrees, and Resolutions of the Cabinet of Ministers. Regularly assess their efficiency and influence on the economic situation.
- Implement comprehensive tax reform providing for a shift from the existing fiscal approach to taxpayers to an approach fostering an increase in legal incomes and their reinvestment.

Optimization of the tax burden on businesses, in particular:

- substituting value-added tax and enterprise income tax (the schemes for evading these taxes are worked out by businesses and tax evasion is now a typical phenomenon) with a 5-10% turnover tax (the rate should depend upon the kind of activity),
- reducing the tax burden on wages to 10-15%,
- decreasing payroll tax to 30%,
- providing stable tax legislation,
- normalizing and simplifying penalties for tax violations.

In addition, legislation should be designed to abolish tax privileges owed to enterprises through private lobbying. In future, tax privileges should be provided in defined areas of activity (and not for individual enterprises), and:

- Implement a mechanism for raising internal and foreign investment in long-term projects through tax privileges, investment protection and state guarantees.
- Create favorable conditions for businesses of all forms of ownership engaged in production and to foster the growth of small-sized businesses through a 50% reduction in their tax burden.
- Establish a tax court for disputes related to tax violation.

61% of polled experts consider that accountability for concealment of incomes and tax evasion should become stricter. 39% of experts are opposed to this.

State supervisory bodies need to be coordinated to enhance control over compliance. After liberalizing tax legislation and lifting restrictions on businesses activity, there should be a period of investigation of non-compliant individuals and organizations, and appropriate punitive measures.

Conditions should be established for legalization of shadow capital (with allowance for the ethical and legislative aspects of this problem). For this purpose, special areas of investment may be created. Confiscation of capital should be prohibited, regardless of any political changes in the state.

The attitude of citizens, including polled experts, to the concept of legalizing shadow capital through amnesty or other state decisions is ambiguous. The majority of experts (92%) consider that this direction is legal and reasonable. However, experts actually failed to specify what types of capital may be placed under amnesty.
Moreover, a number of experts argue that amnesty and legalization of shadow capital would only exacerbate the trend of legal nihilism and increase criminal activity.

In Ukraine, the issue of amnesty of shadow capital has been debated for several years without positive results. The Law of Ukraine “On Legalization of Illegally Gained Funds”, which is being debated in parliament also appears to have produced no positive results.

There are many differences in opinion and approaches to resolving problems of legalization and amnesty of shadow capital in the Verkhovna Rada, in the Cabinet of Ministers, in political parties, as well as among citizens of Ukraine. As a result of these differences, it is unlikely that the issue of amnesty and legalization of shadow capital in Ukraine will be resolved in the near future. Therefore, investments of this capital in the Ukrainian economy will continue coming back as foreign investments.

Experts failed to give a clear answer to the question of which capital should be considered capital of non-criminal origin and which may be placed under amnesty or legalized.

Though 71% of experts believe that a period of amnesty is possible, 27% of the poll’s participants argue that it is impossible on moral and ethical grounds, as well as on grounds of common sense and international practice.

We may conclude, then, that the opinion of 75% of experts is that the repatriation of shadow capital to Ukraine is difficult.

- Remove obstacles, restrictions, and bans established by various state agencies that hinder business activity. Only the Laws of Ukraine should impose such bans and prohibitions.
- Create conditions for business growth, especially those businesses engaged in production.
- Simplify the process of registering businesses and systems of reporting and licensing.
- Enhance control over functioning of existing and new businesses in order to prevent fictitious commercial structures, to ensure conclusion of commercial agreements and relevant payments.
- In a goal-oriented manner, mould public opinion to positively assesses any business initiative and treat entrepreneurs and successful people with respect.
- Establish that the main direction and one criterion of efficient economic policy is the number of established and operating businesses.
- Clearly define and approve the function of the state structures aimed at preventing illegal actions.
- Provide for the transparency of state activity that regulates economic activity within the legislatively defined functions, introduce personal accountability for misuses of power.
- Provide state guarantees regarding provision of adequate standards of living for state officials in case of resignation for reasons other than violation of existing legislation.
- Prevent corrupt checks on entrepreneurial structures.
- Create a mechanism protecting entrepreneurs and citizens against arbitrary behavior of state office holders.

It is also imperative to prevent budget resources from entering the commercial sphere and enhance control over the budget and targeted use of resources through:

- developing computer technology for automated control over flows and use of budget resources,
- imposing stricter control on the part of the Accounting Chamber over budget revenue and expenditure and legislate accordingly,
- establishing a special group under the Verkhovna Rada Budget Committee for monitoring the “shadowization” of the budget sphere and developing measures aimed at restricting this kind of activity,
• liquidating all extra-budget funds\(^2\); spending on all state programs should be at the expense of the State Budget of Ukraine and local budgets,

• providing a gradual reduction of barter operations with a full abolition of this type of settlement by mid-2000, implementing a normal commodity exchange, increasing of the money supply as a share of GDP to an optimum amount,

• imposing personal financial responsibility on managers and chief accountants of state-owned and non-state enterprises for illegal, non-targeted, and inefficient use of budget resources,

• implementing the Law of Ukraine On Wages, and the Labor Code of Ukraine. Where wages are in arrears for longer than two weeks the employers should be held accountable by law.

And similarly the following measures can be taken by legislative bodies concerning business and the country at large:

• Enhance financial control over the areas where fraudulent activity occurs and inform the public of such fraud. Undertake measures to protect the public and business entities against wheeler-dealer finance, deceit, etc.

• Implement universal declaration of property and income followed by imposition of a procedure for confirmation of citizens’ incomes in case of purchase of expensive goods (apartments, houses, furniture, cars, large blocks of shares, etc.).

61% of experts consider it reasonable to implement such a universal declaration of property and income. 39% experts consider that this measure is premature.

• Undertake measures to gradually reduce cash payments for goods and services to reveal discrepancies between individual income and expenditure. Restrict the use of cash funds and impose cash reporting mechanisms. Develop a mechanism for control over the cash flows and funds on accounts with commercial banks and foreign banks opened in Ukraine.

• Change the targets of privatization. Privatization should be implemented according to economic considerations and through advertised bidding. Prevent privatization at underestimated prices, which results in further resale of purchases.

To this end:

• for property privatization should specify investment commitments of the future owner and these should be enforced,

• entities offered for privatization should be appraised by independent expert organizations,

• hold authorities accountable for understated value of objects and violations of existing legislation\(^3\)

• implement post-privatization audits and “automatic” re-privatization in keeping with legislation in cases of non-implementation or violation of privatization agreements.

Staff state-administration and law-enforcement bodies with skilled personnel, improve their material and technical base, and increase salaries of top and medium-level officials.

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\(^2\) [Ed. This is generally true. However, some funds such as parents’ contributions to special language and computer classes where parents have direct oversight on use of funds should stay out of the budget process; blending such purpose-specific funds with general revenue funds would actually reduce accountability. Also, selected funds that are based on insurance principles (like pension funds) or on user charges (like road funds) may be kept in a separate earmarked portion of the budget - i.e., clearly accounted for but not blended with other general resources.]

\(^3\) [Ed. Caution is needed with respect to holding officials responsible for evaluation of property being privatized. To avoid prosecution for underevaluation officials will set values too high, thud, stalling privatization. Markets, no officials, should set values. Officials should only be held responsible to assuring that all the prerequisites of a well functioning market have been established - full information, transparency and equity in rules of game, widespread competition in bidding, etc.]
According to expert opinion, the main directions of state activity aimed at reduction of the shadow economy should include:

- decreased tax burden on business structures (80% - average; 96% governmental experts; 63% non-governmental experts);
- legislative regulation of the conditions for legalization of capital and their investment; (61% - average; 63% governmental experts; 58% non-governmental experts);
- removal of all unreasonable restrictions, bans, and obstacles hindering business activity and creation of favorable conditions for starting new businesses (63% - average; 67% governmental experts; 58% non-governmental experts);

These measures should be defined in draft programs.

### COMPARATIVE TABLE OF VARIANTS OF THE STRATEGY REGARDING THE SHADOW ECONOMY

<table>
<thead>
<tr>
<th>Strategy</th>
<th>“Liberalization” (proposed by the authors)</th>
<th>“Enhancement of Struggle” (alternative)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goals</td>
<td>Legalizing the shadow economy.</td>
<td>Reduction of the shadow economy</td>
</tr>
<tr>
<td></td>
<td>This strategy is supported by 87% of polled experts</td>
<td>This strategy is supported by 8.7% of polled experts</td>
</tr>
<tr>
<td>Anticipated outcomes</td>
<td>Short-term outcomes (up to 2 years):</td>
<td></td>
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<tr>
<td></td>
<td>• Temporary fall in budget receipts;</td>
<td>• Continued economic decline;</td>
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<td></td>
<td>• Gradual restoration of confidence in the state and its structures;</td>
<td>• Recurrent financial crisis, further falls in the exchange rate;</td>
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<tr>
<td></td>
<td>• Increased number of business structures, including those which used to operate “in the shadows”;</td>
<td>• Political and social instability;</td>
</tr>
<tr>
<td></td>
<td>• Increased internal investment resources;</td>
<td>• Loss of confidence in Ukraine on the part of other countries;</td>
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<tr>
<td></td>
<td>• Decline in production halted;</td>
<td>• Regional separatism;</td>
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<tr>
<td></td>
<td>• Increased official incomes and wages;</td>
<td>• Increased political and economic pressure on Ukraine on the part of other countries;</td>
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<td></td>
<td>• Reduction of corruption and organized crime</td>
<td>• Reduced tax and non-tax payments to the State Budget;</td>
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<td></td>
<td></td>
<td>• Increased budget arrears;</td>
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<td></td>
<td></td>
<td>• Further reduction of investment activity, outflow of capital to other countries;</td>
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<tr>
<td></td>
<td>Long-term outcomes (3 years +):</td>
<td>• Suspension of operation of many productions, shift to “the shadows”</td>
</tr>
<tr>
<td></td>
<td>• Increased tax and non-tax payments to the State Budget;</td>
<td>Long-term outcomes (3 years +):</td>
</tr>
<tr>
<td></td>
<td>• Considerable increase in official incomes;</td>
<td>• Economic decline;</td>
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<td></td>
<td>Shifting businesses from shadow to legal economic activity;</td>
<td>• Fall in the standard of living;</td>
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<td></td>
<td></td>
<td>• Aggravated social tension and possible social upheaval;</td>
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<td></td>
<td></td>
<td>Economic and financial default of the state;</td>
</tr>
<tr>
<td>Strategy</td>
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<tr>
<td>• Reduction of organized crime;</td>
<td>• Loss of economic and social independence.</td>
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<tr>
<td>• Ukraine’s integration with developed countries and active role in international structures;</td>
<td>• Degradation of public and personal morals;</td>
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<tr>
<td>• Political stability and social harmony of society;</td>
<td>• Increased levels of corruption, state loss of regulatory, supervisory, and other functions;</td>
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<tr>
<td>• Economic rebirth.</td>
<td>• Expansion of organized crimes, “legal” capture of power structures by criminal groups;</td>
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<tr>
<td></td>
<td>• Economic and cultural decay of Ukraine.</td>
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IV. IMPLEMENTING THE NEW POLICY

This analytical report is the first step towards the legalization of the Ukrainian shadow economy - of encouraging otherwise legitimate shadow economic activity to move into the formal sector and pay taxes. It defines general directions and development of work related to this problem.

The next stage will be the development of a set of proposals specifying concrete measures; terms of implementation, responsible executors, and other materials aimed at legalizing specified types of shadow activity identified in this document.

Taking into account present peculiarities of the economic and political development of Ukraine, the stage of transition, consideration and approval of such proposals passage of laws regulating economic activity in Ukraine, it is reasonable to undertake a number of urgent measures. These measures should be based on simplified implementation schemes, which would promote official economic activity and reduction of shadow economic activity.

First of all, measures must be undertaken on the basis of Presidential Decrees and resolutions of the Cabinet of Ministers to lift all restrictions and bans hindering the development of small-sized businesses, especially production-related business. The number of small-sized enterprises should increase by at least a factor of 20 during 1999-2000. National and local authorities must create favorable conditions for developing this type of entrepreneurial activity. These measures should be defined in special economic programs. Assessment of the local authority and individual competence should be based on the number and success of businesses established in their jurisdictions.

Passage of the newly developed Tax Code by Verkhovna Rada appears to be taking a considerable length of time. Therefore, it is worthwhile to use Presidential Decrees and Resolutions of the Cabinet of Ministers of Ukraine in order to decrease the tax burden on manufacturers by at least 50% as early as the end of 1999.4

One more extremely important direction would be to enhance the struggle against corruption in all branches of power and organized crime in the state. At the same time, these measures are doomed to failure unless issues concerning the

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4 [Ed. The cost to the budget of a substantial tax cut would be at least partially offset through higher voluntary collections. To further assure adequate budget revenues—and equally important, to reduce corruption and establish a more level playing field, all tax privileges should be removed. A transitional strategy, an immediate cut of 50% in the privilege could be implemented, followed by another 25% cut in 12 months and the remaining 25% after 24 months to give enterprises time to restructure and increase efficiency.]
remuneration of government employees and administrative reform are addressed.

It should be emphasized that the main prerequisite for reversing adverse trends in the development of the shadow sector is economic growth.

Obstacles to implementation due to differences in opinion

In the process of investigation, a specially developed questionnaire revealed some differences in expert opinion on individual issues related to the shadow economy.

The aim of the questionnaire was to show the degree of consensus among experts, specialists, and researchers regarding the main types of shadow economic activity, benefits of conducting shadow business, and directions of government activity in reducing shadow activity.

In total, 90 questionnaires were distributed among governmental and non-governmental organizations, business associations, banking establishments, and research and development institutes. Responses were obtained from 51 experts, including 27 governmental experts and 24 representatives of non-governmental and business organizations.

The questionnaires revealed the following:

1. Adjustments and amendments to the definition of the shadow economy. These adjustments and amendments were taken into account in formulating the definition in this report.

2. Differences in opinions regarding the types of shadow economic activity, its harmful and favorable manifestations which determine the differences in priorities.

3. Regarding the feasibility of reducing shadow activity under conditions of aggravating social crises accompanied by economic breakdown, 35% experts believe that this is feasible and 65% experts do not.

4. Experts have different opinions about the main influences on the development of the shadow economy in Ukraine. 23 experts think that the main contribution was made by the Government of Ukraine, 26 experts said that it is mainly supported by the legislative power; and 5 experts believe that the largest contribution was made by individual officials.

5. There is no consensus among experts as to the degree to which Ukrainian citizens and entrepreneurs are interested in restricting the shadow economy.

6. There is also some difference in opinion about the feasibility of restricting shadow economic activity just by passing appropriate laws: 71% of experts consider that this may be achieved only partially and 24% of experts believe that this cannot be achieved.

7. Regarding the level of corruption: 51% of experts think that today business activity may be conducted and issues in government agencies may be settled without bribes (or bribes are needed only in some cases). 49% of experts consider that bribery is necessary.

8. Regarding amnesty of shadow capital: 71% of experts believe that it is possible; 27% of experts do not.

9. 67% of experts consider that owners of shadow capital would partially believe in amnesty of shadow capital. 29% experts do not agree with this.

10. Opinions also vary as to the expediency of universal declaration of incomes and confirmation of sources of income when purchasing expensive goods: 61% of experts support this, 39% of experts are against this measure.

11. 53% of experts support the restricted use of cash. 45% of experts do not support this proposal.

12. 61% of experts believe that the responsibility for concealing incomes and tax evasion should be enhanced; 39% of experts do not agree with this.

13. Regarding struggle against the shadow economy: 45% of experts think that the penalty for shadow economic activity should be more severe; 35% of experts consider that this should remain unchanged or even less severe (16%).

Issues on which experts agree

1. According to 92% of experts, further liberalization of economic activity, lifting
groundless restrictions and bans hindering businesses and legalization of the shadow economy should form the basis of activity.

2. The majority of experts (53% of) believe that tax rates exert an important influence on the development of the shadow economy.

3. 65% of experts think that it is very easy or rather easy to evade taxes in Ukraine, 35% of experts consider that it is very difficult or somewhat difficult.

4. 71% of experts consider that it is very easy or rather easy in Ukraine to evade penalty for shadow economic activity and violation of existing laws, and only 28% do not agree with this.

5. 69% of experts believe that it is easy in Ukraine to transgress laws that regulate business activity, 27% of experts do not agree with this opinion.

6. Only 6% of experts think that the state should stiffen penalties and restrictions and more widely initiate criminal cases against people engaged in shadow economic activity.

7. Many experts (82%) have similar opinions about possible consequences of further expansion of the shadow economy. They believe that this would aggravate the socio-economic situation in Ukraine. 24% of experts consider that this may result in a social upheaval.

8. 75% of experts believe that shadow capital may be fully or partially repatriated from other countries. 20% of experts think that this will not take place.

9. 37% of experts consider that there are no business structures engaged in shadow activity in Ukraine and 61% of experts are sure that such business structures exist.

10. 67% of experts support the proposal of universal declaration of incomes, 31% of experts do not support this proposal.

11. 94% of experts support the proposal about expert examination of legislative acts to estimate their possible impact on the development of the shadow economy; 6% oppose this proposal.

A general assessment of responses to the questionnaire on “The Shadow Economy” allow us to conclude that the contents of questions, their orientation, and responses offered in the multiple choice were developed properly. The responses received confirmed the reliability of provisions related to problems of the shadow economy as discussed in this analytical report.

V. CONCLUSIONS

Were liberalization of economic activity to happen, the real volume of the shadow economy in Ukraine would decrease due to its legalization and shift to the formal economy. We consider that in the medium term this policy would result in:

- an increase in official GDP by UAH 20-25 billion (in 1998, official GDP amounted to UAH 103.9 billion);
- a UAH 5-8 billion increase in yearly receipts of the State budget and local budgets (in 1998, receipts of the consolidated budget of Ukraine totaled UAH 28.4 billion);
- a USD 5-6 billion increase in internal investment and inflow of foreign investment (as of early 1999, the volume of inflow of foreign investment amounted to USD 2.8 billion since independence).
8. SOCIAL PROTECTION POLICIES

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Ministry of Economy

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I. INTRODUCTION

The fundamental reform of social policy is an important aspect of economic reform. Solving the most pressing problems such as controlling and overcoming poverty through radical reform of remuneration systems; provision of pensions and social benefits; activation of employment policies; and implementation of insurance principles in the system of social protection is a prerequisite of sustainable development.

The lack of a safety net in Ukraine under conditions of general financial instability in September 1998 inevitably took its toll upon a socially vulnerable population, causing deterioration of financial support for wages, pensions, social benefits, and reduction of disposable income.

The objective of establishing a stable and transparent legal basis for social protection is urgent, particularly for people beyond working age. It is also necessary to meet constitutional requirements regarding social protection on a level which is not less than the level of minimal social standards, as well as to observe international norms and international experience.

This report supports efforts to overcome and deter poverty through radically reforming the pension system and enhancing public influence over employment policies; to identify the key issues in pension provision and employment; to establish reform guidelines, to assess readiness to adopt reforms; and to measure success thereof in both the long and short-term.

The section “Analysis of existing public policies” reviews the current state of affairs and public policies in regard to the pension system, employment, and unemployment.

In the next section, “Framework of new policies”, the authors present strategic reform of the pension system and public employment policies. It also presents an alternative strategy, implying refusal to implement reforms which ultimately lead to negative outcomes. The subsection “Implementation of new policies”, which is based on a poll conducted by researchers among governmental and non-governmental experts, analyzes the main obstacles facing implementation of the proposed strategy, and recommends appropriate action.

The report draws on material from various public and R&D institutions, comments by Ukrainian and international experts, and expert discussions. The outcomes of the survey “Differences in expert opinion” was of significant importance in writing this paper, as 23 experts from 12 public and 11 non-governmental institutions and organizations were involved.

II. ANALYSIS OF EXISTING PUBLIC POLICIES

CHARACTERISTICS OF THE CURRENT SITUATION

Established during the Soviet times, the Ukrainian system of social insurance must be converted into an effective efficient system of social protection for the most vulnerable sectors of the population. This system faces major challenges— a steep decline in GDP and falling real wages. Initially, the system was based on the principle of solidarity and now is becoming incapable of protecting the masses from current difficulties in the conditions of rapid decline in employment and growth of the non-formal sector.

Even though the state spends about 18 percent of GDP on implementing social programs within current legislation, it is only able to provide a very low level of pensions (an average pension is UAH 54). Child allowances, unemployment relief, etc. are also minimal. A conflict between the ever-growing demands of society and limited financial capacity is becoming obvious and requires resolute actions by both legislative and executive branches.

The situation in the labor market is becoming more dire. From January-December 1998, the unemployment rate grew from 2.3 to 3.7 percent.

Divisions in the population according to personal income levels are becoming more marked with a growing proportion of citizens having incomes less than UAH 30. Currently, 8.2 per-
percent of citizens have monthly incomes between UAH 180 and UAH 300 and 7.5 percent have incomes lower than UAH 30. A major share of very poor live in rural areas. More than 50 percent of the population have an income which is below the subsistence level (UAH 73.7 per month), and average levels of consumption for major food products are below levels used to calculate subsistence level, especially for the urban population.

There is no doubt that solution of the social protection problem depends primarily on the following:

- raising the level of economic and social development;
- ensuring principles of social protection for aged people, unemployed, disabled, etc.; and
- fundamental reforms in the provision of social benefits.

To help establish encouraging conditions for development of small scale entrepreneurship in Ukraine, the “Program for development of small scale entrepreneurship in Ukraine for the period 1997-1998” and regional programs of assistance to small scale businesses in Ukraine for the period 1997-1998 were adopted.

The program envisages an increased number of jobs in the sphere of small businesses. The number of jobs in small businesses was 1,283,700 in 1997. In 1998 and 1999, the number is expected to increase to 1,250,000 and 1,330,000 jobs respectively.

To satisfy the human resource demands of business, measures are taken to train personnel for business activities including:

Introducing training in theory and practices of business in vocational and higher education. In 1997, 300 educational institutions provided services in post-graduate retraining in business development. This involved 25,000 students in 16 disciplines and 49 professions through full-time and night classes, by correspondence, and through external studies.

- Improving the system of advisory services for the unemployed. Each region has designated educational institutions where training for unemployed people to become entrepreneurs is provided. The State Employment Center and the Ministry of Education have developed and sent ten standard curriculums to regions in order to provide training for the unemployed in business principles.
- Organizing training centers designed to educate specialists in business activities, using European technologies, etc.
- Where possible, international financial support will be sought for these programs.

**PENSION PROVISION POLICIES**

The pension system is characterized by low pensions, a lack of differentiation of pensions, significant advantages and benefits in provision of pensions for certain categories of workers, and delayed payment of social insurance contributions to the Pension Fund of Ukraine, which leads to significant pension arrears.

The principle of social insurance in the pension system is implemented only partially and in its essence is of administrative-distributional nature; it does not make actual amounts of pensions dependent on paid fees. Many payments, which do not correlate with labor input and do not depend on participation in the system of benefits, are made.

**Types of pensions**


According to current legislation, there are the following types of pensions:

- old age pension,
- disability pension,
- survivor pension
- service pension,
- social pensions.
Demographic processes
Changes in the demography of pension recipients which have occurred during the last quarter of this century (and prevail currently) demonstrate the following:

- a declining number of people of working age who apply for old age pensions;
- "rejuvenation" of pensioners due to the increasing number of disability pensioners and survival pensioners. It means that according to the existing legislation, there will be a stable and significant proportion of pensioners whose pensions are not related to labor input and do not depend on pension insurance contributions.

Pension provision in Ukraine is very sensitive to demographic processes, which can be characterized by the increasing number of pension recipients and by a simultaneously decreasing number of social insurance contributors.

Primarily, the data show a reduction in the working population. Currently in Ukraine, the ratio of working population to non-working is the highest among CIS nations. In some regions, this ratio is 1:1 and even higher.

The trend will prevail for some time to come. Sizeable proportions of world war veterans, Chornobyl veterans, and disabled people will be a specific feature of Ukraine.

Influence of legislation on the pension system
Updated pensions legislation during the last 6 years has led to a rapid increase in the number of pensioners compared with the total number of people of pensionable age. The proportion of privileged old age pensioners increased from 14.6 percent in 1990 to 28.33 in 1998 (see graph 2).

Table 1. Number of pensioners as of January 1

<table>
<thead>
<tr>
<th>Categories</th>
<th>Number (thousand persons)</th>
<th>Proportion compared with the total number of pensioners ( percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pensioners receiving pensions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>according to law “On provision of pensions”</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>7,669</td>
<td>11,854</td>
</tr>
<tr>
<td>Including:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Old age and long service pensioners</td>
<td>5,488</td>
<td>9,661</td>
</tr>
<tr>
<td>Disability pensioners</td>
<td>1,302</td>
<td>1,188</td>
</tr>
<tr>
<td>Old age social pensioners</td>
<td>21,863</td>
<td>6,494</td>
</tr>
<tr>
<td>Other categories</td>
<td>116,689</td>
<td>239,617</td>
</tr>
</tbody>
</table>
Table 2. Demographics of working and non-working age population

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Population - total (thousand)</td>
<td>51,452</td>
<td>51,548</td>
<td>50,600</td>
<td>50,245</td>
</tr>
<tr>
<td>Proportion compared to total number of population:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>People beyond working age, percent</td>
<td>21.2</td>
<td>21.2</td>
<td>22.9</td>
<td>23.2</td>
</tr>
<tr>
<td>People after age of 60, percent</td>
<td>18.0</td>
<td>18.3</td>
<td>18.9</td>
<td>19.6</td>
</tr>
<tr>
<td>People after age of 65, percent</td>
<td>11.7</td>
<td>12.0</td>
<td>13.9</td>
<td>14.1</td>
</tr>
<tr>
<td>People after age of 75, percent</td>
<td>5.0</td>
<td>5.2</td>
<td>4.5</td>
<td>4.6</td>
</tr>
<tr>
<td>Dependency rates (per thousand)</td>
<td>379</td>
<td>381</td>
<td>411</td>
<td>388</td>
</tr>
</tbody>
</table>

Graph 2. Structure of old age pension recipients according to the time the pensions are granted (in retirement age and before retirement age)

In 1997, according to the Council on Productive Forces, the average life expectancy at the time of retirement (60 years for men and 55 years for women) is 14.3 and 22.1 years respectively. The average duration of service at the time of retirement in 1996 was 36 years for men and 29 years for women.

Working pensioners

The recent crisis in the financial system and therefore in the pension system has affected almost 14 million pensioners leading many to return to work. The falling rate of employment of young people plus a growing proportion of working pensioners (22 percent of which work in budget offices and organizations) has put the interests of pensioners in conflict with those of the working age population.

Table 3. Proportions of pensioners working in various sectors (1997)

<table>
<thead>
<tr>
<th>Proportion</th>
<th>Number of working pensioners (thousand)</th>
<th>Distribution by sector</th>
<th>Number of workers in sector (thousands)</th>
<th>Working pensioners as share of total workers (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total:</td>
<td>2,056.9</td>
<td>100.0</td>
<td>15,853.9</td>
<td>13.0</td>
</tr>
<tr>
<td>Including:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Industrial production</td>
<td>668.4</td>
<td>32.5</td>
<td>4,586.0</td>
<td>14.57</td>
</tr>
<tr>
<td>Agriculture</td>
<td>387.3</td>
<td>18.8</td>
<td>3,139.5</td>
<td>12.34</td>
</tr>
<tr>
<td>Transportation</td>
<td>103.7</td>
<td>5</td>
<td>983.7</td>
<td>10.54</td>
</tr>
<tr>
<td>Construction</td>
<td>120.8</td>
<td>5.9</td>
<td>911.2</td>
<td>13.26</td>
</tr>
<tr>
<td>In budget-financed institutions and organizations</td>
<td>452.4</td>
<td>22</td>
<td>4,080.7</td>
<td>11.1</td>
</tr>
<tr>
<td>Other spheres</td>
<td>324.3</td>
<td>15.8</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>
The pensions of more than 160,000 working pensioners exceeded average wages across industry last year. Reducing pensions to working pensioners through legislation would reduce the load on the Pension Fund budget by approximately UAH 180 million per year.

Efficiency of existing policies

In conditions of widespread non-formal employment, deterioration of payment discipline, and avoidance of social insurance contributions, even the high contribution rates fall to provide adequate resources for pensions and by making compliance costs high thus encouraging tax evasion, the high rates actually reduce the revenues available.

While pension deductions are a significant proportion of GDP (around 10%), actual pension provision is inadmissible low. The average income of pensioners does not exceed one third of average salary, and the maximum old age pension is below the poverty line.

Minimal pension, together with targeted money assistance, equals UAH 37 (equivalent to $8), and for old aged persons living alone and handicapped persons UAH 48 (equivalent to $12).

Financial sources of pensions

Pensions are paid from deductions from wages, state and local budgets, the Employment Fund, and Chornobyl Fund, which collectively finance the Pension Fund.

Compulsory public insurance equals 32 percent for legal entities which is deducted payroll. For individuals, it is 1 percent of their gross wage. Due to unsatisfactory payment discipline and growing amounts of salaries paid in kind, actual 1998 proceeds from enterprise payroll made up 25.6 percent of the payroll fund.

Table 4. Replacement rates - average pensions that are granted according to the Law of Ukraine "On provision of pension" and average salaries of workers in employment

<table>
<thead>
<tr>
<th>Period (year)</th>
<th>Unit of measurement</th>
<th>Average* wage</th>
<th>Average** pension</th>
<th>Ratio of pension to wage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971</td>
<td>KRB</td>
<td>106.97</td>
<td>30.42</td>
<td>28.4 percent</td>
</tr>
<tr>
<td>1980</td>
<td>KRB</td>
<td>155.10</td>
<td>51.36</td>
<td>33.1 percent</td>
</tr>
<tr>
<td>1990</td>
<td>KRB</td>
<td>244.30</td>
<td>85.23</td>
<td>34.9 percent</td>
</tr>
<tr>
<td>1991</td>
<td>KRB</td>
<td>479.70</td>
<td>173.20</td>
<td>36.1 percent</td>
</tr>
<tr>
<td>1992</td>
<td>KRB</td>
<td>1,523.50</td>
<td>537.59</td>
<td>35.30 percent</td>
</tr>
<tr>
<td>1993*</td>
<td>KRB</td>
<td>14,204.00</td>
<td>9,716.00</td>
<td>68.4 percent</td>
</tr>
<tr>
<td>1994</td>
<td>KRB</td>
<td>745,523.00</td>
<td>336,000.00</td>
<td>45.01 percent</td>
</tr>
<tr>
<td>1995</td>
<td>UAH</td>
<td>32.08</td>
<td>11.57</td>
<td>36.1 percent</td>
</tr>
<tr>
<td>1996</td>
<td>UAH</td>
<td>103.28</td>
<td>37.83</td>
<td>36.6 percent</td>
</tr>
<tr>
<td>1997</td>
<td>UAH</td>
<td>126.68</td>
<td>49.31</td>
<td>38.9 percent</td>
</tr>
<tr>
<td>1998</td>
<td>UAH</td>
<td>132.82</td>
<td>49.42</td>
<td>36.1 percent</td>
</tr>
<tr>
<td>Oct. 1, 1998</td>
<td>UAH</td>
<td>156.40</td>
<td>56.00</td>
<td>35.8 percent</td>
</tr>
</tbody>
</table>

Notes:

in the beginning of 1992, the contribution rate to the Pension Fund was equal to 61 percent of wage bill, starting July, 1993 - 37 percent, and in 1997 - 32 percent.

* including compensation payments and targeted assistance

** - for 1971, 1990-1991 annual figures

as of 01.10.1998, average pensions are rated
Table 5. Distribution of pensioners who are registered in the social protection agency as of January 1, 1998 according to the amount of pensions

<table>
<thead>
<tr>
<th>Categories of pensioners</th>
<th>Unit of measurement (UAH)</th>
<th>Number of persons</th>
<th>Proportion</th>
</tr>
</thead>
<tbody>
<tr>
<td>All pensioners</td>
<td></td>
<td>1 399 4385</td>
<td>100.0 percent</td>
</tr>
<tr>
<td>Size of pension</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(number of min</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>pension equivalent)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>up to 3</td>
<td>Up to 49.86</td>
<td>9 225 591</td>
<td>65.9</td>
</tr>
<tr>
<td></td>
<td>From 49.87 up to 66.48</td>
<td>3 516 553</td>
<td>25.1</td>
</tr>
<tr>
<td>from 3 up to 4</td>
<td>From 66.49 up to 89.10</td>
<td>792 882</td>
<td>5.7</td>
</tr>
<tr>
<td>from 4 up to 5</td>
<td>From 89.11 up to 166.20</td>
<td>367 060</td>
<td>2.6</td>
</tr>
<tr>
<td>from 5 up to 10</td>
<td>More than 166.20</td>
<td>92 299</td>
<td>0.7</td>
</tr>
</tbody>
</table>

The Pension Fund is financing the different types of pensions according to the Law of Ukraine On provision of pension (about 70 percent of all expenses), On the status of war veterans and their social guarantees (about 5 percent), On public service (0.5 percent), targeted allowances to needy pensioners (about 4 percent) and funeral expenses.

The existing policy of pension provision in Ukraine is based exclusively on public pension insurance and principle of inter-generational solidarity. Numerous types of pensions, low amounts of pensions, a low retirement age, a significant number of privileged pensioners, a lack of alternative financial sources, and the limited correlation between contributions and payment lead to a crisis in the pension system. Fundamental reforms are urgently needed.

Policies in the sphere of employment and unemployment

Employment structure

Along with a decline in production, total employment in industry has fallen. Over the last six years about 1 million people annually have been made redundant from different industries.

A constant reduction of employed workers in the general structure of labor resources leads to an increased pension burden on each worker.

Labor market situation

The labor market is in a situation whereby the labor supply significantly outstrips demand. At the beginning of 1996 there were two persons unemployed per vacant job. By 1999 this has risen to 30.

This situation creates a strain on the labor market. The registration of unemployed people started in 1991 and ever since the number has been growing steadily since then.

According to projections by the Ministry of Economy, it is expected that excess workers will be made redundant due to further structural changes in the economy, numerous cases of bankruptcies, and restructuring. This will put further strain on the Employment Fund, which is responsible for the second and third months of severance payments.

The amount of employment benefit is proportional to growth of the unemployment rate, which is estimated to equal 6.2 percent of the working population, and 7.3 percent in 2000.

The general structure of unemployment differs across regions. In Western oblasts, the unemployment rate exceeds the average national rate of unemployment. As of January 1999, the national unemployment rate was 3.18 percent, and respectively 6.18, 4.39, 5.35 and 5.47 percent in
Ivano-Frankivsk, Transcarpathian, Lviv, and Volyn oblasts.

An analysis of regional labor markets situation shows the dependence of unemployment on the industrial structure of a given region. Hardest hit are the coal mining regions. Despite the mine closure program, additional public support is needed to provide social protection for redundant miners and to help them find new jobs.

**Hidden unemployment**

Most workers work for enterprises part time or take compulsory leave. In the current year, there is a trend towards reducing the number of workers in specific categories. In particular, in the first half of 1999 1,299.8 thousand workers were on administrative leave (2,189.0 thousand in 1997), and 925.0 thousand were engaged part time (1,793.5 thousand in 1997).

There is a discrepancy in figures for laid-off workers with workers registered with employment agencies. In particular, according to a comparative study of households by the State Committee of Statistics in October 1997 only one third of laid-off workers try to find jobs through employment agencies.

Recent survey results indicate that the reason why most unemployed people do not approach employment agencies is the low jobseekers allowance, as well as a lack of confidence in agencies’ capacity to find jobs with an appropriate level of remuneration.

Almost 70 percent of respondents connect this phenomena to the low level of the jobseeker allowance and half cite the lack of incentives to look for a new job.

<table>
<thead>
<tr>
<th>Table 6. Number of workers employed (thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>-----------------------------------------------</td>
</tr>
<tr>
<td>Employed</td>
</tr>
<tr>
<td>Manufacturing</td>
</tr>
<tr>
<td>Industry</td>
</tr>
<tr>
<td>Construction</td>
</tr>
<tr>
<td>Agriculture</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Table 7. Number of unemployed people and unemployment rates by the end of a given year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year (year-end)</td>
</tr>
<tr>
<td>-----------------</td>
</tr>
<tr>
<td>1991</td>
</tr>
<tr>
<td>1992</td>
</tr>
<tr>
<td>1993</td>
</tr>
<tr>
<td>1994</td>
</tr>
<tr>
<td>1995</td>
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<td>1996</td>
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<tr>
<td>1997</td>
</tr>
<tr>
<td>1998</td>
</tr>
<tr>
<td>1999</td>
</tr>
<tr>
<td>2000</td>
</tr>
</tbody>
</table>
Problems of youth unemployment

Failure to solve the above problems reduces the number of young people applying to employment agencies and worsens the crime situation.

Bearing in mind that people in this category do not have work experience, enterprises neither hire them nor offer them promising jobs. Employment agencies offer professional training or participation in seasonal public work. This begs the question of how to find a job without any experience, and how to stimulate enterprises to provide graduates with their first job.

During recent years women's employment has been falling despite their higher quality of education and professional training.

Of the total number of workers who were registered by the employment service during 9 months of the current year, women make up almost 55 percent. Women approach employment offices more often for help, since they more likely to accept low salary jobs and are less inclined to be engaged in the non-formal sector and shadow economy.

Creation of new jobs

The number of redundancies outweighs the number of newly created jobs, and regional unemployment rates in given regions may exceed the average unemployment rate in Ukraine.

According to the State Committee for Statistics, in 1998 they created 60.1 thousand jobs, which is much less than in previous years. One of the potential ways of solving the problem is by targeting funds to local oblast administrations in order to create alternative jobs.

To mitigate tension on labor markets, measures are taken to implement active employment policies within the Population Employment Program in 1997-2000. Implementation of the programs resulted in 296,000 placements of unemployed people registered at employment agencies in 9 months of 1998.

Table 8. Structure of youth in comparison with the total number of unemployed people

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Unemployed people, registered by public employment agencies during year</td>
<td>569</td>
<td>640</td>
<td>561</td>
<td>1,455</td>
<td>1,640</td>
</tr>
<tr>
<td>Including:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Young graduates from secondary schools, vocational schools who were not assigned jobs</td>
<td>240</td>
<td>278</td>
<td>385</td>
<td>536</td>
<td>599</td>
</tr>
<tr>
<td>percent of total</td>
<td>42.2</td>
<td>43.5</td>
<td>39.2</td>
<td>36.8</td>
<td>36.5</td>
</tr>
</tbody>
</table>

Table 9. Female unemployment in the general unemployment structure

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Unemployed people, registered by public employment agencies during a given year (thousand)</td>
<td>569.2</td>
<td>640.1</td>
<td>982.6</td>
<td>1455.2</td>
<td>1640.4</td>
</tr>
<tr>
<td>Women</td>
<td>328.3</td>
<td>358.4</td>
<td>560.9</td>
<td>828.0</td>
<td>943.3</td>
</tr>
<tr>
<td>Women as percent of total</td>
<td>57.7</td>
<td>56.0</td>
<td>57.1</td>
<td>56.9</td>
<td>57.5</td>
</tr>
</tbody>
</table>
According to the Employment Program for 1997-2000, the creation of jobs at the expense of enterprises, especially in trade and catering services is envisaged.


At the same time, scarcity of finance prevents the allocation of funds to create new jobs.

To ensure that workers of appropriate qualification are placed in vacant jobs, employment offices provide professional training services to the employed as well as to the unemployed. In the first 9 months of 1998, training services were rendered to 982,000 persons, and another 56,200 thousand were sent on re-training courses. Due to the diminishing scope of professional training in secondary and vocational schools, the major part of such services to school students is provided by employment offices. The main direction of employment office activity is becoming not only material assistance to unemployed but also professional training corresponding to the demand of labor market. The offices have begun to train entrepreneurs in newly-emerged business “incubators” in Kherson, Sumy, Poltava, Donetsk oblasts, and Kiev.

Employment offices carry out activities aimed at organizing various public works and obtaining funds from enterprises, local budgets and other sources for this purpose. There is a widespread practice of concluding agreements with enterprises on seasonal work. Over 9 months of the current year, 150,100 people will participate in public work, including 66,000 unemployed people, and 396 agreements on seasonal jobs have been concluded.

To provide jobs for those who cannot compete on the labor market, enterprises reserve specific jobs equal to 5 percent of total number of jobs. In 1998, 58,500 persons were assigned such jobs.

The limited resources of the employment fund complicate their application to a wider scope of measures of active policies, hinder the enhancement of minimal unemployment assistance, and fail to support appropriate logistics in employment offices. Additional expenses such as reimbursement to the Pension Fund for early retirements, and two months allowance for laid-off workers will lead to a Pension fund deficit in 1999.

The opinion that it is necessary to grant state subsidies to the State Employment Fund is not universal by any means (39 percent of experts supported this suggestion, and 30 percent opposed it). The proposal to separate the State Employment Fund from the state budget is also disputable (only 43 percent of experts supported the idea).

The problems of employment can also be addressed by traditional measures on the labor market. According to the Law of Ukraine “On Employment of the Population”, such active measures include the following: professional orientation, retraining of redundant workers, relocation expenses, new enterprise loans, and public works.

The existing policy does not take into account economic, structural, educational, and social factors. In fact, it is not reconciled with industrial, agricultural, and investment policies. It also refers to the policies of small and middle-size businesses. Lack of coordination with the sphere of education is a clear discrepancy. These factors lead to negative structural changes in employment, growth of real and hidden unemployment, and misbalance of the labor supply and demand, etc.
III. FRAMEWORK OF PROSPECTIVE POLICIES

REFORM OF THE PENSION SYSTEM

The major factors that caused the crisis of the pension system are economic and demographic:

- decline in the financial strength of enterprises,
- low contributions to the Pension Fund,
- constant growth in the number of people of pensionable age.

Unless the economy changes its influence on the pension system from negative to positive in the nearest future, demographic factors will be a burden for the pension system both in the short and long term.

According to some forecasts, by the year 2026 the number of people beyond working age will grow and will have reached 29.7 percent. The correlation between working people and persons of pensionable age is affected accordingly.

Under this situation, the interests of both present day and future pensioners force us to place the issue of the pension reform into practical dimension.

Objective of pension system reform

The major objective pension system reform is that the system become solvent. The structure of the pension system must have a real plan of financial income which will secure adequate revenues in line with future projections, taking into account the limited lending capacity of the state. Payments to the Pension Fund should be perceived not as tax but as savings and future security.

The Government prepared and submitted to Verkhovna Rada of Ukraine the Draft Pension Reform in Ukraine, Draft Laws of Ukraine On compulsory government pension insurance and On Non-Government Pension Funds. The drafts of these normative acts determine the principles, essence and stages of pension reform.

**Principles of organization of the future pension system**

In terms of concept, it is recommended that the core of the pension reform program should be the principle of supplementing the existing solidarity (PAYG) pension insurance system with additional types based on accumulating insurance payments on individual accounts - a “fully-funded” type of pension system. This provides for additional types of compulsory and voluntary pension insurance. It is obvious that the low rate of wages in the national economy will not allow the redistribution or relocation of significant amounts from the solidarity system to the accumulative one. However the development of an accumulative system is both useful and necessary.

**Table 10. Burden on the working Ukrainian population, (per 1000 people)**

<table>
<thead>
<tr>
<th>Years</th>
<th>Children under 15 years old</th>
<th>Persons above capable age</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>372</td>
<td>410</td>
<td>782</td>
</tr>
<tr>
<td>1999</td>
<td>363</td>
<td>406</td>
<td>769</td>
</tr>
<tr>
<td>2000</td>
<td>351</td>
<td>400</td>
<td>751</td>
</tr>
<tr>
<td>2001</td>
<td>339</td>
<td>391</td>
<td>730</td>
</tr>
<tr>
<td>2006</td>
<td>293</td>
<td>368</td>
<td>661</td>
</tr>
<tr>
<td>2011</td>
<td>291</td>
<td>391</td>
<td>682</td>
</tr>
<tr>
<td>2016</td>
<td>308</td>
<td>444</td>
<td>752</td>
</tr>
<tr>
<td>2021</td>
<td>318</td>
<td>503</td>
<td>821</td>
</tr>
<tr>
<td>2026</td>
<td>314</td>
<td>554</td>
<td>868</td>
</tr>
</tbody>
</table>
Undoubtedly, it is necessary to implement compulsory accumulative accounts today. The research which was carried out to find the ways of implementing an efficient system of pension insurance showed that 61 percent of government officials and scientists support it. Only 9 percent of respondents were opposed.

The funds generated in an accumulative system will secure additional payments to the pensions paid from the solidarity system in the future and they will additionally serve as a significant source of domestic investments (according to some estimates up to UAH 300 million annually).

**Three level pension system**

Thus, the future pension system will consist of three levels of financial support for the aged.

**First level** - compulsory governmental pension system ("pay-as-you-go").

The main objective is to provide all people of pensionable age with a state-guaranteed minimum level of income. This will be the system of social support in old age. At the same time, this pension system provides for some differentiation depending on the extent to which individuals made insurance payments.

Sources of funding would be the Pension Fund of Ukraine and the State Budget. Funding of the payments is based on the principle of redistribution and solidarity of generations.

**Second level** compulsory additional pension insurance ("compulsory fully-funded")

Like in most developed countries, to function along the lines of accumulation according to insurance payments. This system provides two forms of accumulation: personal saving accounts and accumulation at the place of employment. Management of this system can be performed by both government and private institutions.

**Third level** principle of voluntary contributions ("voluntary fully-funded").

Management can be done by private pension insurance companies which must meet requirements as to liquidity, profitability, diversification and activity of assets. The amount of pensions paid by a non-governmental pension fund are determined by the amount of contribution and the duration of payment.

The following key issues need to be resolved in the process of pension system reform:

- Which systems will reliably protect people in old age and at the same time promote economic growth?
- What stages and speed of the pension system reform must be in place to make sure that reform does not harm people and to minimize losses for society?
- How should management of the system be organized - on centralized, decentralized, and competitive levels?
- Should the system be voluntary, compulsory, or a blend of the two?

The outcomes of reform depend mainly choosing an adequate way of resolving existing issues. It should be emphasized that there is no alternative to improvement of the solidarity system and implementation of personalized accounting in Ukraine. This conclusion is shared by both experts and 83 percent of respondents. Among government officials this opinion is unanimous.

**Achieving balance between solidarity and accumulative systems**

From the forecast of social and economic development of Ukraine by the year 2010 and the existing rates of payments to the solidarity pension system, the following balance between solidarity and compulsory accumulative systems is recommended as an acceptable and painless approach to building the pension system: 24 percent of salary goes to the solidarity system and 10 percent goes to the accumulative system.

Such correlation will be reached gradually, since it depends first of all on the dynamics of the level of salaries, the demographic situation, the situation in the labor market, minimum guaranteed payments, development of the stock market and its infrastructure in particular.

Deductions from salary to the accumulative system will be imposed only on employees under 40 years old as of January 1, 2000.

The length of time required to reach the aforementioned balance will be conditioned by the ability of the budget to service government securities which are issued for sale to holders of personal accounts in the accumulative system.
Table 11. Pattern of redistribution of funds between solidarity and accumulative systems of pension support

<table>
<thead>
<tr>
<th>Year</th>
<th>Deductions from the amount of salary, percent</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
</tr>
<tr>
<td>2000</td>
<td>34,0</td>
</tr>
<tr>
<td>2001</td>
<td>34,0</td>
</tr>
<tr>
<td>2002</td>
<td>34,0</td>
</tr>
<tr>
<td>2003</td>
<td>34,0</td>
</tr>
<tr>
<td>2004</td>
<td>34,0</td>
</tr>
<tr>
<td>2005</td>
<td>34,0</td>
</tr>
<tr>
<td>2006</td>
<td>34,0</td>
</tr>
<tr>
<td>2007</td>
<td>34,0</td>
</tr>
<tr>
<td>2008</td>
<td>34,0</td>
</tr>
<tr>
<td>2009</td>
<td>34,0</td>
</tr>
<tr>
<td>2010</td>
<td>34,0</td>
</tr>
</tbody>
</table>

Thus, under the assumption that this balance is fully implemented in the year 2000, special securities are required (based on the number of people employed in 1998):

- year 2000 - UAH 3760 million
- year 2001 - UAH 3870 million
- year 2002 - UAH 4050 million

Even with minimum annual interest rate which secures their profitability and protection from inflation, budget financing of 500 to 600 million will be required annually. In the foreseeable future the government will be unable to fulfill such obligations.

In order to ensure that people are not exposed to double taxation, the funds which go to raise employees’ salaries and which are deducted for pension insurance in the accumulative system are expected to be included in the minimum non-taxable income.

Personalized accounting of insurance payments are required that include data such as: insurance term, amount of salary, and contributions.

The conditions of granting pensions and establishing their amounts in the future will be closely interrelated with the length of service, that is the period of labor activity, during which funds were transferred to the Pension Fund. Moreover, the length of the insurance term will be gradually increased to 35 years, during which the amount salary is taken into consideration in determining the amount of pension.

In combination with personalized accounting of insurance payments, the aforementioned measures will no doubt stimulate people to productive, transparent and well-paid work during their entire career and will foster sustainable transfer of funds to the Pension Fund.

**Gradual increase of the pension age**

One of the most acute challenges that appears in the process of preparing and implementing reform is the issue of pensionable age. It has been already emphasized that the need to raise the pension age derives from demographic and economic circumstance. There are, however, some weighty counter-arguments too.

One of them is the recession, when most enterprises work at half of their capacity and even less, when a large number of employees work part time or out of work. Besides, it is not expected that business activity and investment activity will recover significantly in the nearest future, an increase which would create new jobs.
Under such circumstances, the disingenuous increase of pensionable age could artificially complicate these processes. We should also keep in mind that given the current situation any attempts to change the retirement age are perceived negatively both by public and political forces.

Thus, among the respondents that were involved in discussion of the results of the research, the issue lacked conformity. Despite the fact that over 50 percent of them support this measure, about 30 percent are against it, at least in the next 10 years. And among government officials every third person sees it as an ineffective tool for overcoming the crisis in the pension support system.

Bearing the aforementioned in mind, the proposed solution of the pension age issue contained in the program of pension reform can be evaluated as an adequate one at this stage. It is based on the principle of material incentive to retire at an older age. In particular, it is expected that full amount of old age pension will grow per each year of insurance term from the day a person is entitled to pension. At the same time, the Draft Law of Ukraine On governmental pension insurance determines that in case of lack of sufficient length of service a citizen is entitled only to a reduced pension.

There is no doubt that such an approach would influence the actual age of retirement. However, we should already start thinking about the second stage of the reform - the legislative raising of the pensionable age. In our opinion, it will become possible after the year 2010.

This conclusion is based on the fact that in the period between 2001 and 2010 it is expected that the number people of working age will grow, and at the same time, the number of pensionable people will fall slightly. After the year 2010, when a reverse trend is expected, an increase in pensionable age will become a simple necessity.

Taking into account the life expectancy for men and women after retirement, it is projected that the retirement age for men will be raised to 63 years old and to 60 years old for women. These parameters will be implemented gradually in the period between the year 2011 and year 2020 through raising the pension age for men by 3 months per year and by 6 months per year for women.

It is clear that such a move must be preceded by an in-depth analysis of the situation on the labor market, demographic conditions, and in particular, evaluation of projected life expectancy for men and women after retirement.

Changes in the approaches to working pensioners

It is recommended that approaches to pension payments to working pensioners are changed, in order to systemize them and to reduce the burden on the Pension Fund in the near future. It is meant to limit payment to working pensioners to two average salaries of employees who work in industry.

This will allow an increase in the amount of minimum old age pension and to remove limits on maximum payment, to restore differentiation of pensions, and to guarantee timely payment.

Unfortunately, 30 percent of all respondents and 33 percent of government officials do not see limitation of pensions for working pensioners as enhancing the efficiency of the pension system.

REFORM OF EMPLOYMENT POLICY

The unemployment problem in the last years has grown more acute, and analysis of projected employment rates indicate negative trends in the future. These factors justify a greater role of the government in improving the employment situation.

The major activities in terms of resolution of the unemployment problem are as follows:

- increased investment in the economy,
- fostering the development of small and medium businesses,
- improvement of legislative and normative framework,
- stimulating enterprises and investors to create new jobs,
- improvement of work on the labor market under the conditions of growing unemployment.

An important direction of economic reform in Ukraine is the creation of a favorable environ-
ment for development of small and medium business. As of today, there are about 140,000 small enterprises in Ukraine; it is expected that there will be even more in the future. To improve the legislative framework which governs business activity, a Presidential Decree has introduced a simplified system of taxation, accounting and reporting for small businesses. Further measures are needed to stimulate small and medium businesses:

- Financial, technological, consultative, external economic and cadre development programs aimed at small and medium businesses.
- Streamlined governmental regulation of this sector for registration procedures, licensing, accounting and reporting, auditing, etc.
- A favorable tax environment including a simplified mechanism of taxation for small enterprises based on the number employees and its turnover.
- Significantly improved system of accounting and reporting to the government, and accounting of small enterprises.

There was not a single opponent among the participants of the research to the development of small and medium businesses. 75 percent of respondents have a positive attitude towards need to develop loan opportunities for employers to create new jobs.

Regulation of the issues of employment and social protection for unemployed

The Draft Law of Ukraine On compulsory state social insurance in case of unemployment determines legal, financial and organizational grounds for compulsory state social insurance in case of unemployment. This law, which has been already prepared for consideration by Verkhovna Rada of Ukraine, provides material support and social services in case of unemployment at the expense of the Fund of Compulsory State Social Insurance of Ukraine in Case of Unemployment. The Draft Law determines definition of persons that are covered by the insurance as well as the rights, duties and responsibilities of the subjects of insurance.

Provision of unemployment benefit to insured persons will depend upon the length of service and social insurance contributions before unemployment. The level of benefit is established in proportion with the previous salary, depending on the insurance term and length of unemployment. This stimulates active job-hunting. For persons of pre-pensionable age, the term of payment of unemployment aid will be prolonged in consideration of the difficulties with regard to job-hunting or retraining. Employees who have resigned retain the possibility of pre-term retirement in accordance with the Law of Ukraine On Employment of the Population. In this case, pension expenditure will be reimbursed to the Pension Fund from insurance unemployment fund.

Labor market development measures

Taking into consideration the forecasts of rapid growth in the number of unemployed in the nearest future, other labor market policies should also be implemented.

- Create the system of on-going control over the status of the labor market (on a quarterly basis) that is based on the analysis of sample surveys to make it possible react immediately to changes in the labor market.
- Evaluate the methods of the State Employment Center and connected bodies, improve equipment of the State Employment Center to meet short-term needs (for example, registration of clients, calculation of social assistance, prevention of fraud) and resolve long-term issues such as registration of new jobs, development of a vacancy database in order to improve mobility of the labor force, and controlling implementation of existing labor market development programs.
- Simplify the complex of social guarantees for registered unemployed and their sources of budgetary revenues. Focus on organizing employment services and not on providing social assistance and social payments.
- Introduce amendments to the Law of Ukraine On Bankruptcy to secure payment of severance allowances in case of enterprise insolvency.
- Revise the Law of Ukraine On Privatization in terms of provision of social guarantees and services to employees who are subject to redundancy.
Set up conditions for improved labor mobility.

As an institutional basis of the employment policy, the Government needs to establish a clear program of structural re-building of the economy; programs for restructuring specific industries, informed loan and taxation policies; and policies for attraction of direct foreign investments. The cumulative effect of such programs would be to kick-start the development of business activity and secure conditions for economic growth.

### COMPARATIVE ANALYSIS OF SOCIAL POLICY ALTERNATIVES

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Proposed in the project</th>
<th>Alternative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Name of the strategy:</td>
<td>“Radical reform of pension support”</td>
<td>“Improvement of the current system of pension support”</td>
</tr>
<tr>
<td>Objectives</td>
<td>To secure solvency of the pension system.</td>
<td>To safeguard the human right to social protection in case of insurance risk (old age, disability, loss of bread winner) within effective legislation framework.</td>
</tr>
<tr>
<td>What problems does it resolve?</td>
<td>• Lack of equality of rights of insured persons in terms of granting pensions and provision of social services in comparison to social insurance contributions. • Inability to secure relations between labor contribution and the amount of pension. • Insufficient differentiation of the amounts of pensions and assistance depending on the length of insurance term and the level of compensation. • Poor efficiency of the mechanism of deductions for pension support.</td>
<td>• Legal protection of constitutional norms in the field of pension support.</td>
</tr>
<tr>
<td>How it is resolved? (key measures)</td>
<td>• Implement personalized accounting of insurance payments. • Eliminate the existing principles of provision of privileges, their financing at the expense of employer. • Improve the tax base. • Implement an accumulative pension system. • Improve tax legislation and to toughen responsibility for inappropriate usage of funds.</td>
<td>• Raising of the effective rates of payments to compulsory pension insurance. • Implementation of additional types of dues for financing. • Limitation of maximum amount of pensions. • Delimitation of the sources of funding pensions and social aid.</td>
</tr>
<tr>
<td>What will be the consequences of these decisions?</td>
<td>• Long-term (over 3 years): Increased supply on the market of investment capital and enhancement of business activity. Increase in the number of people of</td>
<td>• Long-term (over 3 years): Growing number of privileged pensioners. Sharpening of social tension due to decline of actual income of pensioners.</td>
</tr>
<tr>
<td><strong>Strategy</strong></td>
<td><strong>Proposed in the project</strong></td>
<td><strong>Alternative</strong></td>
</tr>
<tr>
<td>--------------</td>
<td>----------------------------</td>
<td>-----------------</td>
</tr>
</tbody>
</table>
| working age. | • Expansion of tax base and reduction of shadow non-taxed income.  
• Raising of minimum amount of pensions to the poverty line.  
• Solvency of the pension system.  
  *Short-term (within 2 years):*  
• Limited pensions for working pensioners.  
• Narrowing of the range of privileged categories of pensioners.  
• Sharpening of social tension due to frustration of those groups who will lose privileges or whose income will drop. | • Insolvency (bankruptcy) of the pension system.  
  *Short-term (within 2 years):*  
• Growth of pension arrears.  
• Strengthening of tax pressure on enterprises.  
• Growth of arrears in payments to the Pension Fund.  
• Toughening of the pressure on the part of the parliament and populace on redistribution of the available budgetary funds for social expenditures.  
• Retention of the low level of pension support with the high level of deductions to the current voluntary system.  
• Insecure differentiation of pensions due to the absence of personalized accounting of insurance payments.  
• Unaccounted-for demographic burden on the working population.  
• Retention of the current mechanism of charging social insurance contributions.  
• Retention of privileged pensions  
• Reaching and retention of the employment rate which adequately meets the needs of the economy.  
• Protection of existing jobs. |
| **Objectives** | • To shape the mechanisms of employment regulations: to institutionalize the labor market.  
• To secure guarantees of social protection for unemployed people.  
• To prevent further mass unemployment. | |
| **What problems does it resolve?** | • Hidden unemployment.  
• Imbalance between supply and demand of labor force.  
• Expansion of poverty.  
• Growing number of jobs in the shadow economy. | • Mass layoffs and a sharp increase in unemployment.  
• Social protection at a minimum level. |
<table>
<thead>
<tr>
<th>Strategy</th>
<th>Proposed in the project</th>
<th>Alternative</th>
</tr>
</thead>
</table>
| How it is resolved? (key measures) | • Create favorable investment climate and implement tax exemptions for creation of new jobs.  
• Liberalize the activity of small and medium businesses.  
• Extend type and amount of public works.  
• Create unified national informational system on availability of jobs and relevant skilled labor force.  
• Provide tax exemptions to enterprises of the infrastructure of the labor market on the condition that they would reinvest the saved funds.  
• Implement social insurance in case of unemployment  
• Implement educational programs for training for competitive professionals | • Regulation of non-governmental infrastructure of the labor market.  
• Protection of domestic producers.  
• Higher responsibility of employers to employees.  
• Increase of insurance payments as unemployment relief.  
• Granting independent status to the State Fund for Employment Promotion. |

**Long-term (over 3 years):**
- Increase of insurance payments as unemployment relief.  
- Formation of a transparent labor market.  
- Flow of labor resources from inefficient sectors of economy and enterprises to competitive ones.  
- Stabilization of the labor market.  
- Accuracy of actual and registered unemployment indicators.

**Short-term (within 2 years):**
- Gradual decrease of shadow employment via legalization.  
- Creation of new jobs in the economy.  
- Mass layoffs at unprofitable enterprises.

**Long-term (over 3 years):**
- Shaping inefficient flows of internal and external migration.  
- Distortion of the industrial structure of the economy.  
- Lower investment attractiveness.  
- Inappropriate use of the Employment Fund funds

**Short-term (within 2 years):**
- Spontaneous changes in the structure of employment.  
- Increase of insurance payments as unemployment benefit.  
- Growth in official and hidden unemployment.  
- Low employment in the official sector of the economy.  
- Deeper stratification in society in terms of level of income.
IMPLEMENTATION OF NEW POLICIES

This survey was conducted for the purpose of finding differences in the opinions of researchers and experts dealing with development and implementation of the state policy in the sphere of social protection.

23 specialists were polled. 12 of the specialists are representatives of central executive bodies, 9 are representatives of research institutions and agencies, and 2 are representatives of businesses. Among those polled were specialists from the Ministry of Economy, the Ministry of Finance, the Ministry of Labor, the Main State Treasury, the Ukrainian Association of Entrepreneurs and Industrialists, the National Academy of Sciences of Ukraine and some other educational institutions. 51 percent of those who received polling forms responded (45 forms were sent and 23 forms were completed).

Major differences

Major differences were found in understanding discrepancies between actual and hidden unemployment and finding ways to achieve efficiency in the system of pension insurance, thereby strengthening social protection of the unemployed population.

In particular, 33 percent of officials polled rejected the idea of gradual raising of pension age and limitation of pensions for those who continue to work.¹

26 percent of all respondents did not support the proposal on gradual prolongation of the insurance term which is necessary in order to receive a full pension. Every fifth polled did not agree with the proposal to stop granting privilege pensions.

Such different findings regarding issues in question attest, first of all, to the fact that it is expedient to implement the aforementioned measures in the long-term after reaching general agreement among all parties interested.

Different opinions on guidelines for implementing the policy of social protection testify to the fact that respondents being members of NGOs have no confidence in the efficiency of measures aimed at financial support of the Employment Fund and granting special independent status to the Fund.

Almost one third of respondents did not consider that the reason of such differences in parameters of actual and hidden unemployment is lack of stimuli to seek new jobs or vacant positions low salaries.

In addition, public opinion is negative (45 percent) regarding ability of state institutions to make the acting system of social protection more efficient in the future.

Representatives of research institutions and higher education institutions (65 percent) do not see that fund shortages is the reason why targeted social programs are absent.

However, such a point of view does not tally with the following poll results regarding obstacles in the reform process. Experts were almost unanimous (from 85 to 95 percent) when defining the current problems concerning pension financing.

Such problems are as follows:

- low level of salaries which, under the present unfavorable demographic conditions, results in high level of allocations to the voluntary system (95 percent of experts)
- widespread barter in the economy as well as tax evasion (90 percent).
- delay in passing legislation that would cancel privileges (90 percent of experts).

The issues that received considerable support

A fairly high unanimity of responses was noted on issues characterizing the strategy proposed by researchers regarding the improvement of pension systems. Their conclusions correspond by 60-90 percent with the views of researchers in citing reasons for weaknesses in the pension structure.

¹ [Ed. On the other hand, note that over half of all respondents favor increasing the pension age, a position supported by an even larger percentage of those not working in government]
Table 12. Issues agreed to the least degree (the highest level of dispersion)

<table>
<thead>
<tr>
<th>Dispersion</th>
<th>Support, percent</th>
<th>Do not support, percent</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Public Total</td>
<td>Officials Total</td>
</tr>
<tr>
<td>Efficiency system of pension insurance and appropriate level of pension payment can be achieved through:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>rejection of many privilege pensions and transfer the responsibility of making relevant payments to enterprises</td>
<td>0.98</td>
<td>52</td>
</tr>
<tr>
<td>gradual prolongation of the insurance term which is necessary for granting full pension</td>
<td>0.95</td>
<td>48</td>
</tr>
<tr>
<td>gradual increase of pensionable age</td>
<td>1.44</td>
<td>52</td>
</tr>
<tr>
<td>limitation of pensions for working pensioners</td>
<td>1.54</td>
<td>44</td>
</tr>
<tr>
<td>The following measures will facilitate social protection of unemployed population:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>State subsidies for the Employment Fund</td>
<td>1.27</td>
<td>39</td>
</tr>
<tr>
<td>withdrawal of the Employment Fund from the State Budget.</td>
<td>0.98</td>
<td>44</td>
</tr>
<tr>
<td>Discrepancy between actual and registered unemployment is connected with:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>low level of unemployment insurance payments</td>
<td>1.17</td>
<td>70</td>
</tr>
<tr>
<td>absence of stimuli for seeking new jobs</td>
<td>1.34</td>
<td>48</td>
</tr>
</tbody>
</table>

Respondents almost unanimously perceive the guidelines for and ways of strengthening social protection of the unemployed population. From 74 to 96 respondents expressed their support for the idea that it is necessity to create a system of regular labor market monitoring, modernization of employment services, introduction of credit lines for employers and employees to create new jobs, reorientation towards active forms of support to the unemployed, and the introduction of stimuli for small and medium businesses.

Experts demonstrated a fairly high percentage of agreement with the position of researchers on reasons for discrepancies in actual and registered unemployment. Moreover, the degree of agreement was the highest on the issues which are most important for the choice of strategy, in particular, with the conclusions of researchers that the reasons include the delay of enterprise restructuring and poor mechanisms used for declaring an enterprise bankrupt. From 80 percent to 95 percent of respondents agreed.

As is known, 1998 was marked by only UAH 10-20 increase in pension amounts for 6 million pensioners as well as by UAH 3-5 increase in governmental aid for needy pensioners from December 1998.
Table 13. Affirmative answers

<table>
<thead>
<tr>
<th>Efficiency of the System of Pension Insurance and appropriate level of pension payments could be achieved through:</th>
<th>Dispersion</th>
<th>Support, percent</th>
<th>Do not support, percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>introduction of compulsory accumulative accounts and voluntary pension insurance with the help of private pension funds</td>
<td>0.77</td>
<td>61</td>
<td>50</td>
</tr>
<tr>
<td>gradual approaching of minimal pension payments to the government poverty line</td>
<td>0.94</td>
<td>74</td>
<td>5</td>
</tr>
<tr>
<td>optimization of allocations basis and reduction of shadow incomes</td>
<td>0.49</td>
<td>87</td>
<td>83</td>
</tr>
<tr>
<td>improvement of the solidarity system and introduction of personalized accounting</td>
<td>0.77</td>
<td>83</td>
<td>5</td>
</tr>
</tbody>
</table>

Major reasons for inefficiency of the system of pensions provision:

| absence of appropriate differentiation of pension payments depending on fees and length of service | 0.80 | 91 | 92 | 9 | 8 |
| absence of personalized accounting | 0.42 | 87 | 83 | 0 | 0 |

The following measures will facilitate social protection of unemployed population:

| creation of the system of regular labor market monitoring | 0.51 | 96 | 100 | 4 | 0 |
| reorientation towards active forms of support of unemployed population | 0.48 | 83 | 75 | 0 | 0 |
| introduction of credit lines for employers and employees to create new jobs | 0.86 | 74 | 75 | 9 | 8 |
| modernization of the employment institution activities aimed at solving short-term and long-term challenges | 0.36 | 92 | 83 | 0 | 0 |
| improvement of cooperation between employment institutions and local government bodies | 0.57 | 87 | 83 | 4 | 0 |
| development of small and medium businesses | 0.44 | 92 | 83 | 0 | 0 |
A number of measures have been implemented to reduce arrears by means of enforcing compulsory payments on the debtor enterprises, transfer of property and ownership rights in exchange for debts, extension of the tax base and introduction of additional rates, extension of promissory note debt registration, and granting pensions in kind. These have helped, but not as much as expected. Such measures have not worked in the Donetsk, Luhansk, Kharkiv, Chernihiv, Kyiv, Lviv regions. So, the conclusion of researchers and almost 80 percent of respondents is that the existing system of pension support is not able, within the framework of legislation in force, to adequately respond to increasing demographic pressure and new economic conditions.

IV. CONCLUSIONS

Poll results indicate that there is no alternative to the strategy aimed at coping with and restraining poverty through reforming social and pension support systems and strengthening state employment policies in Ukraine.

In spite of the fact that Ukraine spends almost 15 percent of GDP in this area, pension benefits for those who receive them are inadmissably low. Absence of targeted social programs is the key problem caused by numerous privilege categories, and lack of adequate poverty indicators. In addition, inappropriate mechanisms for income declaration and systems that take into account income while setting benefit levels are also a big problem. Taking into consideration the low cash contributions to the Pension Fund and the State Employment Fund, it is impossible to foresee when the current system will provide an adequate system of pensions. It is recommended that politicians implement key measures within the framework of the proposed strategy to reform pension and social protection insurance and employment policies in the following succession:

<table>
<thead>
<tr>
<th>Long-term:</th>
<th>Short-term:</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Widen the taxation base and reduce shadow non-taxable incomes.</td>
<td>• Introduce social insurance contributions via personalized accounting.</td>
</tr>
<tr>
<td>• Increase minimal pension amounts up to the government poverty line.</td>
<td>• Limit pensions for working pensioners.</td>
</tr>
<tr>
<td>• Increase the retirement age insurance term for granting pensions.</td>
<td>• Reduce of the number of privileged categories of pensioners.</td>
</tr>
<tr>
<td>• Liberalize conditions for functioning of small and medium businesses.</td>
<td>• Introduce an accumulative pension system.</td>
</tr>
<tr>
<td>• Introduce tax privileges for enterprises of the labor market infrastructure on condition that the funds spared will be reinvested.</td>
<td>• Create a unified national information system on vacant positions and adequate working force.</td>
</tr>
<tr>
<td>• Grant independent extra-budget status to the State Fund for Employment Promotion</td>
<td>• Create a favorable investment climate and introduction of taxation privileges for those creating new jobs.</td>
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<tr>
<td></td>
<td>• Increase the number of types and scope of public works.</td>
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<tr>
<td></td>
<td>• Introduce unemployment benefit insurance.</td>
</tr>
<tr>
<td></td>
<td>• Introduce changes into the Laws of Ukraine <em>On Bankruptcy</em> and <em>On Privatization</em> to grant social guarantees for employees.</td>
</tr>
</tbody>
</table>
ANNEX A: LIST OF UKRAINIAN CEM PROJECT CONTRIBUTORS

Preparation of this and the other documents generated by the participatory country economic memorandum project involved dozens of Ukrainian professionals from a wide range of backgrounds in a year-long process of discussing, researching, writing, and reviewing some of the key macroeconomic and sectoral issues facing Ukraine today. The members of the eight research groups that participated in this process and the experts who helped advise and review the work of these researchers are listed below.

A great debt of gratitude is owed to these people. Their work contributed greatly to the quality of the discussions and the final products of this participatory process.

**AGRARIAN POLICY**

<table>
<thead>
<tr>
<th>Ukrainian research group</th>
<th>Ukrainian experts, who commented on the analytical materials</th>
</tr>
</thead>
<tbody>
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</tr>
</tbody>
</table>

**POLICY IN EDUCATION**

<table>
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<tr>
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<td></td>
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<tr>
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</thead>
<tbody>
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</table>
### HEALTH CARE POLICY

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<td></td>
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<tr>
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<td>Ukrainian experts, who commented on the analytical materials</td>
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<td></td>
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<tr>
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</tbody>
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