Towards Higher Standards of Living

An Economic Agenda for Ukraine

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INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING

GERMAN ADVISORY GROUP ON ECONOMIC REFORMS
WITH THE UKRAINIAN GOVERNMENT

Abbreviations

ALMP	Active Labour Market Policy
CEE	Central and Eastern European Countries
CIS	Commonwealth of Independent States
CMU	Cabinet of Ministers of Ukraine
CPI	Consumer Price Index
EPT	Enterprise Profit Tax
EU	European Union
FDI	Foreign Direct Investment
GAG	German Advisory Group with the Government of Ukraine
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GVA	Gross Value Added
IER	Institute for Economic Research and Policy Consulting
ILO	International Labour Organisation
IMF	International Monetary Fund
LGE	Local Self-Governmental Entity
LIOU	League of Insurance Organisations of Ukraine
MAP	Ministry of Agricultural Policy
MBS	Mortgage Backed Securities
MFN	Most Favoured Nations
MTPL	Motor Third Party Liability
NBU	National Bank of Ukraine
NERC	National Electricity Regulation Commission
NJSC	National Joint Stock Company
NPF	Non-State Pension Funds
OECD	Organisation for Economic Co-operation and Development
PAYG	Pay-As-You-Go
PIT	Personal Income Tax
PPI	Producer Price Index
PPP	Public-Private-Partnership
SME	Small and Medium Sized Enterprise
TWDIF	Temporary Work Disability Insurance Fund
UAH	Ukrainian Hryvnia
UIF	Unemployment Insurance Fund
UN	United Nations
USD	US Dollar
VAT	Value Added Tax
WAF	Work Accident Fund
WHO	World Health Organisation

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1 Introduction

1.1 Past success and future challenges

At the end of 2004, Ukraine can look back on a phase of economic stabilisation and growth that has surpassed even the most optimistic expectations. Annual GDP growth in the years 2000 to 2004 has averaged 8.0%; inflation has averaged 6.3% over the same period and remained below 10% for the last three years; the exchange rate has been stable; and currency reserves have grown.

Does this mean that Ukraine's reform agenda has been completed? In a word: 'No'. While recent growth has been impressive, the Ukrainian economy is still smaller than it was prior to the onset of transition. More important than the size of the economy *per se*, standards of living in Ukraine remain lower than they once were and lower than the levels attained in most other transition economies of Central and Eastern Europe. Economic performance in a number of key sectors such as agriculture remains disappointing, and much of the recent growth has been concentrated in a handful of key regions, while others look on.

Hence, it is imperative that economic growth and stability continue in the coming years. The only way to ensure this is to continue market-oriented reforms and institution building. There are signs of complacency in some policy areas in Ukraine, signs that economic success is being taken for granted and the need for further reform downplayed. Complacency, however, is not warranted. Recent economic success has been supported and sustained by reforms and prudent economic policies in Ukraine, especially in late 1999 and 2000. But it has also been the result of positive exogenous factors (such as depreciation in the aftermath of the financial crisis in 1998, good economic performance in neighbouring countries and key trading partners, and surging international demand for products such as steel that Ukraine can produce competitively).

Of course, it is not possible to determine exactly how much recent growth has been due to exogenous factors and how much can be attributed to sound economic policy making in Ukraine. One thing is sure, however: while Ukrainian policy makers cannot influence the future course of exogenous factors such as the price of steel on world markets, they can determine the course of future economic policy in Ukraine. A renewed commitment to market-oriented reforms is necessary to ensure that economic growth in Ukraine continues regardless of how developments outside the country unfold in the future.

At the same time, the economic success of recent years represents an opportunity to address important social concerns. Economic growth is not an end in and of itself. Economic growth is important because it is a

necessary condition for improvements in standards of living. Real wages and salaries remain low in Ukraine, and poverty is a very real affliction for many Ukrainians. Health standards are also low: The incidence of illnesses such as tuberculosis and HIV/AIDS has grown alarmingly, and healthy life expectancy at birth has declined to very low levels in international comparison – 54.9 years for men and 63.6 years for women according to the World Health Organisation Report (WHO, 2004).

Ukrainians have responded to declining standards of living. Fertility rates have plummeted and the share of children in the (shrinking) population has dropped from 22.3% in 1990 to 15.7% in 2002. Furthermore, many Ukrainians – generally younger individuals with above-average education and skills – have responded by leaving the country. Altogether, the number of economically active Ukrainians declined from 25.6 m in 1995 to 22.6 m in 2003, and no end to this trend is in sight. In this way, low standards of living today are undermining the basis for economic growth in the future.

It is therefore imperative that economic growth in Ukraine not only be maintained, but also channelled into increased standards of living for all Ukrainians. This is not simply a question of equity and distribution. Increased standards of living are a prerequisite for the continued acceptance of reforms by the Ukrainian people. Ensuring minimum standards of living in the form of social security systems is also necessary to ease the implementation of necessary, but painful reforms in sectors that have been largely spared so far. As it is, enterprises are not privatised, restructured or – where necessary – subjected to bankruptcy because it is claimed that the resulting unemployment would be socially unacceptable; efficient pricing of energy, utility and public infrastructure services is not implemented because it is claimed that this would impose unacceptable burdens on pensioners, the poor and other vulnerable groups. The result is the worst of all possible worlds: an inefficient indirect social policy that does not help the truly needy nearly enough, and crippling barriers to continued growth and development in key sectors of the economy.

In 1999 the German Advisory Group wrote in the introduction to its Red Book ('The Next 1000 Days: An Economic Reform Agenda for Ukraine')[1] that "Ukraine's chief target in the next few years must be to create and maintain the conditions for sustainable growth. Growth increases the population's material prosperity and makes the solution of social problems easier". In the years since we wrote this, the Government of Ukraine has succeeded in creating conditions for growth. The challenge today lies in maintaining this growth and addressing the social problems that we referred to in 1999, many of which have grown in the interim. These two goals are inseparable, as growth generates the dividends that are required to solve social problems, and solutions to these problems are necessary to ensure continued growth.

The current conditions for a new, revitalised reform initiative aimed at generating growth for all Ukrainians are good. The new government that will be installed at the end of 2004 can build on a foundation of monetary and fiscal stability that did not exist in 1999. Reforms are always easier to

[1] Available online http://www.ier.kiev.ua/English/books/TTP_Englisch.pdf.

implement against a background of growth. History would pass harsh judgement on those who miss such an opportunity.

1.2 The structure of this reform agenda

In the following nine chapters we move from the general to the specific, beginning with macroeconomic policies, social policy, fiscal federalism and investment policy, and moving to more specific policies in the areas of private insurance, lending, agriculture, utilities and energy. Throughout, the emphasis is on linkages to standards of living in Ukraine. In particular, this has guided our choice of which general policy areas (e.g. social security, regional development) and which specific policy topics (e.g. private insurance, utilities, rural areas) to analyse.

Chapter 2 deals with the **current monetary, trade policy and fiscal environment** and related challenges. Recent successes should not distract from the need to initiate a reorientation of monetary policy away from exchange rate and towards price stability. While Ukraine's foreign trade has increased significantly, policy makers should focus their efforts on the reduction of the often significant barriers to trade that remain. Accession to the WTO is of crucial importance in this regard, as calculations show that joining the WTO would lead to medium-term increases of 3% in real household incomes and almost 2% in GDP. In fiscal policy, payroll taxes continue to inflate the wage bill and significant steps to improve the VAT system are required. Recent pro-cyclical fiscal expansion, presumably linked to the 2004 elections, could add to inflation pressures and must be checked as soon as possible.

Chapter 3 looks at **social policy in Ukraine**. This is a very broad field, covering the pension system, unemployment insurance and health care, among others. Reform in this area is vital because a functioning social security system is necessary to cushion individuals against misfortune and the real hardships that inevitably occur, especially in an economy in transition. A functioning social security system is also needed to unburden other sectors and areas of economic policy (for example agriculture, transportation, energy and utilities) so that they can focus on their true priorities. Our recommendations would streamline the current system, simplifying the multitude of often overlapping funds. They would make sure that support is targeted to those truly in need, and not wasted as is often the case today. They would also reduce the 'social tax wedge', thus reducing labour costs, unemployment and flight into the shadow economy.

In **Chapter 4** we deal with **regional policy in Ukraine**. Regional growth and standards of living have been uneven in Ukraine, and some regions are being left behind. Regional policy in Ukraine has been largely 'vertical', based on the distribution of funds and other 'favours' by the central government. In retrospect, this redistribution has tended to benefit more developed regions that have effective lobbies. It has emphasised inefficient and discretionary tools such as capital transfers to specific sectors and industries, and special economic zones, that fuel lengthy political bargaining processes and rent seeking. We propose the adoption of a horizontal or bottom-up regional policy approach that requires the state to promote market incentives for efficiency and growth, and to concentrate its

active policy on the provision of public goods and private goods with significant externalities. Recommendations include an administrative-territorial reform that considerably reduces the number of local government entities and establishes units that are independent and sufficiently strong organisationally and financially. This administrative reform should be coupled with revenue reform and substantial decentralisation of public tasks. The fiscal equalisation coefficients should be set significantly below 1 for both donor and recipient regions to create more incentives for local governments to improve their revenue capacities and increase tax collection.

Chapter 5 deals with **investment policies** in Ukraine. Investment drives growth, and while overall levels of public investment in Ukraine would appear acceptable, there is reason to be concerned that this public investment is allocated in an inefficient, primarily political manner and without sufficient regard to transparency and accountability. Furthermore, the vast innovative potential of private domestic and foreign investment is not being tapped in Ukraine. The ultimate objective of our recommendations is to limit the scope for public interventionism and thus to increase the impact of investment on the long-term growth prospects of the Ukrainian economy. The key is to increase the efficiency of both public investment and public support of private investment. Public investment must be subject to much clearer budgeting and assessment procedures, and private investors should be encouraged to participate via concession schemes, public private partnerships, etc.

In **Chapter 6** the potential of the **private insurance** to increase standards of living in Ukraine is considered. A functioning private insurance sector can contribute to growth and prosperity, and increase the well-being of the population. The government can also profit considerably from a healthy insurance sector, as private insurance can replace some types of publicly funded social security, and complement others. The Ukrainian insurance market is very underdeveloped and urgently needs a clear-cut, comprehensive and above all consistent political strategy for its long-term development. At this stage, government and insurers should set realistic priorities and focus on a few crucial measures. From our point of view these are first and foremost the political and financial reinforcement of the *State Commission for Regulation of Financial Services Markets* and the enhancement of consumer protection to increase awareness and trust in private insurance. We propose the promotion of motor insurance as a means of developing the private insurance market in a way that can yield tangible benefits to millions of Ukrainian in the short to medium run.

Chapter 7 deals with **mortgage lending** in Ukraine. A functioning mortgage loan system benefits not only banks but also borrowers, especially typical middle-income households and small entrepreneurs. Mortgage lending provides individuals and enterprises that would otherwise not be creditworthy with access to finance, and the safety of secured loans contributes to lower interest rates and thereby lower cost of borrowing. These positive influences are especially important for Ukraine, where access to finance is limited, interest rates are high and the maturity of most credits short. There is considerable scope for developing the mortgage lending market in Ukraine. To this end we recommend steps that would enable banks to securitize mortgage loans and, thus, increase their

access to low-cost refinancing. The key is to ensure that mortgage securities are safe and liquid by, among other things, ensuring that the evaluation of property that is pledged as collateral is carried out in a prudent and objective manner.

Chapter 8 focuses on **agriculture and rural policy**. We argue that policy makers in Ukraine too often assume that agriculture and rural policy are one and the same, and that supporting agriculture is necessarily the best way to help rural areas. Rural policy must focus on making rural areas worth living in, by diversifying local economies to create jobs outside agriculture, and by providing basic social, cultural and infrastructural amenities in rural areas. This is a task that should be addressed by a number of ministries in cooperation, under the leadership of the ministry of economy. Agricultural policy can contribute to rural policy goals, but it is no substitute for a comprehensive rural policy. We also point out that agricultural policy continues to be highly contradictory in Ukraine; elements of support for agriculture are combined with taxation (for example the oilseeds export tax, regional interference in agricultural trade). We advocate refocusing agricultural policy and public spending on agriculture, away from intervention and price and market support and towards investments in research, education and extension that will help Ukraine to close its still huge productivity gap in agriculture.

Utilities, in particular water, wastewater and heating are the focus of **Chapter 9**. Access to and the quality of utilities services is a crucial component of standards of living. However, utilities have suffered from neglect and misguided policies in Ukraine. The system of utility subsidies is complex and lacks structure and clear goals. It provides broad coverage for households, but it also causes substantial price distortions. It puts an additional burden on industries through relatively high tariffs for industrial consumers. Utility enterprises do not receive full cost-covering payments, so they neither pay their suppliers (primarily energy suppliers) nor maintain their technical facilities. While the system clearly fails to target truly needy households, social considerations are always presented as a 'shield' against reform. We propose reforming the public utility sector in two stages. In the first stage, an independent regulator would be established to supervise the activities of all three utilities. The regulator would sets specific tariffs for all enterprises at 'reasonable' price cap levels relative to initial costs. This would create incentives for cost-reducing (in other words, energy-saving) investments. In the second stage, regulatory methods would be changed to more advanced techniques that stimulate competition on the market (e.g. yardstick competition, benchmarking schemes). In this way, the regulator could transparently revise the established price caps and thereby stimulate competition.

Finally, **Chapter 10** deals with the **energy sector** in Ukraine. Here too, social considerations are often used as an excuse for delaying or diluting reforms. The problems of the sector, which were alleviated but not solved in recent years, include persisting cross-subsidisation of household and public utility tariffs for energy services via higher prices for industry; under-investment in network maintenance; continuing indirect subsidies of gas consumption by households; subsidies to the coal mining industry; and growing intra-industry debts. Together, these are symptoms of serious distortions in tariff setting policies. We recommend first that tariff policy

should allow firms to make profits on the services provided. Second, contract enforcement should be guaranteed by the state. Accompanying these steps, an efficient regulator must be put in place to regulate access to the network segments in the energy sector. Finally, it is also advisable to embark on a full-fledged public awareness campaign to save resources and increase energy efficiency. Growth in primary energy consumption should not be taken for granted or considered a goal in and of itself. The growing Ukrainian economy requires not the growth of primary energy, but rather of energy services.

2 Macroeconomic Policy Priorities

2.1 Monetary and exchange rate policy in Ukraine

2.1.1 Description and evaluation

The cornerstone of the monetary and exchange rate policy in Ukraine has been the *de facto*[2] fixing of the hryvnia to the US dollar at 5.33 UAH/USD since 2000.[3] As the US dollar has depreciated considerably against the major other currencies, especially the euro, in recent years, the hryvnia also depreciated against these currencies. This increased the competitiveness of Ukrainian exports, which was underpinned by a strong world demand for Ukraine's traditional export commodities. In particular, world prices for metal products reached peak levels in 2003 and 2004. Strong export performance and several restrictions[4] in the foreign exchange market led to a very high surplus of the current account in Ukraine (see Graph 2.1).

Due to the sizeable current account surplus, the National Bank of Ukraine (NBU) intervened heavily in the foreign exchange market to prevent the hryvnia from appreciating against the US dollar. To stabilise the exchange rate, the NBU continued to buy out the excess US dollar supply, which allowed the NBU to significantly raise its stock of official reserves. Gross currency reserves now stand at about USD 11 bn, and have more than doubled from USD 4.4 bn at the end of 2002. With a view to import coverage, gross international reserves now make up about 3 months of imports of goods and services, compared with 2 months in 2002 and less than 1 month in 2000.

Most of the NBU's foreign exchange market interventions have not been sterilized.[5] As a result, the money supply has risen sharply. The monetary base (currency in circulation plus reserves) increased from UAH 28 bn at the end of July 2002 to more than UAH 50 bn at the end of July 2004.

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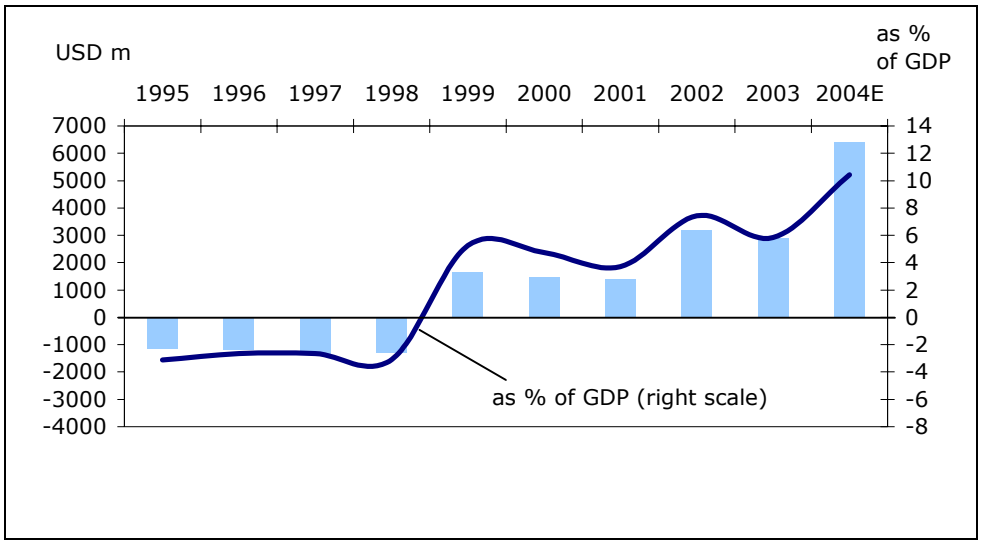
2 *De jure*, the National Bank of Ukraine has a policy of managed floating.

3 Recent slight appreciation of the hryvnia against the US dollar cannot be interpreted as a fundamental change in policy.

4 Main restrictions are the mandatory sale of 50% of foreign currency receipts (excluding, among others, credits in a foreign currency, foreign investments and deposits in a foreign currency in Ukrainian banks); licensing rules and restrictions of transactions in foreign currencies, the obligation that Ukrainian exporters deposit their foreign currency earnings in the Ukrainian banking system and anti-speculation regulations such as the ban on forward contracts or arbitrage operations.

5 The purchase of foreign currency by the NBU leads to an increase in domestic monetary aggregates. To a certain degree, the NBU can neutralise (‚sterilise') this increase by reducing the amount of money in circulation through monetary policy instruments such as its control over credits to commercial banks.

Graph 2.1
Ukraine's current account balance (1995-2004)



Note: E - Estimate by National Bank of Ukraine
Source: National Bank of Ukraine

Fortunately, a simultaneous increase in money demand prevented an increase in inflation. The re-monetisation of the Ukrainian economy is proceeding and has long been consistent with single-digit inflation rates. Nonetheless, Ukraine is currently experiencing a significant rise in prices. The producer price index (PPI) has on a yearly basis increased by over 20% in the first half of 2004, mainly due to higher world prices for metal, coke and oil. Since 2003, the consumer price index (CPI) has also risen considerably. Rapid growth of wholesale producer prices may spill over to retail prices in the future and further increase the pressure on consumer prices. Inflationary pressures are expected to mount and are a major future concern.

In sum, since 2000, monetary policy in Ukraine has been successful. The US dollar exchange rate has been stabilised, inflation has been relatively low, the current account shows a large surplus and foreign reserves are growing.

2.1.2 Policy recommendations

Monetary policy makers in Ukraine continue to rely on the benefits of a *de facto* fixed exchange rate regime. However, it is unlikely that this policy will be appropriate in the years to come. Economic circumstances have changed considerably since 2000. This raises the question whether the system should be changed and at what point in time a change, if any, should take place. We argue that monetary policy in Ukraine should be altered for two main reasons.

First, the longer the fixed exchange rate to the US dollar holds, the more people will conclude that this rate will last for a very long time. This false perception induces an ever-increasing number of economic agents to enter a 'currency mismatch'. To take advantage of lower interest rates for credits

in foreign currency than for credits in hryvnia, many enterprises and households incur debts or enter long term liabilities in US dollars. However, future income and related revenues will be in hryvnia. Some Ukrainian banks, likewise, refinance themselves in foreign currency, whereas the debt service of their domestic customers will depend on the future value of the hryvnia. Such imbalances are a major risk for the financial sector and the economy as a whole. Many contracts in foreign currency are irrevocable and have a long duration, although nobody can foresee the exchange rate in several years. The current strength of the hryvnia notwithstanding, one can never rule out the possibility of devaluation in the future. A severe devaluation of the hryvnia could leave some borrowers or banks unable to repay their foreign currency debts. The resulting bankruptcies and arrears could trigger a chain reaction and pose a significant threat to financial and economic stability.

Second, in the short and medium run, the fixed exchange rate regime is likely to increase inflationary pressure. If current account surpluses persist and the inflow of foreign currency remains high, the NBU will have to continue its foreign exchange interventions to stabilise the exchange rate. This will further feed money supply. Money demand cannot be expected to grow at current rates forever, un-sterilised US dollar inflows are likely to translate into high inflation, which would have negative effects on economic development in the country.

To address these concerns we recommend that the NBU reform its monetary and exchange rate policy. We suggest a more flexible exchange rate regime that would give the NBU more control over monetary aggregates and avoid the accumulation of financial vulnerabilities. More fundamentally, the NBU should contribute to a general re-orientation of the way Ukrainians think about money. It should make a major effort to promote confidence in the national currency, and guide the population and the business community away from the US dollar and towards the hryvnia. Price stability, and not the exchange rate, should be the main focus of monetary policy.

What would be a suitable time for these changes in monetary policy? We are convinced that Ukraine would be well-advised to abandon its policy of fixing from a position of external strength and in the presence of political stability. Consequently, we think that the change in policy should be conducted soon after the presidential elections.

2.2 Trade policy in Ukraine

2.2.1 Evaluation

A major determinant for the recent recovery of Ukraine's economy has been the substantial increase in both exports and imports. For many key industries, sales opportunities abroad have by far exceeded those on domestic markets. Key industries such as metallurgy or chemicals manufacturing currently export more than half of their total output. Accordingly, export earnings have contributed significantly to Ukraine's

GDP. The share of exports in GDP has increased from 54.3% in 1999 to 58.4% in 2003 and even 65.7% in 2004.[6]

Similarly, the recent increase in imports has also played an important role for the recovery of the Ukrainian economy. Increased availability of high-quality imports has improved the welfare of final consumers and the efficiency of domestic producers. The availability of new varieties – for example on food markets – has stimulated competition in the respective sectors and induced further product development. Opportunities to import machinery have contributed to renewing the domestic capital stock, and have thereby contributed to economic growth. Finally, many imports – once established on Ukrainian markets – have often been followed by direct investments of foreign firms, and have thereby enhanced economic growth even further.

The development of aggregate exports as well as imports during the past five years is shown in Table 2.1. Obviously, as Ukraine's economy has recovered, trade has become ever more important. This rising importance as such has been accompanied by a strong diversification of trade flows. In recent years, exports to the EU including its new members and (to a lesser extent) to other markets such as Asia or the Middle East have grown almost twice as much as exports to Russia and other CIS countries. Similarly, imports the EU have increased around one and a half times more than imports (of mainly energy) from Russia and other CIS countries.

Table 2.1
Ukraine's exports and imports of goods (1998 and 2003)

	1998	**2003**	**Change (in %)**
Total Exports (USD m)	13699	23739	73%
to Russia and other CIS countries	4202	6048	44%
to EU-25*	3489	7872	126%
to the rest of the world	6008	9819	63%
Total Imports (USD m)	16283	24008	47%
from Russia and other CIS countries	7897	11508	46%
from EU-25*	4682	7759	66%
from the rest of the world	3704	4741	28%

* EU-25 includes the current 25 members of the European Union

Source: National Bank of Ukraine

Despite the importance of trade for the economy, Ukrainian policy-makers have done little to support further improvements in this area. While Ukraine applied for WTO (then GATT) membership as early as 1993 and established a responsible Working Party in 1994, consensus on Ukraine's accession to the WTO is still far from being reached. In the meantime, trade flows in particular with non-CIS countries are restricted by several administrative measures. In particular, import-weighted average 'MFN

[6] State Statistics Committee of Ukraine, projection for 2004.

tariffs'[7] for non-agricultural commodities have remained at a constant level of around 6% to 7%. What is of greater concern, tariffs for agricultural commodities – in particular for semi-processed and processed products – have sharply increased since 1993 (Table 2.2). This has especially hurt households that spend a large share of their income on consumption of food products. In addition, frequently changing non-tariff barriers further reduce the extent to which Ukrainian consumers and producers benefit from foreign trade. These measures include, among others, price controls on domestic markets and administrative measures to restrain exports of agricultural commodities; price control measures in the steel industry aimed at reducing exports in favour of sales on domestic markets at lower prices; a prohibitive tax on exports of scrap metal; and specifically high duties on imports of vehicles. Since CIS countries are typically excluded from tariffs due to Free Trade Agreements signed during the 1990s, these measures specifically constrain trade with Western Europe and other non-CIS countries. Consequently, it can be expected that despite the recent reorientation of Ukraine's trade flows away from the CIS and towards the EU, Asia and other countries, much more could be achieved if remaining barriers to trade were removed.

Table 2.2
Import-weighted* average MFN tariff rates in Ukraine

	1993	**1998**	**2002**
Agricultural commodities:			
- unprocessed	7%	22%	25%
- semi-processed	9%	41%	58%
- processed	9%	53%	76%
Non-agricultural commodities *	6%	7%	6%

* Structure of imports in 2002 was applied as a constant weigh

Source: IER (2004): Ukraine's Trade Regime: Quantitative and Institutional Aspects. Ukraine trade regime overview. Research Report, Kyiv

2.2.2 Policy recommendations

Given the crucial importance of trade for Ukraine's economy, we urge Ukrainian policy makers to focus their efforts on the reduction of the significant barriers to trade that remain.

Existing administrative measures aiming at reducing foreign trade should be removed. Not only do they distort domestic markets and allow for various types of fraud, they also reduce the turnovers of Ukrainian companies and thus, national income, and come at the cost of reduced efficiency.

[7] 'MFN tariffs' apply to all imports from 'Most Favoured Nations'. Essentially, all of Ukraine's trading partners outside the CIS are considered MFN countries (according to the State Committee of Statistics, trade with non-CIS, non-MFN countries accounts for only 3% of total imports).

With regard to the increasing diversification of trade partners, Ukraine's integration into the global framework of rules that govern international trade should be fostered. Therefore, accession to the WTO is of crucial importance. This step would benefit Ukraine's economy in several ways. First, lower import tariffs reduce domestic price levels and thus benefit final and intermediate consumers. Moreover, since increased imports also stimulate exports though their depreciating effect on the real exchange rate, additional income can be generated and partially compensate losses from increased competition on domestic markets. Second, membership in the WTO also improves the legal position of Ukrainian exporters on foreign markets and especially protects them from unreasonable dumping allegations and the accompanying sanctions. Also, the WTO membership could improve Ukraine's chances of obtaining 'market economy' status, which is crucial for strengthening its position in anti-dumping investigations conducted by the USA and EU. In the past, such measures have frequently reduced Ukrainian exports, mainly of steel, chemical and agricultural goods to the EU and North American markets. Finally, WTO membership also commits domestic policy makers to better ensure fair competition. In a country in which the general level of competition is rather low by international standards,[8] such commitments lead to significant improvements. Altogether, the impact of WTO membership must not be underestimated. According to a quantitative assessment carried out by the IER, joining the WTO would lead to additional medium-term increases of 3% in real household incomes and almost 2% in GDP. Lower domestic prices due to the reduction of import tariffs as well as an increased level of competition due to the elimination of direct subsidies and tax privileges are the main drivers of these results.[9]

2.3 Fiscal policy in Ukraine

2.3.1 The current situation

Fiscal policy in recent years has been mostly successful in supporting macroeconomic stability in Ukraine. It has been characterised by strong revenue developments backed by impressive macroeconomic dynamics, improved budgeting, and increasing budget realism (Table 2.3). The fiscal position and the debt-to-GDP ratio have both improved considerably since the beginning of 2000. The fiscal position varied from a deficit of 2% of GDP in 2001 to a surplus of 0.7% in 2002. The debt to GDP ratio declined from 60% at the beginning of 2000 to 30% at the end of 2003. Interest payments are no higher than 1% of GDP and have declined as a share of consolidated fiscal expenditure.

However, this prudent stance has been endangered by substantial pro-cyclical impulses in the course of the 2004 election year. In particular, both

8 For example, the Growth Competitiveness Index of the World Economic Forum (www.weforum.org) that compares the competitive condition of 104 economies ranks Ukraine only 86th in 2004, which is two positions lower than in 2003.

9 IER (2004): Ukraine's Trade Regime: Quantitative and Institutional Aspects. Ukraine trade regime overview. Research Report, Kyiv.

the recent 2004 budget amendments and the draft 2005 budget foresee unsustainable increases in social spending.

Table 2.3
The consolidated (state and local) budget of Ukraine (in % of GDP)

	2000	2001	2002	2003	2004*
Revenues	26.7	25.5	28.1	28.6	27.7
Expenditures	27.3	27.4	27.3	28.8	30.4
Surplus/Deficit	–0.7	–1.9	0.7	–0.2	–2.8

Note: 2004 figures relate to the approved 2004 Budget including amendments of 17 June, 2004

Source: Treasury statistics, IER calculations

2.3.2 Expenditures

Ukrainian consolidated budget spending grew from 27.3% of GDP in 2000 to 30.4% of GDP, as projected in the 2004 budget, reflecting an expansionary trend made possible by favourable macroeconomic conditions and an accelerated pace of privatisation. Simultaneous improvements in the management of public funds and in the effectiveness of their use can be attributed to the approval of the Budget Code in 2001 and to an improved management of Treasury operations. The Budget Code introduced program-based expenditure execution and improved the assignment of responsibilities and of revenues between different levels of government.

However, the growing size of the government is not consistent with the objective of sustainable economic growth. Increases in the wage bill are almost entirely the consequence of minimum wage hikes. Furthermore, while sustainable growth requires investment in infrastructure and human capital, Ukrainian public capital outlays have been directed towards building physical capital in industries in which the rationale for public funding is weak. In particular, the share of state aid in the form of capital transfers to enterprises in all capital expenditures rose from 22% in 2001 to 52% in the budget for 2004.

While the recent 2004 budget amendments and the draft 2005 budget foresee increases in social spending, the priority of fiscal expansion has over the recent years been in the least transparent functional group of expenditures, the support of 'economic activity'. The GDP share of this category increased from 3.5 to 6.5% of GDP between 2001 and 2004. Much of this reflects state support for the industries referred to above.

Problems with the composition, quality, and equity of public services provided still remain. Workable priorities and medium term planning are still absent and there is a lack of measurable targets to allow for ex post evaluation of program outcomes. An unbalanced approach to decentralisation has left local governments without adequate sources of finance.

2.3.3 Revenues

Sustainable development requires a tax structure founded on sound legislation and tax enforcement. Ukraine has taken steps toward reforming the Customs Code, the Personal Income Tax (PIT), and the Enterprise Profit Tax (EPT). Tax rates have been significantly reduced and there have been attempts to broaden the tax base. In particular, the EPT rate was reduced from 30% to 25%. PIT reform has initiated a shift to a flat tax rate of 13%, replaced the non-taxable minimum with tax credits for low-income taxpayers, reduced the average tax burden on wages, broadened the tax base, and eliminated some profession-based privileges. These steps – together with a better budgeting procedure and economic growth – have improved tax revenue performance.

VAT and excise taxes account for 43% of tax collections of the consolidated budget. This reliance on indirect taxes is in line with international best practice and is consistent with trade liberalisation: EPT and PIT may imply international trade distortions, while consumption taxes are neutral to the place of production. Moreover, while consumption taxes are regressive, the influence of income taxes on savings, investment decisions and growth is much more detrimental in the long run.

However, two aspects of the tax structure are of major concern. These are the level of payroll taxes and poor VAT administration that has resulted in sizeable VAT refund arrears. Payroll taxes inflate the wage bill, hence affecting employment decisions and contributing to the shadow economy. VAT arrears create a series of distortions in economic activity including an increased tax burden for enterprises in exporting sectors, and incentives for corruption. Underdeveloped credit markets make cash flow an important source of investment financing, but VAT refund arrears withdraw these funds from a firm's turnover. Also, VAT arrears distort the allocation of investment and create artificial incentives for vertical mergers.

2.3.4 Outlook

Official debt and deficit figures may underestimate real and contingent public liabilities. The financing of some state-guaranteed social privileges is in fact levied on enterprises: e.g., social transport privileges are only insufficiently covered by budget transfers. The total volume of unfunded but publicly guaranteed privileges was UAH 12.2 bn in 2003. Also, wage arrears are not included in public debt, although wage arrears to teachers alone amount to roughly UAH 3.5 bn.

We acknowledge the recent economic successes in Ukraine, successes based on prudent fiscal policies. In particular, we welcome the tax rate reductions, the attempts at tax base broadening, and the resulting decline in the debt to GDP ratio. At the same time, recent fiscal expansion via increases in current expenditures – especially via transfers to the population and minimum wage increases – could result in inflationary pressure. Indeed, there are indications that inflation is heating up in Ukraine, and there is a risk that beside the fiscal policy influences discussed here, monetary policy influences discussed above could exacerbate this trend and threaten macroeconomic stability in the country.

Current expenditures are re-current expenditures: expansions made while the economy is growing are, for political reasons, difficult to cut later on when growth slows. This could result in an increasing deficit and a growing debt burden in the event of a future economic downturn and/or reduction in privatisation receipts. All of the above highlight the need for further fiscal policy reforms that are consistent with sustainable growth in Ukraine.

3 A Strategy for Reforming the Social Security System in Ukraine

3.1 The importance of social security

During their lives, individuals are exposed to risks stemming from accident, loss of employment and income, and illness. Private insurance can provide protection against some of these risks.[10] However, private insurance alone cannot provide all people with efficient or socially acceptable levels of insurance against important economic and health-related risks.

State intervention in the form of a social system can complement private insurance and improve this situation. A functioning social system can help to ensure that those who are unable to work due to age, physical inability, illness or unemployment do not fall below acceptable levels of income. It can also ensure that the burden of risks such as illness and unemployment is not borne entirely by those who have the misfortune to be afflicted, but is distributed more evenly across all members of society based on the principle of solidarity.

These are key ingredients in a recipe for improving standards of living in Ukraine, both by reducing the fear and anxiety felt by individuals who are vulnerable to risk, and by providing concrete assistance to those who are subject to misfortune.

An effective social system is of exceptional importance in Ukraine because the lack of such a system is often presented as an excuse for the failure to carry out important reforms in key sectors of the economy. Enterprises are not privatized, restructured or – where necessary – subjected to bankruptcy because it is claimed that the resulting unemployment would be socially unacceptable; efficient pricing of energy, utility and public infrastructure services is not implemented because it is claimed that this would impose unacceptable burdens on pensioners, the poor and other vulnerable groups. In other words, the lack of an effective set of social policies in Ukraine means that policy making in important areas such as agriculture and energy is hamstrung and that reforms at the sectoral and enterprise level that are required to ensure that economic growth continues are put off or diluted. In the medium and long term this also reduces standards of living in Ukraine.

3.2 Overview of the current social security system in Ukraine

Ukrainian policy makers tried for a long period to preserve the defunct Soviet social system based on numerous 'social privileges', most of which

[10] Chapter 5 deals in more detail with the private insurance market in Ukraine and steps that should be taken to stimulate its development.

were paid in kind. According to this system prices and tariffs for numerous goods and services were regulated and cross subsidisation was the rule. Social benefits were often provided by enterprises. This Soviet type of social assistance could not prevent the spread of poverty during transition, and over time its deficiencies became more and more apparent.

Instead of reforming the inefficient old system, policy makers largely focused on shoring it up by introducing several additions to the existing new social insurance system. These additions are based on mandatory contributions attached to the gross wages and salaries of the working population. Contributions are paid to state administered insurance funds (pension, unemployment, work accident, temporary sickness), which in turn provide certain services to the population. The health care system and social welfare remained tax financed.

The new social insurance add-ons suffer from substantial design flaws. First, the demographic situation (see Graph 8.1, page 75) is not properly taken into account: too few contributors pay for too many eligible beneficiaries. Regressive redistribution occurs within the system in the sense that low income workers subsidize benefits for high income workers. Unfunded schemes – such as the recent increases in minimal pension payments - increase the financial burden on current contributors and lead to large inter-group transfers. The various funds and the health care system are inefficient and bureaucratic. Funds are expected to perform functions for which they were not conceived (e.g., the Temporary Working Disability Fund finances Christmas presents for children). Substantial cross payments between the various funds add to cost and reduce transparency and accountability. The funds do not report to the public, i.e. to their contributors and clients. The result is an environment in which waste and fraud can thrive.

The design flaws of the current social system come with a hefty price tag and, consequently, mandatory contribution rates are very high in international comparison (see Table 3.1). At the same time the quality of services performed by the social system is poor and does not correspond with the enormous cost. The high social tax wedge and the rather low benefits encourage tax evasion and avoidance, adding incentives for shadow economic activity.

The looming demographic development and persistent poverty in Ukraine make substantial reform of the current social system inevitable. Reforms should be aimed at lowering the social tax wedge to 25-30%, while broadening the contribution base. Streamlining the social system and making the administration of the social security funds more efficient would reduce unproductive overheads. In the next sections we discuss the present system in more detail and provide clear reform proposals for each type of social security. First we address welfare payments and pensions as means of guaranteeing minimum income levels. The second part deals with unemployment, sickness and work accident insurance as means of sharing the burdens of misfortune. The third part proposes a health care reform.

Table 3.1
Payroll tax and deductions from wages[1]

	Contributions paid by employer (%)	Contributions paid by employee (%)	Total contributions (%)
Social insurance contributions[2]	37.66-50.6	3	40.64-53.6
Pension insurance	32	2	34
Social insurance in case of temporary working disability and expenses associated with birth and funeral	2.9	0.5 - 1[3]	3.4-3.9
Social insurance in case of unemployment	1.9	0,5	2.4
Social insurance in case of working accident and occupational illness	0.86 – 13.8	0	0.84 – 13.8
Personal Income Tax 2004-2006[4]	not applicable	13	13

[1] Monthly wage income above UAH 2600 is exempt from mandatory contributions

[2] Total contributions depend on the class of occupational risk involved, and the level of the contribution to temporary working disability insurance

[3] If the employee's wage is lower than the subsistence minimum, the contribution rate is 0.5%, otherwise 1%

[4] In 2004, a 13% flat rate PIT, increasing to 15% in 2007, was introduced

Source: Law of Ukraine "On the level of contributions for some types of compulsory state social insurance" No. 2213-III, Jan. 11, 2001; Law of Ukraine "On insurance rates for compulsory state insurance in case of working accidents and occupational disease that caused the loss of working ability" No. 2272-III, Feb. 22, 2001; the Decree of CMU "On personal income tax" No. 13-32, Dec. 12, 1992; the Law of Ukraine "On the taxation of revenues physical persons" No. 889-IV, May 22, 2003

3.3 The social welfare system

The main objective of the social welfare system is to provide assistance to individuals who do not earn enough income to finance basic needs such as clothing, housing, food and basic services. The social welfare system is a state guaranteed social safety net, following the principle of ensuring basic needs. The amount and quantity of assistance might differ among societies and regions. Social welfare should be accessible for all citizens in case of real need. Therefore, social welfare should be financed by the whole society through taxes.

The present social welfare system in Ukraine is overwhelmingly based on a system of social privileges for various social and occupational groups of population. Most welfare assistance is provided in kind rather than in cash.

Groups receiving the bulk of social assistance are pensioners (13.8 m individuals), veterans of labour (4.6 m individuals) veterans of war and their families (3.7 m individuals) and persons directly affected by the Chornobyl catastrophe (2.9 m individuals). Another large group of beneficiaries are state employees such as civil servants, policemen and military personnel. A third eligible group is composed of individuals with recognized outstanding merits for the fatherland. The legislation governing social privileges is complex, including 46 legislative acts, 24 of which regulate benefits by occupational characteristics of recipients, and 22 of which regulate privileges by social characteristics. Currently over 30% of the population is entitled to some type of benefit.

Among the key privileges granted to these groups of recipients are reduced tariffs for utility services, housing, electricity and transportation, as well as lower prices for fuel and gas. The Ministry of Finance estimated these subsidies and privileges to be worth around UAH 17 bn (or roughly 25% of the state budget) in 2003. Privileges are provided to individual members of these groups without taking their real income situations into account. Hence, these privileges can be regarded more as rewards for service to the state than as social assistance to the poor.

The Ukrainian government also tries to provide targeted social welfare assistance to low-income families. According to the respective law, families are eligible for welfare payments if their monthly income per capita is below the subsistence minimum, presently set at the level of UAH 362.23 per person. However, as not enough funds are provided in the state budget, the "maintenance level of the subsistence minimum formula" kicks in, meaning that only UAH 80 per capita[11] are taken into account when providing assistance. In other words, social welfare payments top up incomes only to a level of UAH 80 per capita. Dezhkomstat data show that in 2002 only 32% of the eligible individuals with incomes below UAH 80 actually received cash assistance. Furthermore, payment arrears were not uncommon.

The government does not provide full coverage of social benefits in the budget, as for all payments it only foresees an amount of UAH 5.1 bn. Hence, providers of privileges such as energy and utility services are not fully compensated for these costs as stipulated by law, thus reducing their revenues.

In short, the existing social welfare system is poorly targeted, not properly financed and does not provide a social safety net for the poor and needy.

3.3.1 Policy recommendations

Social welfare is the responsibility of the state and not of energy suppliers or other enterprises. The social welfare system should be accessible to all who are in need. The state needs to identify the poor accurately by taking individuals' income situations into account. Standards of assistance need to be specified and the state has to provide sufficient funds in its budget to finance these standards without resorting to indirect finance by forcing

[11] UAH 110 and 115 are taken into account for working unable persons and disabled persons, respectively.

enterprises such as public utilities to provide in kind services at a loss (see chapters 8 and 9 on utilities and energy). The "maintenance level of the subsistence minimum" and occupational privileges should be abolished.

The responsibility for providing social assistance should be assumed by local governments. This would make it possible to take local conditions – such as different tariff structures for utilities and different costs of living – into account. To this end, the central government has to provide the necessary conditional transfer payments to local budgets, and this will necessitate a reform of the framework of tax collection by local governments.[12]

3.4 The pension system

Pension insurance provides income to people after retirement. During their working lives, individuals contribute some part of their wages and salaries to the pension insurance fund, and the payments an individual later receives from this fund are tied to what he or she has paid in.

Currently Ukraine is implementing first reform steps in its pension system by introducing a three-pillar system. Reform pressure on the pension system is severe due to the ageing of the population and the decline in the number of economically active individuals. The age dependency ratio, calculated as the number of pensioners divided by the number of employed individuals, increased from 51.6% in 1990 to 66.9% in 2003, and is expected to increase further in the foreseeable future. The introduction of the voluntary third pillar is essential for easing this demographic problem, since it gives individuals a means of saving for their old age personally, thus smoothing consumption over a lifetime.

The first pillar of the foreseen three-pillar pension system is a reformed pay-as-you-go (PAYG) scheme with mandatory contributions by employers and employees. This pillar is a safety net that provides an insurance against old-age poverty by providing some minimum payments when a person retires. Contributions to the PAYG currently amount to 34% of the gross employer wage. Pension payments to retired individuals – the retirement age remains unchanged at 60 years for men and 55 for women – are not closely connected to how much or how long individuals have contributed. Certain privileged occupational or social groups, such as state employees, miners, handicapped people etc., receive disproportionately high payments compared to their contributions. Similarly, agricultural employees cover only about 3% of the pension benefits paid in rural areas. Hence, contributors to the PAYG pillar face high mandatory contribution rates followed by disproportionately low pension payments, all of which creates substantial incentives for evasion and understatement of wages.

The reform foresees a new pension formula for the PAYG that takes contribution length and amounts into account. The formula will be identical for all insured. Pension benefits will be indexed to inflation and wage growth, so future pensions will increase as the economy grows. The new formula represents a major step forward.

[12] See Chapter 4 on regional policy and fiscal federalism in Ukraine.

According to the reform, non-insured individuals in need will receive their income from social welfare payments. Privileged pension payments will be either moved to the third pillar (see below), or paid from the state budget. All these measures will help to stabilize or even reduce the rate of pension contributions, and they should be implemented as soon as possible.

The introduction of the second pillar, based on compulsory personalized accumulation accounts at the state pension fund, is planned for the year 2007. However, necessary regulation and infrastructure has not yet been introduced. While the contribution rate will remain the same, the share paid by employees will increase, reducing the social tax rate for employers.[13]

The introduction of the second pillar of the pension system will help to insulate future pensioners from demographic trends, and increase the total amount of pension benefits through investing money of the accumulation funds. The management of the accumulation funds will be entrusted to asset managers selected through open tenders. It is imperative that these tenders be truly open (also to foreign asset managers) and that no instances of fraud or incompetence erode public trust in the second pillar.

There are three players in the so-called third pillar of the pension system – non-state pension funds, banks and life insurance companies. Since the beginning of 2004, individuals and employers can invest into non-state pension funds (NPF). Contributions by employers and individuals up to a certain limit are tax exempt. The long term development of the pension system's third pillar will mostly depend on the new investment products that private providers offer, and on sound regulation of the NPF.

While the first pillar is aimed at ensuring people with a minimum level of pension benefits, the other two pillars could become important sources of investment in the Ukrainian economy, contributing to capital market development. Their success will largely depend on effective regulation. So far, only maximum shares of different asset types have been defined.

3.4.1 Policy recommendations

Ukraine should continue the initiated pension reforms. However, the success of these reforms will depend mostly on the long-term trust of contributing individuals. Sound regulation, proper supervision and transparency are essential, as is the narrowing of the social tax wedge. Regulation should ensure equal treatment of all pensioners: pension benefits should strictly depend on the contributions an individual has made. These steps would increase the attractiveness of the pension system from the point of view of the individual contributor; reduce the costs of the pension system; and, most important, lower contribution rates.

[13] Currently, it is foreseen that employees will pay around 7% of their wage to the accumulative fund.

3.5 Unemployment insurance

Unemployment insurance provides income to individuals in case of job loss. Hence, unemployment insurance is of special importance considering the structural changes in Ukraine's economy. A functioning unemployment insurance system can facilitate structural changes by providing enough income to the unemployed so that politicians are not tempted to interfere with employment decisions at the firm level. On the other hand payments should not be so generous as to create disincentives for the unemployed to search actively for new jobs.

According to ILO methodology, 9% of the economically active population is unemployed in Ukraine. The official unemployment rate in Ukraine is 3.5%. In the past, artificially low official unemployment figures have often tempted Ukrainian governments to (mis-)use the Unemployment Insurance Fund (UIF) as a source of hidden subsidies for other social insurance funds and state programs. For example in 2003/2004 the UIF financed a special government program for restructuring in the coal mining sector. The costs of this program alone were believed to be around 5% of total UIF spending.

While contributions to the unemployment fund are mandatory for all working individuals, some groups of recipients do not contribute but are nonetheless entitled to benefits. These groups include students after graduation and laid-off military servants not yet eligible for retirement.

Unemployment benefits depend on how long and how many contributions an individual has made. Benefit payments – UAH 112.4 per month in 2003 – are made for a period of up to one year. While roughly 60% of the UIF expenditures are directed towards income benefits for unemployed (passive labour market policies), less than 15% are spent on retraining unemployed individuals (active labour market policy – ALMP).

3.5.1 Policy recommendations

Cross subsidisation of other funds and programs using the UIF should stop immediately. Restructuring and other special state programs aimed at creating jobs should not be financed with the working population's contributions. As low unemployment is in the interest of society as a whole, society should contribute to that goal for example through tax-financed ALMP measures aimed at retraining individuals. ALMP measures should be more market oriented and more efficiently managed. In order to increase efficiency, the re-training of unemployed individuals should be conducted by public or private companies selected through open tenders for fixed periods of time. Together, these measures would reduce costs and provide scope for both higher unemployment insurance benefits and lower mandatory contribution rates.

3.6 The work accident insurance system

Ukraine has a system of compulsory insurance against work-related accidents and occupational diseases that lead to the loss of working ability. This insurance covers the individual risk of long-term or permanent income loss due to accidents at work or hazardous working conditions. The

mandatory contribution rate depends on the risk category of the industry in which an individual is employed. For this purpose, the branches of the Ukrainian economy are classified into 67 categories of professional risk.[14] Contribution rates vary from 0.84% of the actual costs of the remuneration of labour in the 1st category (comprising, for example, editors and publishers) to 13.8% in the 67th category (workers in deep coal mines). The average contribution rate is 1.9%. Contributions flow into a work accident fund (WAF) that covers payments of benefits in case of work-related accidents, the provision of medical and social rehabilitation programs, and the implementation of work safety measures in different industries.

Like all other social funds in Ukraine, the WAF suffers from perverse redistribution effects, as the majority of payments (55% in January 2004) are directed at one occupational group – the miners. Furthermore, while miners are charged the highest contribution rates (13.8% of the gross employer wage), other sectors with high accident rates such as agriculture contribute only 0.2%, i.e. even less than sectors in the 1st category.

3.6.1 Policy recommendations

In our view the compulsory state insurance fund against work-related accidents should be abolished. In its current design the fund is expensive, inefficient and an obstacle to structural change. It implies too much micro-management by government officials at the industry and firm level. The government should engage in stimulating safer working conditions through proper incentives and the introduction of standards. Professional organisations should be created to supervise adherence to these standards.

To deal with individual work accident risk, mandatory private work accident insurance for companies should be introduced.[15] Risk profiles of the different companies within a branch can differ considerably, and it is highly inefficient to make all companies pay the same insurance premiums regardless of their safety records. Investment in safety measures would be stimulated through the possibility to lower insurance premiums in a private system. Extremely hazardous plants and mines unable to obtain a private work accident insurance would be closed. Together, these influences would lead to a reduction in the extremely high number of work-related accidents in Ukraine. Furthermore, they could lead to significant reductions in the social tax wedge.

3.7 Temporarily working disability insurance fund

Ukraine has a system of mandatory insurance in case of temporary work disability as well as maternity leave, childbirth and for funeral expenses. Contribution range from 3.4 – 3.9% of the gross employer wage bill and flow into a temporary work disability insurance fund (TWDIF).

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[14] For some branches such as agriculture (see below) the contributions rates are defined separately.

[15] Chapter 6 deals with the development of the private insurance market in Ukraine.

Benefits paid out of the TWDIF compensate for loss of income in case of disability beginning on the sixth day of disability. Benefit payments are between 60 and 100% of income depending on how long an individual has contributed to the TWDIF. State employees receive benefit payments from the TWDIF from the first day of disability. This violates the principles of equal treatment and equal access of all contributors to the insurance fund.

The TWDIF also provides financial assistance in case of death. For 2004 this assistance is set to UAH 700. The third task of the insurance fund is aimed on maternity and childbirth. Payments at individual income levels are made during 10 weeks before and 8 weeks after a child's birth. At birth an insured family becomes eligible for a lump-sum grant of double the subsistence minimum amount, currently UAH 725. Up to the third birthday of the child, a monthly payment of UAH 91 is provided. Finally, the TWDIF provides also discounted sanatorium treatments. These activities overlap with the activities of other insurance funds, such as the work accident fund and health care.

3.7.1 Policy recommendations

The TWDIF covers a number of seemingly unrelated tasks. We propose that some of these tasks be entrusted to other institutions, and that others be merged into the health care system (see below).

The rationale for providing maternity leave and childbirth assistance on the basis of workers' contributions is not clear. If it is government policy to encourage families to have children – something that would be understandable given demographic trends in Ukraine – then the corresponding assistance should be financed out of general budget revenues so that it is borne by all members of society according to their ability to pay. This assistance should be the responsibility of local authorities and geared to local conditions (i.e. costs of living). Furthermore, the decision to have children is influenced at least as strongly by the availability of good and flexible day-care services and schools that enable adults to combine work and parenthood as it is by cash payments over the first three years of a child's life. Funeral payments should be a part of the social welfare system and made strictly according to need. Moreover, they should be made the responsibility of local social welfare institutions.

The provision of discounted sanatorium treatments should be abolished completely. To the extent that such treatments are medically indicated, they should be covered by the health care system. Workers' disability insurance should be paid as a mandatory contribution to a special account in the public health care system. The payment rules (i.e. amounts and duration) for temporary disability leave should be equal for state employees and all other employees beginning on the sixth day of disability.

3.8 Health care

A well-functioning health care system is of enormous importance for standards of living, human capital accumulation and development. The health care system should at least supply basic medical services to all and

prevent the spread of epidemics. The Constitution of Ukraine stipulates that medical services should be provided free of charge to the population.

State financing of the health care sector – 3.6% of GDP in 2004 – is low in international comparison[16] and has steadily declined over the years. Furthermore, this budget money is spent inefficiently. Ukraine's medical services are provided predominantly at hospitals and by specialists. The per capita numbers of physicians and hospital beds in Ukraine are roughly five and three times the OECD average, respectively. The average duration of a hospital stay – at nearly 16 days – is twice as long as in OECD countries. Most budget health care funds are spent on salaries and hospitals energy costs. However, as the medical system remains overstaffed, salaries and wages paid in the health care sector are among the lowest in Ukraine. At the same time, funds for investment in modern diagnostic and treatment equipment and medicine are lacking. Although there is some regional variation, the Ukrainian medical system as a whole is highly overspecialised and fails to deliver affordable basic medical services.

Under these circumstances, a shadow economy in the health care sector has blossomed. Often, patients are treated only after making informal, private side-payments to physicians and other medical staff. Access to medication also often requires substantial private side-payments. Consequently, the share of private spending in the health care sector is increasing, and a two-tiered medical system has emerged. Private medical insurance companies and private clinics and hospitals deliver services to the affluent part of population, while the poor receive at best much less effective medical treatment. Because even this treatment is expensive due to the necessary side-payments, many Ukrainians without private medical insurance are reluctant to seek professional medical treatment at the early stages of an illness. Instead, they rely on self-medication and hope. The resulting lack of prevention and early treatment means that many afflictions are only treated at an acute stage. This substantially increases both the costs of treatment and fatality rates.

3.8.1 Policy recommendations

In the following we propose a two-stage reform of the health care system. The first stage should aim at providing basic quality medical services at affordable prices. The main reason for the dire state of the state-run health care system is an incentive structure based on the absence of property rights. Hence, reform measures should specify property rights. Currently hospitals are essentially bureaus of the Ministry of Health. We propose that these direct relationships be cut, as they foster dependency, a lack of effective allocation of responsibility, and rent seeking. Instead we propose the introduction of a public medical fund for dealing with the health care sector, while the Ministry's role would focus on the development of standards and framework conditions for the operation of the health care sector.

[16] See also the discussion on investment in human capital in Chapter 5. The accumulated depreciation of fixed health care assets is, at 39%, very high.

In the first stage of reform, the public medical fund should be financed through taxes. This fund should pay health care providers for the provision of a basic catalogue of medical services defined by the Ministry of Health. The amount of tax money paid into the fund should depend on the amount of services provided. Medical services that are not included in the basic catalogue would not be covered. Instead, individuals could privately insure themselves for these services.

An integral part of this reform stage is the right of physicians to open their own private clinics/offices. Legislation should explicitly permit private provision of health care services, in order to encourage private investment into the sector, and it should place state-run hospitals and private clinics on an equal footing. Private and state health care providers should receive the same refunds from the public medical fund for the same services. State employed physicians should not be allowed to use state owned property of medical equipment for generating private income. This would attract urgently needed private investment into new equipment at private doctor's offices. At the same time it would ensure that medical staff would leave the overstaffed state-run hospitals to better paid new positions in private clinics.

Such reforms should also aim at reducing the costs of the medical system. The tax financed public medical fund should promote family doctors as a cost-efficient alternative to expensive experts. The public medical fund should also encourage people to seek early treatment of illnesses. To provide incentives for family doctors, their income should depend on the number of patients and medicals services provided. The reforms should not only encourage competition between private and state run health care providers, but also ensure more or less equal access for all Ukrainians. The number of state hospitals, hospital beds and medical staff employed by state owned hospitals should be reduced. The reduction should be used to increase investment and salaries.

The second stage of the health care reform is closely linked to the reforms in the other areas of the social system. As long as institutional capacity is weak and informal employment high, payroll taxes are not a viable alternative to general taxation. However, after the successful and sustainable reduction of social taxes to the goal of 25-30% of the gross employer wage, and once competition among health care providers is functioning, the financing of the public medical funds should be transferred from the budget to individual contributions. These contributions should be independent of individual income and divided into three different classes: one for children under 14 years of age, one for adults, and one for pensioners. If an individual's income is below a certain minimum level, his/her contribution should be paid by the welfare system.

After switching to a contribution financed medical system the public medical fund should be privatised. Competition for individual contributions should be created by splitting up the former public fund and/or allowing private funds to enter the health insurance market, subject to regulation and oversight by the Ministry of Health.

4 Regional Development and Fiscal Federalism

4.1 Growing regional disparities

During the last decade, regional disparities in Ukraine have been growing. Between 1996 and 2003, regional discrepancies measured as standard deviations of gross value added (GVA) per capita in constant prices increased from 311 UAH to 532 UAH (Table 4.1). Significant regional differences are observed for other indicators: regions with higher GVA per capita also have higher per capita levels of monetary income, FDI, investment, and numbers of registered small and medium sized enterprises (SMEs). While Kyiv, Dnipropetrovska, Kharkivska, Zaporizka, and Donetska oblasts are the leaders in economic development, Chernivetska, Vinnytska, Zhytomyrska, and Ternopilska oblasts lag behind.

Table 4.1
Gross Value Added per capita by oblasts in constant prices (m UAH)

	1996	1997	1998	1999	2000	2001	2002	2003
Maximum	1937	2001	2053	2184	2348	2872	3047	3453
Minimum	723	687	677	714	772	870	951	1122
Average	1356	1309	1280	1285	1348	1558	1666	1836
Standard deviation	311	319	326	346	366	446	468	532

Source: IER calculations, based on Derzhkomstat data

Structural problems in old industrialised regions together with the underdevelopment of rural regions generate social tensions, unemployment and poverty. The low level of provision of public goods and low efficiency of public expenditures exacerbate the problems of depressed and poorly developed regions.

Regional policy faces a difficult trade-off between the equalisation of regional development and economic growth, because equalisation can only be achieved in exchange for less dynamic growth. Redistribution in favour of less developed regions can lead to inefficient allocation of resources and reduces the long-term growth potential of the national economy. Presently, the trade-off between equalisation and economic growth is eased by high growth rates in Ukraine. However, the fundamental tension remains and regional development and convergence are high on the political agenda.

4.2 The current situation

International practice offers two approaches to regional policy, which differ in terms of the functions assigned to the state. In the vertical approach, the state plays a 'paternalistic' role redistributing public funds in favour of less developed regions. The horizontal or bottom-up regional policy approach requires the state to establish an institutional framework for

regional development that promotes market incentives for efficiency and growth, and to concentrate its active policy on the provision of public goods and private goods with significant externalities. The main goal is to ensure gradual regional equalisation with respect to the access to basic social services. In the industrialised countries, vertical regional policy dominated until the 1980s, and proved to be inefficient. Later, these countries resorted to horizontal approaches that created more incentives for local self-governmental entities (LGEs) and private agents to contribute to regional growth. In Ukraine, a vertical approach to regional policy was inherited from the former socialist system and continues to prevail. This is reflected in the choice of goals and instruments of regional policy in Ukraine and its low efficiency.

4.2.1 Poorly defined and inappropriate goals

According to legislation, Ukrainian regional policy has numerous goals (e.g. dynamic and balanced socio-economic development of the regions, increasing living standards, deepening of the market transformation, etc.).[17] For the most part, however, these goals are declarative, vague and not supported by sufficient fiscal resources.

In practice, efficiency and growth are subordinated to equalisation, and regional policy in Ukraine is largely limited to the reallocation of economic and financial resources in favour of selected regions. This is also reflected in the development of legislation. The new Budget Code has contributed to equalising the supply of public goods across the regions by improving the transfers system. However, it has not supported fiscal decentralisation, which is crucial for regional growth. The 'Draft Law on Promoting Regional Development' focuses on attempts to equalise economic potential of the regions by granting state aid to the depressed territories. There is a danger that this approach could reduce regional incentives for economic growth and increase rent-seeking.

4.2.2 Inappropriate instruments

The dominance of both the vertical approach and the goal of equalisation in Ukrainian regional policy is reflected in the choice of regional policy instruments. Presently, these instruments include:

- regional development programs;
- sector-related state aid applied at the regional level, i.e. in regions in which the industry in question is concentrated;
- free economic zones and special investment regimes;
- capital investments from the central budget;
- emergency aid for selected regions financed from the State Reserve fund; and
- fiscal equalisation payments.

[17] See the Concept of State Regional Policy of Ukraine approved in 2001.

Most of these instruments involve the redistribution of public funds across regions, and none of them, except fiscal equalisation, has worked effectively.

Regional development programs contain multiple goals which cannot be reconciled under the given fiscal constraints. Typical regional programs are not integrated into regional budget process due to a lack of medium-term local budget planning. As a result, they are often underfinanced both from the central and the local budgets and have no significant impact on regional development.

Sector-related aid channels public funds more towards powerful lobbing groups than disadvantaged regions. For example, considerable tax privileges granted to metallurgy have flowed into regions characterised by above-average economic development. Besides, sector-related aid reduces the incentives for efficiency and growth, since it distorts competition, leads to inefficient reallocation of resources across industries, postpones restructuring, and promotes rent-seeking behaviour and corruption.

Special economic zones and special investment regimes are indirect and opaque forms of state aid that distort competition and promote rent-seeking. They have failed to attract significant amounts of foreign and domestic capital for the development of disadvantaged regions because they do not address the key weaknesses of the investment climate in Ukraine, i.e. the lack of a level 'playing field', poor enforcement of contracts, and insecure property rights.

Public investment is dominated by capital transfers to public enterprises, while public and merit goods are underfinanced. Furthermore, the involvement of the private sector in co-financing investment projects (e.g. in infrastructure) is low.[18] A substantial part of the capital expenditures from the central budget flows into rich oblasts such as Donetska, Luganska, Kyivska and city of Kyiv. At the same time, Chernivetska, Khersonska, Khmelnitska and Ternopilska oblasts lag both in terms of level of economic development and public investments per capita (see Graph 4.1).

The system of intergovernmental fiscal relations is crucial for regional development and deserves a more detailed analysis. This system has been rather successful in promoting equalisation due to the implementation of Budget Code and a substantial improvement in the transfer mechanism. The transfer mechanism focuses on the regional equalisation of the supply of public services in per capita/per entitled person terms. In 2002, fiscal equalisation reduced the standard deviation of regional per capita oblast budget revenues from 274 to 241 UAH (from 90 to 49 UAH if the city of Kyiv is omitted, see Table 4.2). Redistribution of budgetary funds from richer to poorer regions helps to maintain social standards throughout the country and equalise the supply of public goods at the regional level.

[18] Chapter 5 deals with investments in general and especially the role of the public sector in encouraging investment.

Graph 4.1
Budget expenditures per capita in 2002 in the oblasts of Ukraine ranked by GDP per capita

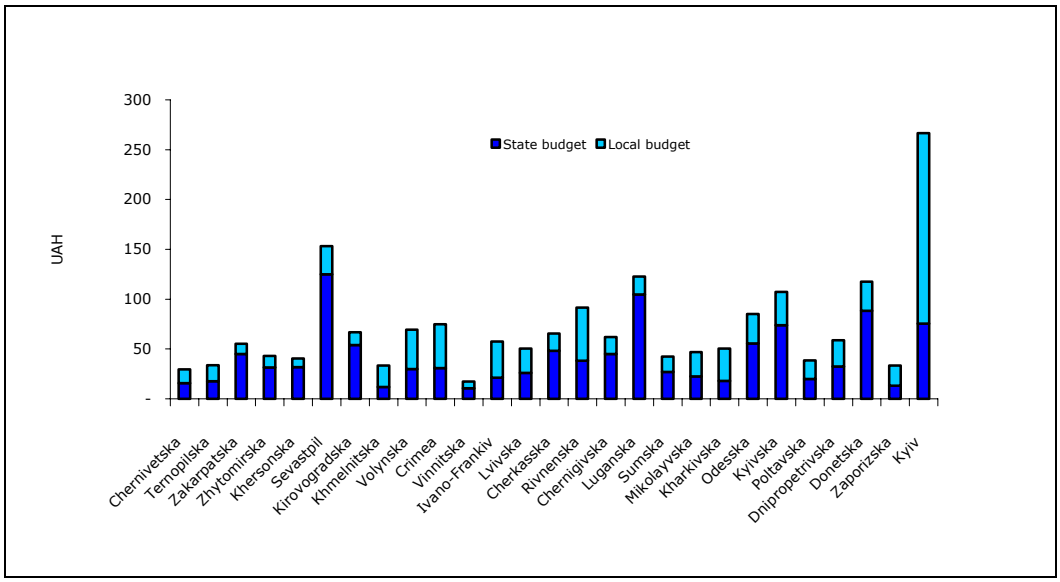

Table 4.2
Revenues of the consolidated oblasts budget (UAH per capita)

	Oblasts budget revenues before equalisation		Oblasts budget revenues after equalisation (including transfers)	
	1996	2002	1996	2002
Maximum 1	389,7	1624,1	390,1	1714,5
Maximum 2 (without Kyiv)	319,4	481,3	339,5	615,3
Minimum	125,8	186,3	187,3	447,0
Average	214,7	403,1	238,4	586,0
Standard deviation 1	56,9	273,6	45,7	240,9
Standard deviation 2 (without Kyiv)	43,3	89,7	33,2	49,2

Source: IER calculations, based on Minfin data

Although the transfer system works rather well, it has several drawbacks. First, a formula-based approach with arbitrarily defined 'depressivity' and 'correction' coefficients is used to determine the amount of transfers. Together with the increasing share of direct transfers that are provided in the form of subsidies, this creates significant scope for political bargaining between the centre and the regions. Second, the calculation of transfers is quite complicated and does not take into account the true tax collection potential of the LGEs. It therefore reduces the incentives for LGEs to improve their tax bases and collection. Third, Kyiv enjoys a privileged position in the system of intergovernmental fiscal transfers. In 2002, GVA per capita in Kyiv was 183% of the national average, while per capita budget revenues after equalisation constituted 293%. Moreover, Kyiv

enjoys a privileged tax sharing scheme. Unlike other regions, Kyiv does not transfer its Enterprise Profit Tax (EPT) to the State budget, and even companies located in other oblasts that maintain headquarters in Kyiv must pay EPT to Kyiv budget.

On the expenditure side, the structure of local budgets is dominated by delegated responsibilities supported by central setting of different norms for local budgetary expenditures. This system ignores economic criteria for the efficient provision of public goods such as subsidiary, territorial equivalency and economies of scale. The division of functions across the different levels of government is not completely clear, and some functions overlap. For example, responsibility for pre-school and general secondary education is assigned both to towns, villages, and rayons. Primary medical and sanitary aid and out-patient and in-patient aid are defined as functions of towns (villages), rayons and oblasts. Both rayon and oblast LGEs are responsible for the development of physical culture and sports. These overlaps blur accountability and generate conflicts regarding the distribution of finance across LGEs at different levels.

The principle of 'presumptive competence of local self-government', which would clarify the division of responsibilities between the different levels of the government is not enshrined in Ukrainian legislation. As a result, some of public activities are not clearly assigned to any specific level of government, and nobody is responsible for their execution. This contradicts Article 4 of European Charter, which underlines that powers given to local authorities should normally be full and exclusive.

Excessive centralisation and the limited fiscal autonomy of LGEs reduces their incentives to manage public funds efficiently, and lowers their accountability to local residents. The lack of a clear division of functions across the levels of government, the obsolete system of expenditure financing and the lack of control over the execution of delegated tasks leads to a low responsibility of LGEs for execution of public tasks and incurs efficiency losses.

Local authorities are strictly constrained in their revenue sources, and local budgets are often underfinanced. Recent trends are alarming:

- The share of own revenues in local budgets is falling. From 19.2% in 2003 it has dropped to a projected 16.9% in 2004. The respective shares of genuine local taxes amounted to 1.7 and 1.4%. This limits the ability of LGEs to pursue their own fiscal policies and threatens the solvency of local governments. The revenue potential of the land tax, which could be a major element of the local finance, is under-used. Taxes on factors of production constitute only a small share in the LGEs' own revenues, and their collection is stagnating despite economic growth. Assigned taxes are dominated by the personal income tax, while the enterprise profit tax does not play a role in local budget revenues. This reduces LGEs' incentives to improve the business environment and attract private capital.
- The share of transfers and direct subsidies in local revenues is increasing dramatically (from 34.2% in 2003 to projected 43.4% in 2004). This makes the LGEs highly dependent on the centre. The use of an equalisation coefficient that is close to 1 in the formula used to

calculate the level of transfers implies that any fiscal gap will be compensated, and any fiscal surplus will be taken away.

- In lieu of strategic and soundly financed regional policies, local authorities often resort to various forms of direct intervention such as intraregional trade barriers for grain (or other agricultural products) and direct price regulation. These *ad hoc* attempts to solve regional problems are highly inefficient and produce spill-over effects that do not further the cause of regional development.

In summary, regional policy failure in Ukraine is explained by the following factors:

a) Regional policy lacks a clear definition of priorities. There is a discrepancy between the declared multiple targets of regional policy and the actual pursuit of these targets. In practice, due to the domination of the vertical approach to regional policy, growth and efficiency are subordinated to equalisation, and regional policy is merely a centralised reallocation of economic and financial resources in favour of selected regions.

b) The choice of opaque redistribution instruments (such as regional and sector-related aid, free economic zones) leads to a failure to realise equalisation goals. Redistribution of public funds tends to favour more developed regions that have effective lobbies.

c) A system of intergovernmental relations based on low fiscal autonomy on the part of LGEs reduces their incentives to pursue policies dedicated to regional growth and efficiency.

4.3 Policy recommendations

4.3.1 Establish appropriate goals and priorities

The focus of regional policy should be shifted from equalisation to efficiency and economy-wide growth. This requires changes in the prevailing understanding of the role of the state in regional development. In particular, the state should concentrate on: 1) improving the general institutional framework and creating favourable conditions for business activity in the whole country (including protection of property rights, simple and predictable regulations, business-friendly and incorrupt public administration, etc.); 2) promoting incentives for LGEs to contribute to regional development; 3) providing public goods and private goods with significant externalities. This would ensure growth and increase efficiency in the whole economy and create a basis for regional convergence. Furthermore, equalisation efforts should be concentrated on the reduction of discrepancies in regional fiscal capacities, rather than levels of regional economic performance.

4.3.2 Apply the right instruments

Efficient regional policy requires an increase in both the role and the accountability of LGEs in regional development, and an improvement in the supply of public goods (including infrastructure and institutions) that

influence socio-economic conditions in the regions and their attractiveness for private capital.

a) Enhancing the role of LGEs in regional development

LGEs should be transformed from simple recipients of transfers into engines of regional economic development. This will require **administrative-territorial reform** that considerably reduces the number of LGEs (on the local and rayon level) and establishes new LGE units that are independent and sufficiently strong organisationally and financially. Self–government executive bodies should be formed at the rayon and oblast level and subordinated to the councils of their respective units. These executive bodies should replace current local state administrations.

Administrative reform should be coupled with revenue reform and substantial decentralisation of public tasks, granting full autonomy to LGEs, and strengthening their responsibilities. This goal must be to increase the capacities and incentives of LGEs to contribute to economic and social development of their localities. Improving fiscal equalisation procedures will contribute to the elimination of social tensions and the reduction of income inequalities across the regions.

A share of the Enterprise Profit Tax should be assigned to LGEs. This **revenue reform** would strengthen the LGEs' financial capacities and create incentives to pursue business-friendly policy at the regional level.

The significance of land tax as a source of own revenues for LGEs should be enhanced by abolishing exemptions. Furthermore, the list of local taxes should be reconsidered. Local taxes and levies whose collection is too costly in comparison with the revenues they generate should be abolished. In the medium term, the introduction of a real estate tax is an important way to increase the revenues of local budgets and create additional incentives for LGEs to improve local living and business conditions. However, efficient performance of this tax requires a proper evaluation of real estate and strong administrative capacities, as well as rather low barriers for cross- and inter-regional labour mobility.

The equalisation coefficients in the **formula-based transfer calculations** should be lowered. Equalisation coefficients should be set significantly below 1 for both donor and recipient regions so that no more than one-half to one-third of any shortfall (surplus) in local tax collection is compensated (taken away). This would create more incentives for LGEs to improve their revenue capacities and increase tax collection. The formula for calculating equalisation transfers should be made more simple and objective. In particular, the complicated estimation of 'expenditure needs' should be eliminated. The potential tax base should be calculated on the basis of the regional economic performance and the special tax sharing scheme and the privileged position of the city of Kyiv in the system of transfers should be reconsidered. Exemptions from general fiscal rules for selected regions should be either abolished or extended to all regions.

An important element of reform would be to **clarify and re-distribute responsibilities** across levels of government based on considerations of subsidiarity, territorial equivalence and economies of scale. Pre-school and

general school education, primary health care,[19] culture, sports, housing and communal amenities, road construction and maintenance and transport services should be clearly delegated to LGEs. At the same time as the LGEs control over the policy in these areas is expanded, their accountability should be increased as well. Furthermore, certain types of regional policy that are not consistent with free and unified markets for goods and services in Ukraine (i.e. barriers to intraregional trade, local price administration) should be abolished.

The independence of LGEs in determining **expenditure patterns** of local budgets should be increased. LGEs should be able to determine the size and structure of their budgets and to allocate funds for the execution of their own and delegated responsibilities independently.

b) Improve the supply of public goods at the national and regional level

The role of state aid as an instrument of regional policy should be changed. **Reform of the state aid system** should focus on reducing enterprise- and sector-specific aid as well as indirect types of state support. The power of the Anti-Monopoly Committee to regulate subsidisation issues should be increased. In the medium term, capital transfers to public enterprises should be re-allocated towards core public activities such as education and health. Regional preferences in the form of special economic zones should be reconsidered due to their distortive effects on competition and, in the medium run, abolished.

At the national level, regional development would benefit from a more favourable **institutional framework for entrepreneurship**. This implies lowering the administration and regulatory barriers to doing business (both for large enterprises and SMEs) via improvements in the relevant legislation and its implementation economy-wide and not just in a selective regional manner.

The **efficiency of public investment projects** should be increased. The government should rely on transparent and objective criteria when distributing funds for public investment. Priority should be given to public investment in infrastructure, in particular transportation (construction of roads, railways and airports), energy distribution networks and utilities. Better infrastructure will reduce the costs of doing business, and make especially peripheral regions more attractive for private capital. The efficiency of infrastructure investment projects could be increased by combining public financing with an active involvement of the private sector via concession schemes and public-private partnerships.[20]

Aid to combat poverty and other social problems should be provided by the appropriate social security systems irrespective of regional distribution. These programs should be financed by the central government directly from the state budget or via conditional transfers to the local budgets,[21]

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19 Decentralised provision of health care services is also proposed in Chapter 3.

20 See Chapter 5 on public and private investments in Ukraine. Reform in the utilities sector is discussed in Chapter 8.

21 See Chapter 3 on the social security system in Ukraine.

which will indirectly contribute to regional equalisation. Providing such aid indirectly in the form of enterprise-specific state aid for inefficient firms and branches of the economy is highly inefficient.

5 Investment Policies: Removing State Interventionism

5.1 Investment, growth, and economic policy

Sustainable growth requires investment, i.e. the accumulation of fixed and human capital. In a market economy, private business accumulates fixed capital to create capacity for future production. Investment in infrastructure, i.e., in transport and network supplies such as energy transmission and distribution, telecommunications, water and sanitation is often made out of public budgets but with the participation of private enterprises. Moreover, long-term growth requires that the technical progress embodied in new capital equipment be supported by appropriate skills in the workforce, i.e. by human capital. These skills, in turn, depend on the education and the health of the workforce. As markets tend to under-invest in human capital, the main way to accumulate it is via public expenditures on health and education. Empirical research suggests significant links between long-term economic growth and an economy's stocks of fixed capital, infrastructure, and human capital.[22]

Growth impulses from investment do not come about automatically but need policy support. Private investment decisions depend on the returns that investors expect and on the uncertainties associated with these returns. Expectations are shaped by the investment climate, which is a general term for the factors that provide incentives or disincentives for private sector investment. These include:

- taxation, policies toward investment financing, and the institutional and regulatory framework. All of this defines a critical role for deliberate public policies towards private investment, over and above macroeconomic, fiscal, monetary, and exchange rate policies and political stability;
- the quality and quantity of the available infrastructure motivates the importance of public and private infrastructure investment for shaping the investment climate.

Policy support, however, should never crowd out private activity. In Ukraine, the prevailing approach towards allocating public funds to support investment is still interventionist. Public investment in Ukraine helps to preserve old structures. It flows into areas with doubtful rationale for long-term state involvement, while budgeting rules lack transparent priorities and rules-based selection criteria. The result is long, primarily political and interest group-driven bargaining processes for public aid. Investment in infrastructure only rarely involves the private sector and investment in human capital does not efficiently exhaust available resources. Public support for private investment follows an approach of selectively targeting

[22] See Barro R. and X. Sala-i-Martin (2003): Economic Growth, Chapter 12.

industries and/or regions in attempting to pick winners at significant cost to the economy yielding unclear benefits.[23]

The solution to these problems is to limit the scope for state interventionism. This chapter outlines ways of achieving this objective with the overall goal of subjecting the allocation of public funds to support investment to transparent and rules-based procedures.

5.2 Public investment activity

5.2.1 The impact of public investment

Investment in Ukraine is by now mostly domestic enterprise investment (Table 5.1). The shrinking economy in the 1990s led to substantial revenue shortfalls for public budgets. The ensuing fiscal austerity had a much more severe impact on public investment than on current expenditures, implying some deterioration of the infrastructure. Following macroeconomic stabilisation, the GDP share of all public investment expenditures, including changes in inventory and capital transfers, has recovered from a low of 1.3% of GDP, according to World Bank data, to 5% in 2003, according to 2003 Budget Act data.

Table 5.1
Gross fixed capital formation in Ukraine, % of GDP

	1999	2000	2001	2002	2003 (est.)	2004 (proj.)
Total fixed capital investment	13.5	13.9	16.0	16.8	19.3	17.2
Out of public budgets	1.6	1.3	1.5	1.5	2.1	1.8
By enterprises	11.9	12.6	14.5	15.3	17.2	15.4
Net FDI inflows	1.6	1.9	2.1	1.7	2.8	2.3

Note: At 19.3%, Ukraine's share of total fixed investment in GDP was within reasonable limits for a transition economy in 2003: the UN Economic Commission for Europe's Common Database reveals a median of 21.1% for a sample of 25 transition economies in 2002. Public fixed capital investment is fixed capital investment directly financed out of state and local budgets. Public capital transfers to enterprises are part of enterprise investment, independent of the nature of the enterprise

Source: State Statistics Committee of Ukraine, World Bank, World Development Indicators 2004, and IER calculations

Although there are significant links between long-term economic growth and an economy's stocks of fixed capital stock, infrastructure and human capital, there is no statistically significant cross-country relationship between public investment and per capita GDP levels or growth. Public investment often involves large projects creating vested interests with inefficient outcomes, so the quality of investment and the efficiency of investment budgeting rules matter a lot in this relationship, as does private versus public ownership in infrastructure. Accordingly, shares of public

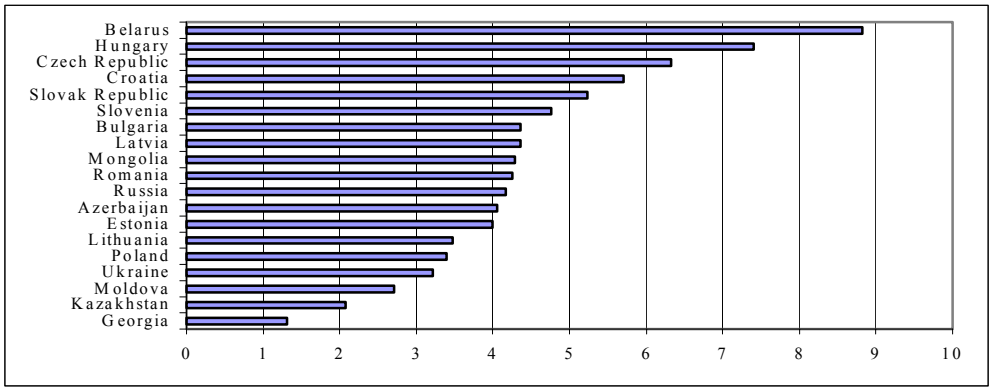
[23] For a discussion of regional policy in Ukraine, see Chapter 4.

investment in GDP sufficient to support sustainable growth are certainly much smaller than the highest levels indicated in Graph 5.1.

After recent increases, current public investment levels in Ukraine are comparable to OECD levels and do not appear to be insufficiently low (Graph 5.1). The impact of public investment on the Ukrainian economy is thus less a problem of the amount than of the efficiency of investment expenditures.

Above all, efficiency requires good public investment budgeting rules. The relevant Ukrainian rules and regulations lack transparent priorities and rules-based selection criteria for selecting between competing projects. For example, as a rule cost-benefit analysis is not applied. Decisions on capital expenditures are not fully integrated with respect to the decision making bodies, the different components of capital expenditures, capital versus current expenditures, and planning horizons. As resource ceilings are set only in the final stages of the project selection process, capital transfer decisions are prone to drawn-out bargaining. The process is thus biased towards creating excess demand for public funds, and results in too much state aid to loss-making public enterprises.

Graph 5.1
Public investment as a share of GDP: Selected transition economies, 1999–2001 averages, in %



Note: Public investment is all consolidated capital expenditure financed out of the central or local budgets. In addition to purchases of fixed assets, this especially includes capital transfers to enterprises, to the population, or abroad. Most OECD countries' public investment to GDP ratios are between 3 and 5 per cent

Sources: IMF, Government Finance Statistics and International Financial Statistics, World Bank, World Development Indicators, and IER calculations

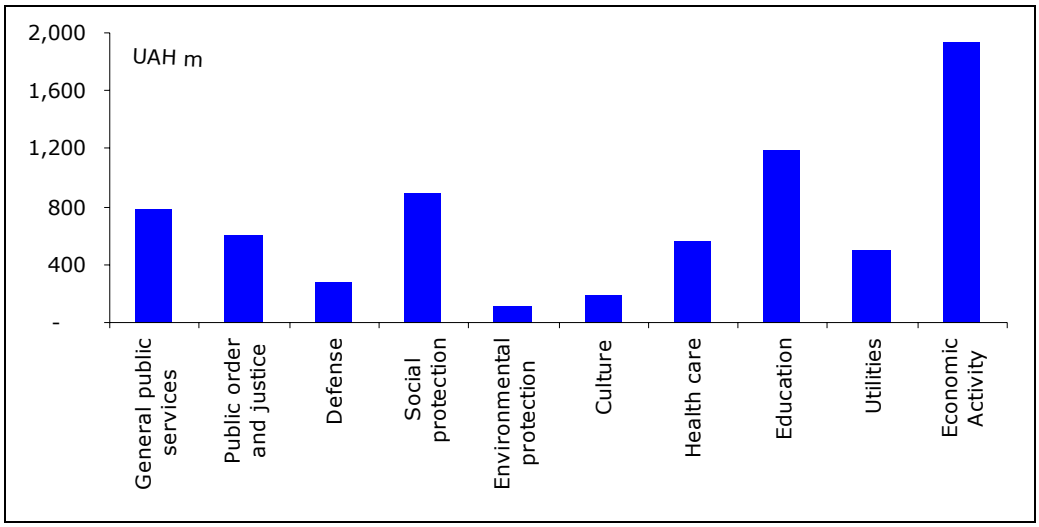
5.2.2 The scope for public investment in Ukraine

Public investment should be motivated by market failure arguments and by distributional objectives. Hence, the strongest grounds for public investment include the provision of core public goods and services (i.e., defence, public order and justice, general public services, and social protection) and equity considerations. Market outcomes may be socially

unacceptable and provide ground for public investment to ensure equal access to a socially agreed upon catalogue of goods and services.[24] Examples include health care and education, which also exhibit spill-over effects, as individuals often ignore the social return of human capital investment.

The prevailing government investment priorities in Ukraine[25] appear dominated by intervention on private markets motivated by only temporarily valid transition-specific concerns over the fuel and energy complex and the implementation of energy and resources saving technologies, agriculture, and the medical and microbiological complex. In fact, core public activities receive only roughly one third (36.3%) of all public capital expenditures in Ukraine in 2002 (Graph 5.2). Another third is composed of investment in environment, health, education and culture, much of which rightly responds to equity considerations and spill-over effects of these goods to society as a whole. Capital expenditures on functions with only some or even doubtful rationale for long-term state intervention, especially the broad sector of all "economic activities" and utilities, attract public investment in the same order of magnitude (34.5%). More than half of this is state aid in the form of capital transfers to publicly owned enterprises.

Graph 5.2
Consolidated budget capital expenditures in Ukraine (2002, in UAH m)



Note: Public investment is defined as in the note to Graph 5.1. Utilities include other (minor) housing and communal services capital expenditures. Public investment in utilities is financed out of local budgets. While most economic activity expenditures are financed out of the central budget, road financing is split between central and local budgets

Source: Statistical Bulletin, Capital Investments in Ukraine for the Year 2002

[24] This point is also made in the introduction to Chapter 3 on the social security system in Ukraine.

[25] As defined in the 'Concept of Regulating Investment Activity under the Conditions of Market Transformation of the Economy' of January 1, 1995, No. 384, with amendments of February 15, 2002, and the MoE 'Order On Approving the Decree on Assessment and Selection of Investment Projects'.

The share of all capital transfers to enterprises in consolidated public investment was 24% in 2002 and has since even risen sharply to 52% in the budget for 2004. Most central government capital transfers go to coal mining, while capital transfers to utilities are financed out of local budgets. Public investment expenditures on economic activities and utilities appear excessively high and can be re-allocated over the medium term.

5.2.3 Public infrastructure investment and the scope for private involvement

Transport and network supplies, such as energy transmission and distribution, telecommunications and water and sanitation are the backbone of a country's infrastructure. An adequate infrastructure is growth enhancing since it improves productivity and competitiveness, reduces poverty, contributes to environmental stability, links people, and is also a major decision criterion for private investment decisions. Given the poor state of infrastructure in Ukraine and limited budget resources, investment in new infrastructure and maintenance of the existing stock represents a serious challenge.

Involving the private sector in public infrastructure investment in the form of public-private-partnerships (PPPs) can reduce the burden on the public budget, especially when there is a potential for revenue generation. The financing of road construction provides a classic opportunity, usually involving concession schemes through which private firms finance and build the project and then operate it for a pre-defined period of time, recovering the investment by collecting user tolls.

Although the legal basis for such concessions exists in Ukraine, World Bank data indicate that between 1997 and 2002 the sum of private and public investments in completed infrastructure projects with private participation were limited to USD 338.5 m. Most of this is in natural gas and electricity transmission, none in road construction. Attempts at making use of road concession schemes have only started in 2002 when concession agreements were reached concerning construction and use of roads between Lviv and Brody and Krakivets and Lviv.

In general, the private sector has so far been reluctant to be involved in PPPs. As the list of potential objects that could be financed via PPPs is extensive, this is likely to be connected to poor policies and inadequate regulations that increase the risk for private investors. High contracting and bidding costs might be due to non-transparent tender conditions. Underdeveloped domestic capital markets contribute to expensive financing terms. To complicate matters, few sub-sovereign governments are creditworthy, and an unbalanced approach towards decentralisation has increased the share of infrastructure that falls under the jurisdiction of provinces and municipalities that do not have adequate sources of finance.[26]

[26] See Chapter 4 on regional development in Ukraine for proposals on how to improve this situation.

5.2.4 Human capital accumulation via public expenditures on education and health

The human capital of an economy lies in the skills of its workforce. As both current and capital expenditures on health care and education generate a future stream of benefits in the form of improved skills in the workforce, both expenditure types meet the economic definition of investment. However, individuals often ignore the social returns of human capital investment, which is to say that they ignore the effect that their health and education has on the productivity of society as a whole. Therefore, private markets tend to under-invest in skills, and human capital accumulation largely depends on public health and education expenditures.

World Bank data indicate a positive link between the GDP share of public expenditures on health care and education and the level of economic development. Specifically, in 2001 high-income countries spent on average 11.5% of GDP on public expenditures on health and education, while middle-income countries spent 7.6% and low-income countries 4.2%. Ukraine's 7.1%, of which 2.9% are on health care and 4.2% go to education, represent the highest figure of all CIS countries represented in Graph 5.1.

However, GDP share data do not reveal information on how much public expenditure reaches individuals. In Ukraine, the government has committed itself to provide equal and free access to health care services. Still, per capita expenditure on health care is one of the lowest in the sample of countries in Graph 5.1. As research indicates that the dominant direction of causality is from human capital to growth, and taking into account the pressure of an ageing population there is a clear-cut need for reform. There is also an evidence of insufficient provision of fixed assets investment in this sphere.[27] In particular, the accumulated depreciation of fixed assets in health care and education (39% and 42%, respectively) are among the highest in the economy. In addition, evidence of large shadow payments to doctors and teachers in Ukraine suggests that funding is insufficient even for the current level of economic development. Also, low quality services in rural areas can be connected to insufficient funding of local budgets.

Even more importantly, as already demonstrated for public investment expenditures on fixed capital, spending levels are less relevant for the impact of public human capital investment on the economy than spending efficiency. The criticism of budgeting rules in the area of fixed capital spending also applies to investments in human capital. In summary, due to inadequacy of funding and inefficiency of spending, only part of the public expenditures on health care and education in Ukraine represents effective investment in human capital formation.

5.3 Public support for private investment

Private investment in physical business equipment provides the main thrust of capital formation. In an open market economy, both private domestic

[27] See the discussion of health care reform in Chapter 3.

investment and foreign direct investment (FDI) contribute to growth impulses.

Public policy to further private investment may in principle follow two different patterns; a selective targeting or an institutional framework approach.[28]

- Public policy towards private domestic investment and FDI may be based on specific support for pre-defined priority sectors, regions, and/or types of investment.
- Public policy towards private investment may concentrate on providing a good business environment and institutional framework for investment.

While the institutional framework approach is advocated by international organisations as well as by us, Ukraine has so far leaned towards a selective targeting approach in providing public support to private investment (Box 5.1). Specifically, as direct transfers out of the budget are mainly reserved for supporting public rather than private enterprises, public support for private investment in Ukraine comes mainly in form of credits out of the budget and, most importantly, via the provision of different forms of tax preferences.

However, selective targeting represents a risky strategy. Deciding which investment projects to subsidise, how much to subsidise them and by means of which instruments involves difficult political and economic choices. Authorities risk finding themselves over-subsidising projects or creating unintended economic disturbances if they do not succeed in 'picking the winners'. At the more practical level, incentive programs are often administratively burdensome.

Box 5.1
Selective targeting to support private investment in Ukraine

Sector-specific incentives allow targeting investment to specific sectors while special economic zones aim at furthering investment in particular regions. Examples of sector-specific supporting programs in Ukraine include: *Stimulating the production of cars in Ukraine*, *State support of plane construction in Ukraine*, *Stimulating the development of agricultural sector*, and *Bronetechnika of Ukraine*. State support to facilitate investment in these sectors covers granting privileges on major taxes such as VAT on output, EPT, import duties, VAT on imported inputs and the land tax.
Ukraine has also established 11 *special economic zones* and 72 *special regimes of investment activity* that were created mainly for the purpose of attracting foreign investors to foster regional development and stimulate investment and innovative activity. Special economic zones usually involve the exemption from VAT and import duties on imported inputs, as well as exemption from EPT and the land tax.

Targeted policies often lack transparency. This relates both to approval procedures, which typically result in rent-seeking activities, and to the assessment of costs and benefits of investment projects. As the instruments applied are not explicitly targeted to measurable objectives, it

[28] There are obvious parallels between this distinction and the distinction between vertical and horizontal approaches to regional policy made in Chapter 4.

is difficult to evaluate the alternatives and the efficiency of the often costly measures (Table 5.3). In fact, many incentives are of little relevance to the investors being targeted, despite high costs to the authority. For example, investment in research and development requires a functioning patent system to secure long-term benefits. In the absence of effective patent protection, any subsidisation is a very costly and ineffective substitute.

Table 5.3
Costs of tax preferences in Ukraine, % of GDP

	2001 est.	2002 est.	2003 est.	2004 proj.
EPT	1.3	0.8	0.4	0.3
VAT	2.1	2.5	1.9	1.6
Import duties	0.2	0.3	0.2	0.3
Land tax	0.5	0.6	0.4	0.4
Excises	0.0	0.0	0.1	0.1
Total revenues foregone	4.3	4.5	3.2	2.7

Note: Table 5.3 contains estimates on all tax preferences, including those explicitly aimed at providing investment incentives. However, in as much as all tax preferences tend to have intended and unintended investment implications, Table 5.3 figures effectively represent upper-bound estimates for private investment-related costs of tax preferences in Ukraine

Source: Ministry of Finance and State Tax Administration of Ukraine, IMF, and IER estimates

For these reasons targeted tax incentives are usually not consistent with international best practice in the area of investment support. We recommend that improving all aspects of the institutional framework for private investment in Ukraine be given priority over selective targeted policies. Especially, we argue against discrimination by type of investment under any circumstances and cannot recommend the use of incentives targeted at specific sectors or regions without prior substantial institutional framework reforms.

5.4 Policy recommendations

The ultimate objective of our recommendations is to limit the scope for public interventionism and thus to increase the impact of investment in fixed capital, infrastructure and human capital on the long-term growth prospects of the Ukrainian economy. This can and must be achieved at current levels of public spending relative to GDP, in order to safeguard the sustainability of public finances.[29] The key is to increase the efficiency of both public investment and public support of private investment.

5.4.1 Proposals to increase the efficiency of public investment activity

The impact of current levels of public investment relative to GDP can be increased by a number of short- and medium-run measures.

[29] See Chapter 1. Maintaining Ukraine's hard-won macroeconomic stability is an absolute priority.

a) Public investment budgeting rules and regulations can be improved immediately. This requires:

- transparent priorities and the application of standardised rules-based selection criteria, such as cost-benefit analysis, in order to eliminate at least the poorest investment projects from the selection process;
- smoother integration of capital expenditures in the budgeting process. Multi-year development programs should be regularly updated against actual budgets. A medium-term planning procedure has to be implemented requiring medium-term budget estimates for spending units. Combined with efficient project selection, this helps policymakers to see the long-term consequences of their decisions. Initially, capital and maintenance decisions should be harmonised by introducing multi-year controls where all project proposals must include a task description, a statement of the financial resources required over the life of the project, and a cost-benefit analysis. This requires the establishment of a database to monitor spending and the progress of multi-year public projects; and
- resource ceilings in project selection should be set early, to minimize the demand for public funds and to avoid long bargaining processes for public aid.

b) In the near future, socially useful infrastructure investment can be stepped up by **increasing the involvement of the private sector**, especially in revenue generating projects.

At the central government level, this concerns concession schemes for road financing. On local level, this could involve utilities and local transport. Advances in regulatory practices and in the transparency of public tender conditions are clear pre-requisites for progress in this area, to overcome the reluctance of the private sector to be involved in PPPs. In the end, private involvement in public infrastructure projects can be an efficient instrument for increasing investment in infrastructure and simultaneously concentrating limited budget resources on investment in core public activities and in human capital formation via increasing public expenditures on education and health. The latter, however, has to be coupled to reforms in these two sectors.

c) In the medium term, this reallocation of public investment can be further strengthened by **phasing out state aid in form of capital transfers to public enterprises**, especially to coal mining and utilities.

Related social policy objectives can be more efficiently dealt with by temporary social assistance to households rather than sustained capital transfers to enterprises. This would again allow for increases in public investment in core public activities and in human capital formation.

5.4.2 Proposals to increase the effectiveness of public support for private investment

In line with private investor preferences and international experience, we recommend replacing prevailing selective targeting practices by a consistent set of non-discriminatory policies, based on the OECD *Guiding Principles for Policies toward Attracting FDI* (Box 5.2), bearing in mind that

a non-discriminatory policy approach dictates that these principles are applicable to domestic private investment as well. These policies should be drafted and published in a document outlining *Ukraine's Guidelines for Public Support of Private Investment*.

Box 5.2
OECD Guiding Principles for Policies toward Attracting FDI

1. Safeguard public sector transparency, including an impartial system of courts and law enforcement
2. Ensure that rules and their implementation rest on the principle of non-discrimination between foreign and domestic enterprises and are in accordance with international law
3. Provide the right for free transfers related to and protecting against arbitrary expropriation
4. Put in place adequate frameworks for a healthy competitive environment in the domestic business sector
5. Remove obstacles to international trade
6. Redress those aspects of the tax system that constitute barriers to FDI
7. Ensure that public spending is adequate and relevant

Source: OECD, Checklist for Foreign Direct Investment Incentive Policies, Paris, 2003

Translated into the Ukrainian context, these principles imply that:

- All instruments of public support for private investment that constitute outright state aid (including state credits or state guarantees for bank credits) should be cancelled. Aid is suitable to correct imperfections in the domestic environment that cannot otherwise be addressed.
- Such imperfections exist in Ukrainian agriculture, at least as long as land cannot be used as collateral to secure investment loans. In the meantime, a second-best instrument to alleviate credit constraints is interest rate subsidisation rather than direct budget aid or quasi-fiscal aid via the banking system. To ensure efficient allocation of subsidised credits, the recommendations made above for public investment budgeting rules and regulations should be applied to such support for agriculture as well.
- A similar imperfection may temporarily exist in the limited access of small and medium enterprises (SMEs) to the capital market, costly access to information, and relatively high administrative costs. However, interest rate subsidisation is no permanent substitute for steps to ease the entry and exit of enterprises, to increase access to information and streamline tax administration.
- Tax investment incentives targeted at specific regional and/or sectoral development are inferior to consistent non-discriminatory policies and institutional improvements: tax legislation needs to be simplified, discriminatory provisions should be eliminated. Depreciation policies need to be aligned with best practice accounting rules in order to avoid

distorting firms' production decisions. To encourage foreign investors, the government should follow the provisions of bilateral agreements that ensure the avoidance of double-taxation.

- Sustainable FDI promotion presupposes stable conditions for investors. This limits the government's scope for reforming existing inefficient and distorting schemes of tax investment incentives that have been misguidedly established to promote FDI. This might imply that a number of existing special economic zones and special regimes of investment activity must be maintained. However, the proliferation of such schemes should stop.
- FDI promotion must be non-discriminatory and must ensure that the private sector benefits from foreign participation through spill-over benefits. In special economic zones, incentives should apply to foreign and domestic investors alike and focus on activities with the strongest potential for spill-over effects, including linkages between foreign and domestic firms, education, training, and research and development. Concerning other investors' rights, these should first be addressed by provisions favouring non-discrimination of foreign investors in land ownership.

6 The Private Insurance Sector: Socioeconomic Benefits and Policy Issues

6.1 Private insurance as a major contributor to welfare

A functioning private insurance sector can significantly contribute to growth and prosperity, and increase the well-being of the population. Insurance companies can raise standards of living in Ukraine as they can benefit households, the development of small and medium enterprises (SMEs) and agriculture. The government can also profit considerably from a healthy insurance sector.

6.1.1 Benefits for households and consumers

In everyday life, households are confronted with a diversity of risks such as illness, accident, death and damage to property. The existence of these risks is a source of discomfort and of economic insecurity. Imagine an ordinary middle-class family, which has earned a solid livelihood. Due to misfortune such as fire in their apartment block, the members of this family could suffer a long-lasting drop in living standards from one day to the next.

With insurance, households can protect themselves against unexpected physical and economic downturns. By purchasing insurance policies, individuals transfer risks from themselves to an insurance company. The insurer provides an assured degree of security and protection against risks in return for a price (the insurance premium). This can provide households with a greater sense of economic security and increase their quality of life. The main insurance products that are sold to households - namely life, car, property and health/disability insurance - accomplish these important tasks in different ways.

Property insurance can protect against the cost of damage or loss of assets. Households are most likely to insure essential belongings such as housing, cars or even livestock from burglary, fire, storm and other disasters. Banks may require the insurance of assets used as collateral for loans e.g. for the purchase of large expense items or real estate. Thus, insurance can help household increase the financial credibility and secure favourable terms of credit.

Motor third party liability (MTPL) insurance establishes an indispensable system of social protection in road traffic. If a car driver who causes an accident is not insured, he might not be able to pay appropriate indemnification to an innocent person he has injured or whose car he has damaged. Compulsory MTPL helps to protect potential victims against the insolvency of injurers.

There are two basic types of **life insurance**. Term insurance covers the risks of premature death. Cash value insurance can additionally be used as an investment and savings tool. In its fundamental form, life insurance is a pure term insurance. Its main aim is to compensate the policyholders' family members from financial losses following the death of the policyholder - commonly the main income earner. Term life insurance can for example cover loss of income, outstanding mortgage payments and/or funeral expenses of the policyholder. The second main type - cash value insurance - adds a savings component to term life insurance and thus involves higher monthly payments. As a policyholder pays his premiums, a portion of each payment is set aside to accumulate the cash value. The insurance company typically invests the cash value, which continues to grow as long as the policy is in force and is paid after a predetermined number of years. Cash value insurance facilitates long run savings and is a convenient way to save for the time after retirement. Life insurance allows households to better plan their future financial situation and makes them less dependent on limited social welfare budgets in old age.

Private health or disability insurance can be a sensible complement to the provision of health services and disability payments by the state. A private health insurance contract can help to secure better quality medical services in case of need. Private disability insurance is commonly designed to replace 45-60% of gross income should sickness prevent a policyholder from earning an income in his occupation.

6.1.2 Benefits for SMEs

Insurance is an important tool for all kinds of businesses. It is, however, the SME sector that will be best able to raise standards of living for the majority of the Ukrainian population in the coming years. A prospering SME sector plays a crucial role for lower and middle classes, as people are enabled to set up or expand a small business on their own and earn a living. In nearly all industrial and transition countries SMEs have been the most reliable motor of job creation, and have facilitated the social advancement of countless people.

Unfortunately, the Ukrainian SME sector still faces many constraints and lacks vitality. A main factor in constraining its development is the lack of financial security and appropriate risk management strategies. Small entrepreneurs such as taxi drivers or shop owners must bear alone the risk that some peril such as fire or an accident could cause substantial losses and endanger their livelihood. Insurance can help small entrepreneurs protect themselves, their employees and their productive assets against such risks. The stability and liquidity provided by insurance coverage encourages small entrepreneurs to invest with the assurance that their resources are protected. Property and liability insurance can help avoid costly business interruption or even the liquidation of firms in case of unforeseen losses. This reduces follow-up costs for employees, clients and suppliers. Hence, insurance can increase the credibility of entrepreneurs just as it can for households. It can facilitate their access to credit at satisfactory conditions - perhaps the main bottleneck for SMEs. In addition, insurance makes it possible to use financial resources more effectively. Rather than holding large amounts of money in reserve ‘for a rainy day’, a

small insurance premium is paid. Small entrepreneurs can thus concentrate on the growth of their business and on the creation of wealth.

6.1.3 Benefits for agriculture

Agriculture plays a crucial role for the well being of large parts of the population in Ukraine. However, it is exposed to a high level of risks, such as hail, frost, drought, diseases, accidents and fire. Most of these risks cannot be insured on private markets. Losses due to nationwide drought or frost affect the majority of insured farmers simultaneously, meaning that the benefits of risk pooling are eliminated. Furthermore, there is no proper international reinsurance market for systemic risks in agriculture. Nevertheless, private insurance can provide beneficial and profitable risk coverage to farmers. Hail insurance is the most popular and is transacted extensively in most countries of Europe and North America. Insurance for machinery or livestock is also widespread. Such policies cushion the negative economic effects of important risks in agriculture and can thus improve the social and economic situation of farmers.

6.1.4 Benefits for the government

By protecting individuals from economic decline in case of misfortune, private insurance fulfils a key purpose of social policy. A functioning voluntary insurance market enables people to choose individually which risks they are willing to take and which risks they wish to protect themselves against. Life insurance also allows them to make provisions for retirement. This reduces the need for government intervention in many areas of social policy. As providers of retirement and health benefits, insurers may in part substitute for government security programs. The insurance industry can thus play a crucial role in reforming the social security system. Altogether, a functioning private insurance market can considerably reduce public spending and allows the government to target social spending to those who most urgently need it.

6.2 The current situation of private insurance in Ukraine

6.2.1 An aggregate view – positive trends

In recent years the Ukrainian insurance market has grown both in size and sophistication. There has been an exponential growth in premium income over the last years, with a more than 100% increase in premiums in 2003 alone.[30] As Table 6.1 shows, insurance penetration (the ratio of total premiums to GDP) appears to be quite high in international comparison (3.52% in 2003), exceeding the level of countries like Slovakia or Thailand. However these official figures are vastly inflated. Large parts of the Ukrainian premium volume reflect pseudo-insurance activity. Property insurance is often used as a vehicle for tax avoidance, for illegal capital

[30] See Swiss Re (Sigma) (2004): World Insurance in 2003, March.

export and for intra-group financial engineering.[31] The overall loss ratio (claims as a proportion of earned premiums) was estimated at only 12.2% in 2002, compared with over 90% in most developed countries.[32] As a result of the low level of 'real' insurance, authorised funds, assets and reserves in the sector are very low, especially when compared to the domestic banking industry. Per capita expenditures (insurance density) amounted to a mere USD 35.4 in 2003, which is considerably lower than the corresponding figures for other transition countries such as Poland and Bulgaria.

Table 6.1
Insurance indicators in selected countries

	Insurance density	**Insurance penetration**	
Country	**Premiums per capita** (USD, 2003)	**Non-life insurance** Premiums (% of GDP, 2003)	**Life insurance** Premiums (% of GDP, 2003)
Japan	3770.9	2.20	8.61
United States	3637.7	5.23	4.38
Denmark	3116.0	2.74	5.18
Germany	2051.2	3.82	3.17
South Korea	1243.0	3.38	8.23
Spain	1146.1	3.20	2.38
Malaysia	227.0	2.05	3.29
Slovakia	210.6	2.00	1.38
Poland	162.2	1.91	1.21
Russia	98.2	2.13	1.12
Bulgaria	49.2	1.69	0.21
Ukraine	**35.4**	**3.52**	**0.03**

Source: Swiss Re (Sigma): World Insurance in 2003

In terms of legislation and regulation, considerable progress has been made in recent years, but the overall framework is still not satisfactory. In 2003 the *State Commission for Regulation of Financial Services Markets* (State Commission) was entrusted with important legal powers to ensure

[31] Insurance companies are often part of a financial group and function mainly as captive insurers. Many companies have been set up to take advantage of the 3% tax regime for insurance premiums to avoid the 30% tax on enterprise profits (now 25%). "Typically one of these 'pocket' insurance companies will issue a policy to its shareholder for a large premium involving no risk. The insurer can then grant a beneficial loan to their shareholder or use reinsurance to export capital abroad." (Axco Insurance Market Report on Ukraine - Non Life, December 2003).

[32] The fact that few claims are actually paid is evidence of the widespread use of grey market transactions in the insurance sector. Additionally, premiums appear to be too high and policyholders poorly able to enforce their claims. See: "Insurance in Ukraine. Legislative and Regulatory Issues", Alberto Monti, Bocconi University, July 2003.

essential supervisory duties in the insurance market. On paper, the Commission's terms of reference appear well-suited to ensure proper regulation. Regrettably, the allocated budget and technical provision of the Commission are absolutely inadequate and political support is too weak. Besides, there still are serious concerns about consumer protection in the insurance market. Many necessary steps to transform the insurance industry in accordance with international standards have yet to be taken. All in all, the market is still not functioning appropriately and there are only few insurance companies in Ukraine that transact business on a sound basis. Nevertheless, recent developments give some reason for optimism.

6.2.2 A disaggregate view – inadequate insurance of consumers and SMEs

The insurance market in Ukraine is dominated by corporate insurance mainly because voluntary property insurance is extensively used as a tool for capital exports and tax avoidance. Commercial and industrial property insurance alone accounted for 76.9% of premium income in 2002.[33] In turn, **private lines of insurance are completely undeveloped**. Few insurance companies meet the requirements of average consumers and SMEs. According to market experts, only 10% of basic risks in Ukraine are presently insured. In comparison, risk coverage in most developed countries commonly surpasses 90%. Uninsured exposure to risk such as fire or accident therefore remains a major threat in day-to-day life of most Ukrainians. The most elementary insurance tools for households, SMEs and agriculture are still in their initial stages of development.

At present only a small number of households and SMEs protect their key possessions such as apartments and belongings through insurance. Most of those who are insured, are so because banks frequently require insurance coverage before granting credit for major purchases such as real estate or machinery.

Despite low car ownership, the numbers of people killed and injured on Ukrainian roads in 2001 were 5,894 and 38,196, respectively. Despite these disquieting numbers, only around 10-20% of the 10 million vehicles in circulation in Ukraine are insured, compared with 94% in Poland and 99% in Germany. **MTPL** both for bodily injury and property damage has been mandatory for years, but enforcement has been extremely limited. At present, the traffic police are not even authorised to check insurance documents. A new law passed in June 2004 aims to oblige car owners to acquire MTPL policies. Although it is a step in the right direction, due to very low fines for non-compliance, the law will not improve the awkward situation of risk coverage in Ukrainian road traffic.

The **life insurance sector** is still in its infancy in Ukraine. It accounts for a mere 0.8% of total premium volume, compared with 60% in many Western countries.[34] Accordingly, life insurance penetration in 2003 was only 0.03%

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33 See Benfield's (2003): Ukraine Insurance Market Review, June. Available at: http://www.benfieldgroup.com/research/reports/industry+analysis+and+market+review/ukraine0603.pdf.

34 See Benfield's (2003): Ukraine Insurance Market Review, June. Available at: http://www.benfieldgroup.com/research/reports/industry+analysis+and+mark

(see Table 6.1), a tiny figure compared to 3.17% in Germany or 1.21% in Poland. Per capita premiums of voluntary life insurance in 2003 did not even reach UAH 1.50.[35] Although life insurers are supposed to play a major role in the pension reform program,[36] they are currently not able to compete with banks in terms of interests and services for retirement provisions. The vast majority of insurance companies in Ukraine are pure non-life insurers and most brokers and agents are inactive in the field of life insurance.

A growing number of companies acquire additional **voluntary health and disability policies** for their employees, and demand in higher income brackets is rising. However, coverage remains very limited.

The introduction of **mandatory crop insurance** in 2002 was misplaced and badly managed.[37] As a consequence, it reinforced the traditional mistrust in state-run insurance on the part of farmers, who mainly see it as a hidden tax that will never lead to meaningful payments in times of need. At present, only approximately 1% of all farmers in Ukraine hold a policy against agricultural risks. Nonetheless, many do understand the value of insurance as a potential risk mitigation tool and would be willing to buy voluntary insurance policies, if only proper policies would be available.

6.3 Reasons for the low prevalence of consumer and SME insurance

6.3.1 Inadequate governmental policy

Incoherent policies have slowed down the development of private insurance in Ukraine. Although the government has improved the regulatory and legal framework in recent years, it has not followed an appropriate and comprehensive program for the long-term development of the market. The authorities have introduced an excessive number of compulsory insurance classes, which have not been enforced nor duly regulated. The negative experiences made with these policies – for example crop insurance – reinforce the perception that insurance is just another tax and have been poison for the insurance sector. There is no uniform and consistent Insurance Code that covers all aspects of insurance legislation. Instead, scattered and partly contradictory laws, bylaws and other legal acts concerning insurance have been enacted and repeatedly amended. Politicians have repeatedly failed to fulfil their financial promises

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et+review/ukraine0603.pdf. The low ratio of life to non-life premiums is a feature of many Eastern European countries in transition.

35 Own calculations based on Swiss Re (Sigma) (2004): World Insurance in 2003, March.

36 Private life insurance is supposed to make an important contribution to the so-called third pillar of the reformed pension system in Ukraine; see Chapter 2.

37 The government has not fulfilled its promise to reimburse 50% of the compulsory insurance premiums. Furthermore, it has provided emergency compensation to farmers who suffer losses, even if they have not purchased 'mandatory' insurance coverage. This has a counterproductive effect and reinforces the perception that insurance is unnecessary because the government will provide assistance in times of need anyhow.

in the field of insurance and, what is worse, have not provided essential funds and support for the main supervisory authorities. All in all, government politics with regard to the insurance sector have been inconsistent and sometimes unpredictable, eroding trust on the part of consumers and insurers.

6.3.2 Insufficient resources and efforts by insurers

Providing insurance products for households and SMEs requires considerable know-how, human resources and investments. Transaction costs and the risks of selling and servicing insurance products are much higher than in the corporate market and can only be encountered with advanced management and risk evaluation techniques. However, in many cases the personnel and management of insurance companies in Ukraine is not sufficiently qualified and poorly motivated. There is a general lack of basic skills for the insurance business. In 2003, only a third of the insurance companies in Ukraine fulfilled the minimum requirements of authorised funds. Most companies are financially weak and not able to cover large damages. Barely half of all insurers actively build up their capital.

So far, insurers have not devoted much effort to marketing and developing products and distribution networks for average consumers and SMEs. Only a limited number of companies offer reasonable and affordable insurance services to lower- and middle-income Ukrainians and in rural areas. Companies invest little in educative marketing and retail activities. As a result, large parts of the population remain unaware of the concept and benefits of insurance. Polls indicate that the overwhelming majority of citizens are unaware of the essence of key insurance classes.[38]

6.3.3 Weak consumer protection and risks for insurers

Consumer protection in Ukraine's insurance system is not satisfactory. There are many deficits in insurance contract law. In general, policyholders are mostly unaware of their rights and often unable to enforce them. Civil courts are overloaded, slow and inexperienced in handling insurance-related litigation. Policyholders are not sufficiently protected against fraudulent conduct and bad advice, as the agents who sell insurance are subject to neither registration nor supervision. This contributes to the poor image of insurers in the population and is a major obstacle to the spread of private insurance.

On the other hand, insurance companies face high risks when selling coverage to households or SMEs in Ukraine. Insurance-related problems due to moral hazard (negligent behaviour after purchasing a policy), adverse selection[39] or outright fraud are very common in Ukraine and a main reason why many types of insurance are presently not offered to the

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[38] See 'Problems hindering the development of the insurance sector' (2003), National Security and Defence, No. 6 (42), Razumkov Center.

[39] Adverse selection means that people facing high risks will be more interested in buying insurance coverage at a certain price than those who have below-average risks.

general public at favourable conditions. As insurance companies do not trust policyholders, they impose many restrictions on their policies to protect themselves against fraudulent claims. These restrictions give rise to disputes and delays in settlement, which again undermine the confidence of the public in the integrity of insurers.

6.4 Policy recommendations

To raise standards of living in Ukraine, policymakers should have a keen interest in the development of a functioning private insurance market for households, farmers and SMEs. The transition towards sizeable and efficient markets will be long-winded and certainly not occur overnight. Gradually developing the private insurance market is a task for both the government and insurers. The insurance sector urgently needs a clear-cut, comprehensive and above all consistent political strategy for its long-term development e.g. until 2010. The government has to announce its key goals and priorities to the public and pursue a realistic time schedule for the implementation of the necessary reforms. Insurance companies in turn, will have to be willing to invest substantial amounts in marketing, sales, customer relationship management and capital reserves to being able to service large parts of the population satisfactorily. Their main challenge will be to convince the population of the benefits associated with insurance. Moreover, they have to display a willingness to effectively self-regulate and professionalize their industry to improve their poor image.

At this stage, government and insurers should set realistic priorities and focus on a few crucial measures. From our point of view these are first and foremost the political and financial reinforcement of the State Commission and the enhancement of consumer protection. In addition, the promotion of motor insurance is a major priority.

6.4.1 Supervision: more support for the State Commission

Effective supervision is imperative for the functioning and development of a solvent and efficient insurance market. Supervision can ensure that insurance companies are financially viable, operating within the laws and offering insurance products at fair and adequate rates. Without proper surveillance, the insurance market can become a breeding ground for criminal activity such as money laundering, tax evasion or illegal self-enrichment. Good supervision is thus a prerequisite for the popularisation of insurance among consumers and SMEs.

In Ukraine, the State Commission lacks the political and financial support that it requires to fulfil its important monitoring tasks. This young and inexperienced body is confronted with the enormous challenge to put into practice a long list of statutory provisions and exerts its supervisory assignments in a very difficult environment. Above all, it has to ensure the compliance with capital adequacy and solvency requirements and increase transparency and conduct of insurance companies. Yet, at present, it does not even have the necessary resources to set up a basic IT-based record of insurers' capital movements. Its directors are unable to hire and train insurance experts at competitive salaries. Furthermore, the State Commission lacks the political power to withdraw licenses or force mergers

and takeovers if financing or management is insufficient. This is alarming, given that supervision is particularly important in the first stages of market development. We strongly recommend providing the State Commission with proper funds as well as technical assistance as soon as possible.

Along with a considerable increase in government funding for the State Commission, we propose the introduction of a charge paid by the insurance companies themselves, as is the case in Germany and many other developed countries. Insurers should pay a regular fee to the State Commission based on their market share. As the companies ultimately benefit from accurate market supervision, such a system has proven successful in many countries. The charges paid by insurers should not exceed a fixed share of total revenue from premiums.

6.4.2 Consumer protection: contract law, Insurance Ombudsman and licensing of agents

Consumer protection is particularly important for lower-income households and SMEs as these are often characterised by low levels of education and financial literacy and are thus especially vulnerable to misconduct by insurance companies. There is serious need for improvement in the following three fields: Insurance law, insurance dispute resolution and the circumstances under which insurance is sold.

First, we recommend a thorough revision of the current legal provisions for insurance contracts. Ukraine badly needs a modern Insurance Code. Legislation has to define and ensure essential consumer rights of contractual information, cancellation and withdrawal. These rights are not effectively protected at present. In addition, supervisory authorities and insurers should jointly design and promote standardized terms and conditions for main consumer contracts such as MTPL, real estate property and personal accident insurance.

To enable policyholders to enforce their rights without difficulty, we recommend the creation of a neutral institution for insurance related litigation as envisaged by the League of Insurance Organisations of Ukraine (hereafter: LIOU). Such an 'Insurance Ombudsman' would be charged with mediating and resolving disputes between policyholders and insurance companies in a flexible, objective and cost-efficient way. This would help to avoid lengthy court litigation. While the Ombudsman's decisions should be binding upon insurance companies, policyholders should retain the option to take further legal action. An Ombudsman is generally more easily accessible and user-friendly than courts. His services should be free of charge for policyholders and no special expertise or professional help should be needed to access his resolution services. The scheme should be financed by the insurance industry. Of course, it is imperative that the Ombudsman be a truly independent institution in its structure, function, and appearance. An Ombudsman is an attractive means of protecting policyholders and increasing confidence among consumers. It has proved of value in many countries such as Germany, India, Poland, Singapore, Switzerland and the United Kingdom.

Government should furthermore address the qualification and seriousness of insurance agents. Only licensed and qualified agents should have the

right to sell insurance. Multi-level marketing should be categorically banned. We recommend delegating the task of registering and controlling Ukraine's insurance agents to an insurance association such as the LIOU in coordination with the State Commission.

6.4.3 Promotion of MTPL insurance: instigate a modern insurance infrastructure

The future of compulsory and voluntary motor insurance in Ukraine will play a key role for the progress of the entire sector. MTPL insurance is a suitable product to propel the underdeveloped insurance market forward and expose large parts of the population to private insurance services for the first time.[40] Additionally, it fulfils an important task of social protection and might considerably improve risk management of Ukraine's citizens in everyday life. We therefore strongly recommend the strict enforcement of appropriate MTPL insurance products as soon as possible. Mostly due to the low level of fines, the new law on compulsory MTPL insurance will not assure effective enforcement. Stricter legislation and a better coordination between all relevant actors including insurance companies, traffic police, the judiciary and damage assessors is necessary. Moreover, minimum levels of MTPL coverage remain too low and should be raised.

Once MTPL insurance is effectively enforced, insurers should put considerable effort into information campaigns, marketing and good consumer relations, for it might be a unique chance to introduce private individuals to other insurance products. A main challenge will be convincing the majority of car holders about benefits of coverage. Insurers are thus advised to undertake substantial investments in appropriate distribution networks, especially outside of the main cities.

The development of automobile insurance can be a good starting point for improved statistics and management techniques for the mass market. The provision of MTPL insurance to millions of policyholders will require insurers to develop more sophisticated internal control and information systems that are vital for small claims management in many other areas of insurance. The LIOU or another qualified insurance association should establish and maintain a statistical database for the insurance market. Good data about risks and claims histories is essential for the sound calculation of any insurance premium. This database might also serve as a black list, to protect insurers against fraud and criminal activities by policyholders.

[40] Experience shows that compulsory MTPL insurance is a motor of premium growth and market development in many emerging countries. In China and South Korea, car insurance accounts for more than 50% of the total market.

7 Mortgage Lending and Standards of Living

7.1 Importance of mortgage lending for standard of living

A mortgage is a loan secured by collateral in the form of specified real estate property. If a borrower defaults on a mortgage loan, the lender receives the right to seize the pledged collateral and sell it in order to recover any remaining debt. The presence of collateral in this respect makes mortgage loans safe and, therefore, attractive. Real estate, in turn, is the most secure pledge against various risks. First, its value can be assessed in a relatively objective way by standard evaluation techniques.[41] Second, it is immobile and cannot be hidden or otherwise removed from the mortgagee's control. And lastly, if the borrower defaults on the mortgage loan, the lender can, at least in principle, easily and rather quickly sell the property to recover his expenses. Therefore, assuming the mortgage lending system works properly, mortgage loans are a safe and attractive instrument for banks.

However, the main beneficiaries of well functioning mortgage system are not banks but borrowers. This is due to the following positive influences that mortgage lending exerts on borrowers:

- mortgage lending provides individuals and enterprises that would otherwise not be creditworthy with access to finance;
- the safety of secured loans contributes to lower interest rates and thereby lower cost of borrowing for individuals; and
- mortgage lending enforces the development of long-term financial contracts and eases access to scarce long-term resources.

This positive influence is especially important for Ukraine where access to finance is limited, interest rates are high, and the maturity of most credits short. During the last years in Ukraine the volume of domestic loans outstanding has increased steadily,[42] but this volume remains low and does not meet the needs of the growing economy. Access to finance for economic agents is limited in Ukraine and in some cases inexistent. In 2003 the volume of total credits provided by the banking sector to the economy was equivalent to 26% of GDP. Although this indicator is higher than in other CIS countries such as Armenia (6.2%), Belarus (15%), and Russia (22.5%), it lags behind CEE countries such as Hungary (55%), the Czech Republic (38%), and Croatia (55.5%). Moreover, in developed economies total credit to the real sector is a multiple of GDP (5.5 in

[41] The right evaluation of property must take into consideration the risk of lower prices in the future. Inadequate property evaluations during "property bubbles" have led to major banking crisis in countries such as Japan.

[42] In year on year terms, bank credits to the economy in 2001 increased by 45%, in 2002 – by 48%, in 2003 – by 61.4%.

Germany, for example). Loans received by households in Ukraine constituted only 13% of the banking credit portfolio in 2003. In Hungary, in contrast, more than 23% of total loans go to individuals, in the Czech Republic 27%. The access to additional sources of finance for households is practically inexistent in Ukraine. The result is an increased call for government financial support which leads to additional burdens on state finances.

The situation in the country is largely worsened by high costs of borrowing. Average interest rates for loans in national currency range between 20 and 26%, whereas loans in US dollars cost 14 to 16%. In Europe interest rates are 2-3 times lower, varying from 6 to 10%. Finally, about 55% of all loans in Ukraine are short-term (up to 1 year). The rest are mainly 1-3 year loans, and maturities rarely exceed 5 years.

In this chapter we argue that by improving access to long-term and cheap financing, a functioning mortgage loan market will have a significant positive impact on standards of living through three main channels:

- the development of housing mortgage aimed at increasing the affordability and quality of housing will allow households to improve their living conditions;
- the development of commercial mortgage will facilitate the development of private business; and
- the creation of safe mortgage securities will revive long-term savings and contribute to income security in old age.

a) **Housing** conditions constitute an integral part of living standards. A functioning housing sector should make adequate and separate housing available and affordable for households. Due to rising real estate prices and lack of access to finance, this is becoming particularly challenging for households with low average incomes in Ukraine. The development of mortgage lending can play crucial role in addressing this challenge. The availability of mortgage loans will create incentives for individuals to save and invest in the housing sector, thereby affecting the quality and the quantity of the housing stock and improving living standards. Increased demand for housing will intensify construction and related services, creating jobs in the construction sector.

Current housing conditions in Ukraine are not adequate and most Ukrainians would like to improve their living conditions both in qualitative and quantitative terms. Average dwelling space per person is 21.6 m² (as of January 1, 2004) in Ukraine. This doesn't differ much from other CIS countries, but it is almost 2 times less than in developed states.[43]

The quality of much housing in Ukraine is far from satisfactory. More than 90% of the total housing stock consists of units that were built before 1991. Most of this stock needs urgent renovation or modernisation. The level of housing stock amenities is low by international comparison. For instance, the share of housing units with piped water in Ukraine is 55.2%,

[43] In Belarus – 19 sq.m., Kyrgyzstan – 17 sq.m., Azerbaijan – 14 sq.m., Estonia – 22.sq.m., Latvia – 22.8 sq.m.. In contrast, in Germany – 39.4 sq.m., France – 36.7 sq.m., Denmark – 49 sq.m., Norway – 42 sq.m.

compared with 90% in Poland, 97% in the Czech Republic and over 85% in Hungary. Only 39% of the dwellings in Ukraine are supplied with hot water and only 54.7% with central heating. Most families would like to modernize the subsidiary quarters in their homes (kitchens, halls, bathrooms, or shower-rooms). Investment in new heating systems, windows and doors could play an important role in promoting energy saving, and installation of new equipment could improve security and the acoustic insulation of houses.

b) Another benefit of mortgage lending is its impact on business and job opportunities through improved access to finance for all enterprises. **Commercial mortgage** is a mortgage secured by real estate which is used for business purposes. Widespread commercial mortgage will provide relatively cheap funds to the private sector for use in starting and developing businesses. Under current conditions in Ukraine, this is especially important for SMEs and agricultural firms.

SMEs in Ukraine depend primarily on equity capital to finance investment projects. Not more than 10% of SMEs are able to use bank credits. According to the results of the *Ukraine SME Survey* performed by *International Finance Corporation* in 2003, bank loans play a minor role as sources of investment for firms regardless of size. Internal resources, such as amortisation and retained earnings as well as private savings remain the major sources of investment. Three quarters of the surveyed firms responded that they do not apply to banks due to high interest rates, high collateral requirements, bank bureaucracy and the unavailability of long-term credits, even though they were confident of their ability to repay.

In agriculture, only 5% of external financing comes from the banking sector. Most bank credits to farmers (74%) are short-term (1-3 years). Using agricultural land as collateral will not solve all problems associated with scarce financial resources in agriculture, even if land becomes a marketable asset on January 1st, 2005. This is because most agricultural producers in Ukraine own no more than 10% of the land that they farm, the rest is rented. Individual land plots are rather small (roughly 4 hectares on average), so accumulating enough land to provide meaningful collateral is difficult. Agricultural buildings are unlikely to play a major role in securing loans, because of their low value and the general lack of alternative usages. However, the land and houses owned by private farmers could be attractive to banks. Consequently, a functioning mortgage lending system has the potential to help primarily private farmers and households, who accounted for 68.7% of gross agricultural production in 2003.[44]

The financial resources obtained by private farmers from mortgage loans could be used to purchase new equipment, machines, seeds and pesticides. They could also increase the liquidity of farm enterprises and thus help farms time their purchases and sales so as to avoid unfavourable seasonal price fluctuations. Currently, many farms are obliged to sell into seasonal post-harvest price lows to service commodity-based credits. In this way,

[44] Mortgage lending is unlikely to improve access to finance for former collective farms, which accounted for 29.5% of gross agricultural production in 2003.

mortgage lending could lead to productivity gains for agricultural enterprises and increase incomes in rural areas.

c) The need to refinance mortgage loans will introduce a new financial instrument, **mortgage securities**, and thus foster the development of capital markets in Ukraine. Because of their safety, liquidity and long-term character, mortgage securities are attractive saving instruments if the mortgage market functions properly. They can contribute to higher income security in old age, as mortgage securities are a common element in the portfolios that life insurers and pension funds manage.[45]

7.2 Mortgage lending in Ukraine: current situation

Mortgage lending has recently experienced dynamic development in Ukraine. During the last two years the volume of outstanding mortgage loans increased by more than three times, reaching a total of UAH 5.1 bn as of April 1, 2004. Nonetheless, this represented only 1.7% of GDP. Compared with other CIS countries mortgage lending is well developed in Ukraine. For instance, in Russia the volume of outstanding mortgage loans is less than 1% of GDP. However, in CEE and EU countries the depth of mortgage finance is far greater, reaching almost 7% in Poland, 7% in Croatia, 8% in Hungary, 6% in the Czech Republic, 14% in Italy, 24% in France, 59% in the UK and 66% in the Netherlands. So there is much room for further development of mortgage lending in Ukraine. It is also instructive to look at the volume of mortgage lending relative to total loans outstanding. At present mortgage loans amount to not more than 7% of the total credit portfolio of Ukrainian commercial banks; corresponding figures for Poland and the EU-15 are 25.8 and 40%, respectively.

35 of 159 functioning banks provide mortgage loans in Ukraine, but the largest 10 banks account for almost 70% of the mortgage market. The prevailing interest rates are high in Ukraine: 14-16% for US dollar loans and 18-22% for hryvnia loans. Another feature of national mortgage market is its dollarisation: more than 60% of all mortgages are provided in foreign currency. Most mortgage loans in Ukraine have a maturity of less than 5 years (generally 1-3 years). The incidence of long-term loans is increasing, however. Normally banks should be able to provide large loans for 20-30 years, as is common in countries with functioning mortgage markets.

About 35% of the mortgage loans in Ukraine are loans to individuals for the purchase of existing dwellings and for housing construction investment. The demand for housing loans is expected to rise in the future mainly due to the recent intensification of housing construction in the country and continuing high demand on the real estate market, notwithstanding the tendency of housing prices to increase. However, insufficient financial resources and their high cost restrict the ability of banks to supply sufficient mortgage loans. Individual deposits constitute over 50% of bank liabilities in Ukraine, whereas credits provided to individuals account for

[45] Reform to further the development of private life insurance and pension funds are discussed in Chapters 2 and 6 above.

less than 20% of the credit portfolio. Consumer loans make up the lion's share of loans to individuals (about 80%).

Striking regional differences in access to mortgage loans and loans in general are evident in Ukraine. One-half of all the mortgage loans are provided in Kyiv and several industrial oblasts (Donetsk, Kharkiv, Dnipropetrovsk and Zaporizhzhia). In the first quarter of 2004, Kyiv accounted for over 40% of credit portfolio of all banks in Ukraine. It is often impossible to receive a housing or commercial loan in a small town or in rural areas. These differences in lending activities are consistent with variations in regional development, but if access to credit is not improved in less developed regions, their prospects for catching up will diminish considerably.

Inequalities in access to lending are also evident between households and firms in Ukraine. Although the volume of mortgage loans to households has increased due to the recent surge in housing loans, mortgage loans to firms and institutions dominate with a share of 70%. Furthermore, large companies are more likely to obtain credit than smaller ones, because they meet collateral requirements more easily and have lower transaction costs.

The reason for tough lending requirements and frequent refusals to provide mortgage loans is that banks are wary of the risks associated with different sources of insecurity when borrowers repay their loans, or when banks are obliged to seize and sell the property pledged to the loan. One of the sources of risk is the absence of effective standardised procedures that banks can use to evaluate a borrower's creditworthiness. There is also a lack of established procedures that can be used to evaluate the property pledged to a loan. Weak title and lien registry, ineffective foreclosure and repossession procedures, and problems arising from the need to evict people in the event of loan default all impede the development of mortgage lending, especially of housing loans. A developed and functioning legal environment is needed to improve security and contribute to the development of mortgage lending. The fundamental problem, however, lies in the lack of cheap and long-term financial resources that could be used by banks to provide loans.

7.3 Policy recommendations

7.3.1 Goals of the Ukrainian mortgage system

The final objective of a mortgage lending system is to enable potential borrowers to obtain long-term loans at low interest rates. But to be able to provide long-term loans at low cost, banks themselves need long-term and cheap refinancing. Consequently, the goal of the Ukrainian mortgage system should be to enable banks to secure cheap and long-term refinancing.

7.3.2 How to pursue these goals

Financial institutions providing mortgage loans should be able to fund their mortgage lending activities through different instruments. In countries with functioning mortgage lending systems, a large portion of the refinancing of

mortgage loans comes from their securitisation. Securitisation is the process of packaging non-tradable claims or assets (such as mortgage loans) into a security (such as a bond) that is covered by these assets and that financial investors can then trade. The refinancing of mortgage loans will only work effectively, if the market demand for mortgage securities is high. Financial investors, in turn, both foreign and domestic, will only stand ready to buy mortgage securities if they are safe and liquid. Safety implies highly guaranteed coverage of the investment, whereas liquidity enables investors to sell mortgage securities on the market quickly and without major financial losses. If one of the features is missing, demand from investors such as life insurers and pension funds for mortgage securities will be limited, making large-scale refinancing unlikely and reducing the viability of the mortgage market.

7.3.3 How to create safe mortgage securities

The safety of a mortgage security is guaranteed by its coverage. That is why the properties of the coverage, and not of the issuer, should ensure the safety of the security. Below, we highlight some important factors which contribute to an adequate coverage of bonds.

a) Proper evaluation of the property pledged to a mortgage loan

Mortgage loans, in principle, are rather safe for banks, and international experience shows that borrower defaults on mortgage loans are relatively rare. Nevertheless, it is important to enable banks to sell a pledged property quickly and at low cost in the event of a borrower's insolvency. What is most important, the bank must be able to recover the amount of the outstanding loan. For this to work, evaluation of the property that is pledged to a loan should be executed in a proper way to make the coverage of bonds safe and prevent possible bank losses. It is always possible that the market price of real estate is lower when it is sold than when the mortgage contract was signed. For this reason, conservative assessment of property values is necessary. A mortgage lending value that is sufficiently lower than the market price of the property is advisable, so that this value is very likely to be maintained over the lending period. To implement the principle of conservative assessment of property, prudent and standardised valuation guidelines should be worked out and special training provided to independent assessors, bankers, and supervisors.

Another concept that adds to the safety of mortgage securities is the 'loan-to-asset' ratio (loan-to-value ratio). This ratio measures the share of the bank loan in the total value of the property that is pledged. The lower this share (i.e. the higher the borrower's equity share), the safer the loan from a bank's perspective. Although stipulating a lower loan-to-asset ratio may reduce access to mortgage loans for some borrowers, it will also increase the viability of the mortgage market overall. Current Ukrainian legislation on mortgage crediting foresees a maximal loan-to-asset ratio of 70%. Given the risk of insecure property evaluation and the predisposition of some Ukrainian banks to high credit risk, we recommend that the experience in many countries of a 60% loan-to-asset ratio be followed.

b) Enforcement of eviction procedure

Mortgage loans are not designed to solve social issues, but rather to provide long-term loans at low cost to creditworthy borrowers. If a mortgage borrower does not meet his debt obligations, the bank should be able to assume ownership of the pledged property and to dispose of it (which generally means sell it) as quickly as possible. To this end, it may be necessary for the bank to evict tenants who are occupying the property. If eviction is impossible, the development of the mortgage loan market will suffer, leading to high social costs in the long run. Currently, the barriers to eviction faced by banks lead to their refusal to lend to individuals who wish to provide apartments occupied by family members and especially children as collateral. The way to resolve the issue is twofold: first, improve eviction procedure and make them legally enforceable; and second, develop effective ways to support evicted families. Note that the recommendations made above on proper evaluation and the loan-to-asset ratio will contribute to lower rates of eviction.

c) Choice of appropriate type of mortgage security

There are two main approaches to mortgage loan refinancing: mortgage loans can be securitised into mortgage bonds as in most European countries, or into mortgage backed securities (MBS) as in the USA. These systems can coexist; however, in the initial stage of mortgage refinancing it is advisable to implement one of them as the basic system – the one that will operate the best.

Refinancing through mortgage bonds involves three agents: mortgage borrowers, mortgage lenders, and investors. Banks providing mortgage loans securitize them into mortgage bonds and sell these bonds to investors. The MBS system requires an additional agent, special purpose vehicle or trust, that buys mortgage loans from banks, securitises them and sells the resulting MBS to institutional investors. Mortgage bonds are safer than MBS for investors because they are standardised instruments and the general procedure of their issuance is simpler, requires less information for investors and leaves the credit risk within the lender (bank). Issuers of mortgage bonds are able to check borrowers' creditworthiness and the pledged properties in a more thorough and prudent way. This reduces overall risks and due diligence costs to financial investors. In general, because of their safety and simplicity, mortgage bonds should be taken as the basis for Ukrainian mortgage system design.

7.3.4 How to create liquid mortgage securities

Financial investors tend to avoid illiquid markets. In other words, they prefer securities that can be sold at a decent price on short notice. The market for mortgage securities can become illiquid if an issuer goes bankrupt or suffers acute liquidity problems. To preserve investors' confidence in market liquidity, they will want guarantees that the issuers of securities are secure and viable, i.e. are able to pay interest on securities outstanding and repay total debt at the date of maturity. To make mortgage securities liquid policymakers should minimise the risk that

issuers might go bankrupt and ensure that the costs of trading on the secondary mortgage securities market are low.

a) Avoid bankruptcy of the issuer

In the framework of the existing banking system and in the absence of specialised mortgage institutions, the bankruptcy of mortgage securities issuers can be reduced by completely separating the mortgage business from the other activities of universal banks. Complete separation implies the creation of a separate mortgage division within each commercial bank. This division requires a separate balance sheet on its activities and specially trained employees. Separation will allow a mortgage division to operate further and perhaps be taken over by some other bank without disrupting the system, even in the event of bankruptcy.

We also recommend that the mortgage pool be isolated from all of a bank's creditors with the exception of the mortgage bondholders. If a bank goes bankrupt, the mortgage pool must be used first to make repayments to investors who bought mortgage bonds covered by the loans from this pool. This measure will make repayment to bondholders in case of emergency more complete and safer, and this will add to their willingness to buy mortgage bonds.

b) Ensure low cost of trading on mortgage securities market

To make mortgage securities liquid, it is important to establish a functioning mortgage securities market on which they can be traded. Low transaction costs on this market will increase traders' willingness to purchase mortgage securities. Hence, policymakers should ensure low costs of running the trading system. Proper supervision of capital markets and ensuring effective, quick and safe clearing are essential steps in this direction.

8 Agricultural Policy versus Rural Policy: Core Tasks and Joint Responsibilities

8.1 Old and new policy concepts for rural areas

The farm sector is expected to contribute to overall welfare in Ukraine by delivering high-quality food at low prices and by generating export earnings. However, agriculture is also responsible for what happens on the lion's share of Ukraine's land. Furthermore, one third of the Ukrainian population lives in rural areas, and most of these individuals still depend to a large extent on agriculture. Since independence, agricultural policy in the narrow sense of production and prices in Ukraine has had a mixed record; undeniable successes have been overshadowed by generally slow progress towards a vital, market-oriented sector. The picture does not improve when policies for rural areas in general are considered. Today, there is no coherent development concept for rural areas in Ukraine, and policy responsibilities are not clearly defined. This Chapter develops policy goals and concepts for both rural areas and the agricultural sector.

8.1.1 Current agricultural policy approaches

The major problem of the agricultural sector in Ukraine today is its low level of productivity. Despite Ukraine's often-cited production potential, despite rising trends in world market prices for the major export crops and products, triggered by increasing world demand, and despite swift economic growth in the rest of the economy; large parts of Ukrainian agriculture continue to stumble rather than stride into the future. According to agronomic experts, current crop yield levels could still almost be doubled in the near future, if the so-called 'productivity gap' could be closed.

Agricultural policy and the activities of the Ministry of Agricultural Policy (MAP) have focused on improving the conditions for the agricultural sector. Unfortunately, most of these policies have largely failed to tackle the productivity gap. The reason for this is that the implicit goals of this policy have not been targeted at productivity increases, but rather at sustaining existing structures and procedures by granting aid[46] and tax breaks to producers, and attempting to control prices and quantities on output (e.g. grains, sunflower seed and sugar) and input (e.g. machinery and credit) markets.

However, policy has been inconsistent in its attempt to support the farm sector. While farmers receive tax breaks and some subsidies on the one hand, they are indirectly taxed by export taxes and bureaucratic 'monitoring and control' of markets on the other. Policy makers are

[46] See the budget figures later in this chapter. Almost 40% of the agricultural budget is spent on financial support of production or farms.

'stepping on the gas and the brakes' at the same time, thus spoiling the car while not getting very far.

8.1.2 Core competences versus shared responsibilities

What is agricultural policy about? Many actors in agricultural policy believe that the agricultural sector is basically identical with the rural economy. However, this view is antiquated. 'Rural' is a geographic concept, and agriculture is only one of many economic sectors and activities that take place in rural areas. Thus, agricultural policy should not strive to assume responsibility for the whole range of rural development issues such as the social situation in rural areas, rural infrastructure, medicine, schools etc. This is primarily the task of other Ministries (Economy, Infrastructure, Education, Social Policy). The MAP should focus on its core competences, because this will make successful work much more likely. Clearly, experts from the MAP must collaborate in inter-ministerial rural policy working groups. Policies aimed at rural areas are a shared responsibility in which agriculture plays an important but by no means exclusive role. Rural development should be regarded as a cross-sectional task to be coordinated between several Ministries.

In the next Section we will describe our suggestions regarding the core competence of agricultural policy, primarily aiming at increased productivity of the sector. Then we deal with rural development policy as a prominent example of a joint responsibility of agricultural policy to be shared with other policy areas.

8.2 Core competences: new goals for agricultural policy

8.2.1 Developing coherent policy goals

Agricultural policy makers in Ukraine should adopt a realistic set of agricultural policy goals against which individual policy measures can be evaluated. In a market economy, agricultural policy should enable agriculture to:

a) create real value added through high productivity;

b) supply high-quality products; and

c) contribute to preserving nature and landscape.

The main intentions behind these policy goals are as follows:

a) Create real value added through high productivity

The purpose of any economic activity is to produce goods the value of which is higher the value of the resources required for their production. Higher production efficiency increases the value added from production, while direct or indirect subsidies from budget funds or through the taxation of competing imports decrease value added, as they increase resource costs for the total economy. Policy should focus on fostering technical progress and avoid prolonged heavy subsidisation, trade protection, and other distortions of market outcomes. Following this principle is the basic

way to ensure that agriculture delivers a real contribution to overall economic growth.

b) Supply high-quality products

Food (domestic or imported) has to be available in sufficient quantities in order to cover the nutritional needs of the population, but it is also important that it is healthy and safe. Moreover, if Ukraine is to benefit from the export of agricultural raw materials and processed food products, product quality is an important factor in determining competitiveness on domestic and international markets.

c) Contribute to preserving nature and landscape

Agricultural production has widespread ecological consequences. The use of fertilisers and chemicals affects groundwater quality and biodiversity. Moreover, the structure of fields and the products produced shape the rural landscape, which defines the feeling of 'being at home' for citizens, as well as the attractiveness of the countryside for tourism. An increasingly important aspect is animal welfare, i.e. that animals are held under decent conditions and do not suffer unnecessarily.

All these goals are compatible with a market economy, and they do not force agricultural policy makers to support agricultural producers in a way which finally leads to excess surpluses and consequent conflicts with international trade partners. But there are conflicts between these goals which have to be overcome through compromises. Efficient production and competitiveness can conflict with ecological considerations. A compromise could consist in setting minimum ecological standards and supporting the competitiveness of organic farming in Ukraine.

Among these goals, priorities should be defined. The core priority should be to increase productivity subject to constraints such as the maintenance of minimum food reserves, quality standards and environmental standards.

8.2.2 Measures to achieve these agricultural policy goals

ad a) Create maximum real value added through high productivity:

- continue reforms by allowing land sales and bankruptcy procedures;
- abolish direct and indirect subsidies and use the funds for long-term investments in public services in the area of agriculture (see below);
- raise educational standards in the agricultural labour force by introducing advisory services, updating curricula and broadening education contents for agricultural professionals;
- improve plant and animal pest control and prevention systems;
- strictly limit the influence of state bodies on commodity markets; and
- join the WTO as soon as possible in order to ensure fair treatment by international trade partners in the future.

ad b) Supply high-quality products:

- enhance competition on the food market, break up remaining regional monopolies;
- introduce quality standards for agricultural products that are consistent with international standards;
- limit inspection services to new, international standards, and aggressively prosecute instances of corruption and bribery involving the inspection services; and
- initiate the introduction of regional food quality labels.

ad c) Contribute to preserving nature and landscape:

- develop environmental standards for the use of fertilisers and pesticides, feed quality, and animal welfare; and
- cooperate with the Ministry for Environment and the state bodies responsible for tourism to turn marginal lands into nature reserves or allocate them to extensive production.

The lists above contain some 'do not' elements aimed at reducing interventionism. Hence, this is partially – but not exclusively – an agenda for state inactivity. Uncoordinated and *ad hoc* activity by various state organisations as well as regional and local authorities is extremely damaging to agriculture and must be reined in. The 'do' elements, however, require a lot of activity from the Ministry of Agricultural Policy, many of them in areas that have received little attention so far, at least when measured in terms of budget priorities in recent years.

8.2.3 Consequences for the agricultural budget

What consequences would the priorities outlined above have on the state budget? On the revenue side, indirect tax exemptions should be phased out within several years. On the other hand, taxation of agriculture through export taxes and export VAT refund arrears should be abandoned. On the expenditure side, individual items of agriculture policy spending should be evaluated against their potential to increase the productivity of Ukrainian farms.

Table 8.1 presents an overview of the agricultural budget in Ukraine for the years 2003 and 2004. At slightly more than UAH 3.5 bn in 2004, the agricultural budget made up 5% of the state budget of Ukraine. In order evaluate whether the budget is likely to contribute to the suggested policy priorities, we distinguish between productivity-decreasing expenditures, productivity-enhancing expenditures, and neutral expenditures. Among the productivity-decreasing expenditures we consider financial support, direct payments and administrative expenditures. These types of spending maintain inefficient structures and therefore tend to reduce the productivity of Ukrainian agriculture in the long run. Administrative expenditure, while not directly affecting productivity, will tend to increase the power of the bureaucracy and the potential for intervention that distorts markets and reduces productivity. Together, productivity-reducing measures account for almost 50% of the agricultural budget.

There are also measures which are useful or necessary, but have a neutral impact on productivity growth. Among these are inspection services, which are supposed to guarantee product quality, but which can also be misused to extort bribes from producers and processors. The share of these measures in the budget is decreasing, mainly because inspection services have been slimmed down.

Table 8.1
Assessment of the agricultural budget in 2003 and 2004

	Share in 2003 (%)	Share in 2004 (%)	Change 2003-2004 (%)	Change 2003-2004 (percentage points)
Financial support	38.9	36.1	-7.2	-2.8
Direct payments	4.9	4.1	-18.0	-0.8
Administrative expenditures	4.8	8.9	+85.8	+4.1
R&D, education, training	23.0	30.4	+32.6	+7.4
Land reform	7.5	2.2	-70.9	-5.3
Pest and crop disease control	2.0	2.1	+3.3	+0.1
Inspection services	15.6	11.5	-26.2	-4.1
Rural development	0.7	0.7	+3.4	+0.0
Reserve stock accumulation	1.0	2.0	+105.1	+1.0
Environmental protection	1.7	2.0	+23.3	+0.3
Expenditures with a negative productivity impact (1-3)	48.6	49.1	0.9	0.5
Expenditures with a positive productivity impact (4-6)	32.5	34.7	6.9	2.2
Expenditures with a neutral productivity impact (7-10)	18.9	16.2	-14.2	-2.7

Measures that are likely to increase the economic productivity of agricultural production are research, education and training, land reform, and disease control. These measures account for slightly more than one-third of the budget, and the significantly increased expenditures on research and training are definitely a positive signal. Land reform, on the other hand, is reduced, which may have to do with the prospect of having these activities financed by a World Bank loan during the next years.

The high share of unspecific financial support to producers under the productivity-decreasing measures (almost 50%) indicates that there is still considerable financial leeway for agricultural policy to change course and adopt long run, productivity-enhancing priorities.

8.3 Rural policy as a joint responsibility

Rural policy is going to be one of the biggest issues in Ukrainian economics over the next years, touching on regional development, social security systems, sustaining economic growth, and many other issues. Rural policy is basically about two issues: a) Delivering public services in rural areas, particularly physical and social infrastructure, and b) Supporting economic development in rural areas. In addition to the core tasks of agricultural policy, the MAP can and should also contribute to this joint task together

with other ministries. This section defines the role of rural areas, points out challenges and dilemmas that rural policy faces under the special circumstances in Ukraine, and makes recommendations for policy.

8.3.1 The economic role of rural areas

It is a common mistake to equate agricultural and rural development. This mistake results in rural policies that are biased towards agriculture, neglecting other economic activities, and thereby contributing to the ongoing depopulation and economic degradation of the countryside. In order to arrive at a reasonable policy agenda, there has to be a clear idea about the role of rural areas for the well-being of Ukrainians, both villagers and city-dwellers. What benefits do rural areas deliver to Ukrainian citizens?

- Rural areas deliver food through a functioning agricultural sector and thus contribute to material needs of all citizens. At the low income levels prevailing in Ukraine, food prices play an important role in consumer budgets.
- Rural areas are the economic basis for many professions including farming but also forestry, inland fisheries and tourism. However, rural areas can be much more. Any larger village or small city should offer various public and private services for the people living there. In most rural areas in Germany, for example, agriculture and forestry play only a marginal role for the creation of value added and employment.
- Rural areas are the living space for the rural population. As such, they need to be endowed with basic infrastructure. An increasing number of city dwellers in Ukraine will probably move to rural areas around the cities and commute to work during the next decade. These new rural inhabitants will be looking for places to build their houses, and will demand local schools, health care and other public services. Other, more remote areas will probably be faced with out-migration and an ageing population. Rural policy will have to be flexible to deal with these diverging trends.
- Another important role of rural areas is that they offer opportunities for recreation. There are many beautiful areas around cities which already today are used for household plots, cottages and other leisure purposes. More remote areas might offer sports-focused tourism. For that reason it is important to preserve nature and what is generally referred to as the 'multifunctional' and 'cultural' landscape.
- Another important reason for preservation efforts is that rural areas and forests in particular deliver ecological goods such as clean water and air. Misusing the countryside as a garbage dump; the use of too much fertilizer and pesticides in intensive agricultural production; the building of roads and pipelines in sensitive areas: all have the potential to damage the ecological balance and endanger rare species.

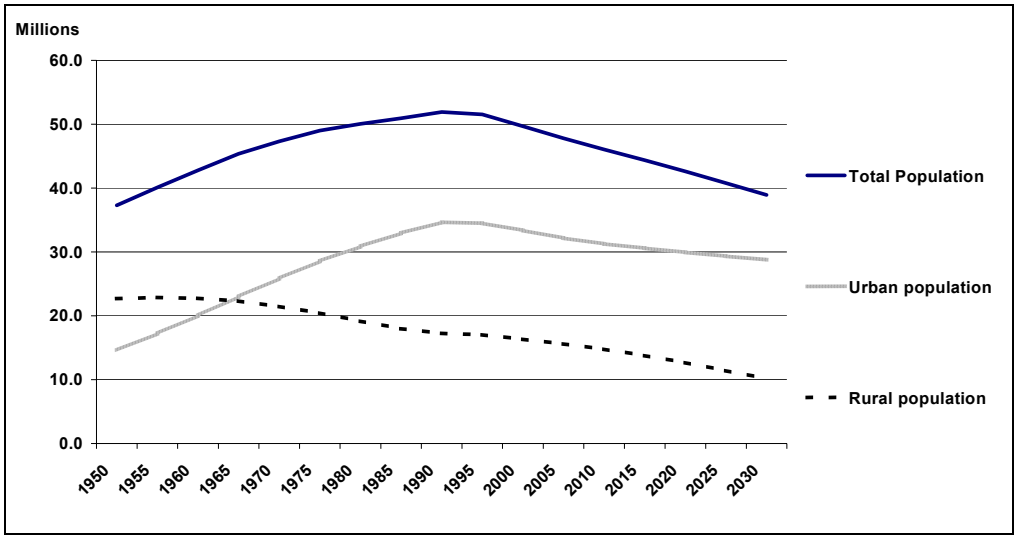
A sustainable balance between all of these functions constitutes the vision for the future of rural areas in Ukraine. Agriculture is an important part of that vision, and must contribute to it. But the MAP can and should not claim sole responsibility for determining rural policy in Ukraine, as this ambitious task has to be carried out by several ministries simultaneously.

8.3.2 Dilemmas facing rural policy in Ukraine

Taking into account their various functions, developing a coherent policy strategy for rural areas is a very complex task. Moreover, rural policy faces several dilemmas. The most important of these is demography: Rural areas need investments to improve living conditions, but the out-migration of rural inhabitants from small settlements will probably continue. The projections of the UN Population Division for Ukraine suggest that its rural population will decrease by one-third in the next 25 years (Graph 8.1).

A related dilemma concerns structural change of the rural economy in the course of technical progress in general and the special demands of the transition from collective to private agriculture. Rural development and diversification in Ukraine will require the massive creation of non-agricultural jobs, especially since farms restructuring will continue to decrease the number of purely agricultural jobs. But in remote rural areas with a general trend to out-migration, there are few promising business alternatives to agriculture and related services.

Graph 8.1
Past and projected population development in Ukraine



Source: UN Population Division

The following conclusions can be drawn:

- Existing rural policy concepts for developing countries should not be copied, as these are rather designed to deal with booming populations under increasing resource pressure. Ukraine's countryside is not confronted with these problems.
- Instead, rural policy designs should explicitly anticipate the demographic and economic trends and go along with them. Out-migration is not so much caused by push-factors (i.e. desperate conditions on the countryside), but rather by pull-factors (more attractive prospects in cities). It is most probably futile to try to 'stem

the tide', and more promising to try to cushion the changes for those who stay in rural areas.

- Policy goals for rural areas should therefore be modest. Otherwise, huge budget funds could be wasted.
- Proper local targeting is a major challenge facing rural policy. Therefore, rural development should be based on the principle of local participation, combined with local responsibility for co-financing. In the case of Ukraine, this requires more fiscal independence for regional and local jurisdictions.[47]
- A project approach should be adopted, oriented at very specific goals. Small, locally based projects have proved to work better than complex national programmes.

8.4 Fields of action for rural policy

Rural development is a complex issue. Besides agriculture it encompasses questions such as the development of roads, transport systems, communication, gas and water supply, sewer systems, health care, education, culture, household services, agricultural and non-agricultural businesses and employment. Beyond agriculture, the following fields of action seem to be most urgent and promising:

a) Non-agricultural employment

It is most likely that new jobs in rural areas will be created in sectors that service agriculture or process agricultural products. Moreover, there will be increasing demand for services for rural households. However, developing these businesses is a task for the private sector and not for the state. Public support could come in the form of ensuring business-friendly environments by fighting both corruption and the harassment of small or newly established businesses. Moreover, technical, social and cultural infrastructure plays an important role in attracting businesses. In areas with a potential for tourism, effective environmental policies play a crucial role.

b) Physical infrastructure

The supply and maintenance of infrastructure is a core public activity in regional and rural policy. While the road network is fairly well developed in Ukraine, much could be done to extend the telecommunications network in order to improve the business environment, particularly through the use of the internet. The various utility networks (water, electricity, sanitation) are in need of repair and reform.[48]

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47 See Chapter 3 for a discussion of regional policy in Ukraine and more detailed recommendations.

48 See the following Chapter 9 for an assessment of the utilities sector in Ukraine.

c) Social infrastructure

One of the most pressing issues is improved health care[49] (especially the prevention of tobacco, drug and alcohol addiction, and to combat AIDS) in order to fight the tremendously high mortality among Ukrainian citizens.

d) Education and training

Finally, education in rural areas is a problem that is often underestimated. According to international statistics, almost 100% of Ukraine's population is literate. However, much physical infrastructure and large parts of the curricula in medium and higher education in Ukraine are outdated. The level of professional and vocational training in particular is below international standards. This hinders the adoption of modern technologies and management techniques in agriculture which, in turn, contributes to persistent low productivity. Ukraine may be able to import capital and technologies from abroad, but an educated and well-trained workforce has to be mainly 'home grown'. Policy makers in Ukraine have largely neglected investment in education and research.[50] Due to the demographic problems in rural areas, providing sufficient schooling and training opportunities in rural areas will be a challenging task.

Almost all ministries can and should be involved in rural policy issues. The list of participating ministries should contain the Ministry of Economy as the coordinating body, and the Ministries of Transport and Communication, Labour and Social Issues, Health Care, Science and Education, and Agrarian Policy as 'sectoral' specialists.

[49] Health care is dealt with in Chapter 2.

[50] See Chapter 5 for a discussion of public investment.

9 The Provision of Utilities in Ukraine

9.1 Introduction

Provision of utility services is still one of the least developed sectors in Ukraine. While sustainability of utility services is a necessary condition for economic growth, the state has only recently started to pay more attention to the sector. Access to and availability of services are key indicators of general standards of living. Utilities policy is challenging since it must balance the economic, political and social interests of society. In Ukraine, structural distortions, institutional rigidities and the deteriorated technical state of technical equipment complicate this task.

In this chapter we concentrate on three sub-sectors: provision of water, wastewater, and heating services. We chose these sub-sectors since they are all essential utility services that rely on 'unique' networks which are necessary to deliver the service but too expensive to be provided more than once. Hence, all these sectors require regulation. Moreover, economic activities in all three sectors are mainly based on the same legislation and face similar problems. It is therefore reasonable to combine them in the implementation of reforms.

9.2 Social considerations

Typically, the pricing and development (and possibly rehabilitation as in the case of Ukraine) of utilities have a high priority on the policy agenda since the availability and affordability of utility services are important indicators of standards of living. Often, the affordability of utilities services is expressed as the average share of utility bills in total household expenditures. In Ukraine, this figure[51] has been at very low levels, even compared with other transition economies. In 1996 the relevant figure for Ukraine was 3.9%, compared with 12.3% in Russia, 12.7% in Moldova and 26.6% in Latvia.[52] In the EU, comparable figures vary from 4.1% in Finland to 11.5% in Austria.[53] However, due to increasing technical and economic pressures, this share increased to 11.4% in 2002. Nevertheless, current utilities prices for residential consumers are still below costs in all regions of Ukraine (State Committee for Housing and Communal Economy) and simply increasing utilities prices to cover costs would be painful for citizens due to widespread poverty problems.[54]

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51 The total utilities bill includes housing, water, electricity, gas and other fuels.

52 'Maintaining utility services for the poor: policies and practices in Central and Eastern Europe and the former Soviet Union', September 2000, The World Bank.

53 Consumers in Europe: facts and figures, Eurostat, 2001.

54 The share of people living below the poverty line varies from 14 to 39% of the population depending on the definition of poverty lines (see GAG/IER: 'Poverty in Ukraine', January 2004, http://www.ier.kiev.ua/English/papers/t25_en.pdf).

In Ukraine, local governments usually set household tariffs for water supply, wastewater treatment and heating at artificially low levels. In this way, households have been receiving indirect subsidies for many years. In addition, the state also grants the following privileges:

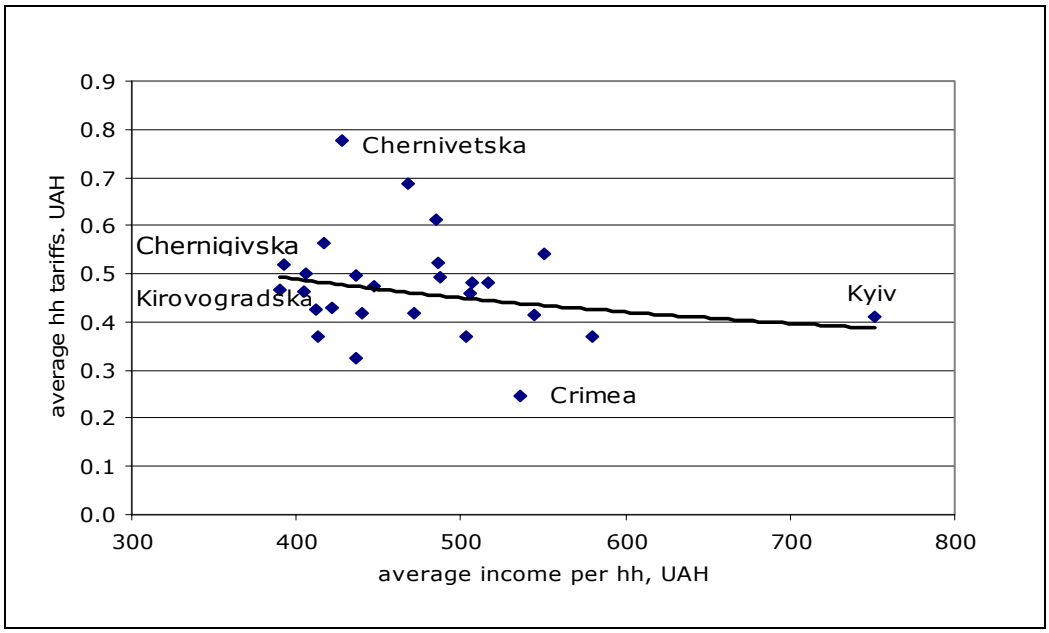
- no disconnection of delinquent residential customers;
- price discounts provided to certain households selected on the basis of occupation, medical history, age, merit, etc.;
- price discounts provided to households if the share of utility expenditures exceeds a certain percentage of monthly household income; and
- earmarked cash transfers to help low-income households pay for utility services. In Ukraine cash transfers are provided to certain households for buying liquefied gas, solid and liquid stove fuels.

All in all, the system of utility subsidies is complex and lacks structure and predefined intentions. While it provides a broad coverage for households – low tariffs and no disconnection are provided to all households, and price discounts are relatively easy to obtain – the system also causes substantial price distortions. First, it puts an additional burden on industries through relatively high tariffs for industrial consumers. Second, utility enterprises do not receive full cost-covering payments. Third, the system involves substantial administrative costs. Moreover, the system also fails to sufficiently target truly needy households as the following analysis shows. Given that utilities prices are intended to be set at "levels that are affordable for the population", we would expect tariff rates in different regions to be correlated with regional income levels. In particular, in regions with low income per capita we would also expect to find relatively low tariff levels. However, Graph 9.1 shows that this is not the case for water utilities. Instead, we observe the highest tariff levels for water in low-income regions. For heating and wastewater tariffs we find no significant correlation with income levels at all. [55]

Hence, while artificially low tariffs for residential consumer fail to cover the costs of service provision – thereby hurting utility-providing enterprises – they also fail to provide efficient social support to poor households. Instead, the current tariff-setting mechanism only creates price distortions and causes a significant fiscal burden. Thus, it should be completely reconsidered. This chapter identifies the main current problems and proposes guidelines for reforms in Ukraine's utility sector.

[55] For more information see GAG-IER: 'Developing the Public Utility Sector in Ukraine: toward a concrete strategy', June 2004, http://www.ier.kiev.ua/English/papers/t37_en.pdf.

Graph 9.1
Household income versus water supply tariffs for households in different regions (2002, in UAH)



Source: State Statistics Committee; The State Committee for Housing and Communal Economy; own calculations

9.3 The current situation

The present problems of utility providers can be divided into three categories - institutional, economic, and technical problems.

9.3.1 Institutional problems

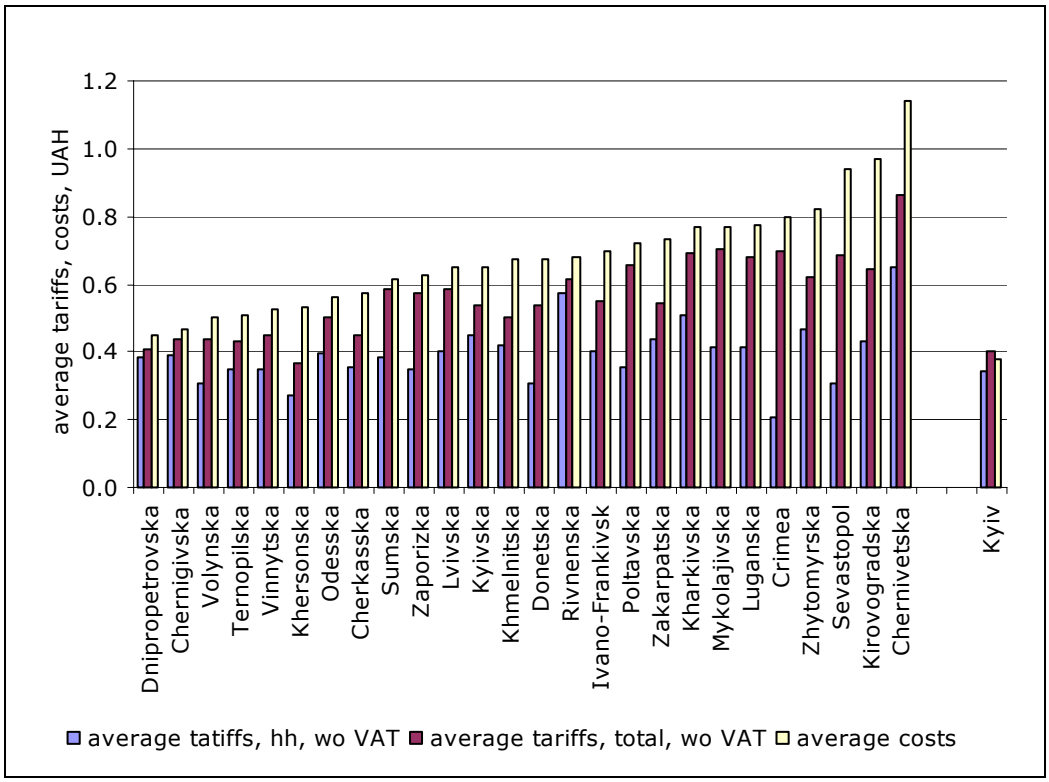
Providing utility services is very costly since it requires substantial infrastructure and resources. At the same time, the dependable provision of such services is of high social importance and a necessary condition for economic growth. Since public utility providers are in a monopoly position, regulation of tariff setting is necessary to prevent abuse of market power. In Ukraine, local governments are charged with balancing the interests of all stakeholders. However, as elected authorities they are tempted to follow their own political considerations in utilities policy. Since almost all utilities are communally owned, short-run popular decisions are easily implemented. The discussion on tariff setting in the next section will show that local governments have so far failed to sufficiently balance the interests of all stakeholders. Thus, poor regulation and the ambiguity of government policies are the main institutional problems of the sector.

9.3.2 Economic problems

The main economic problems stem from tariff setting at below-cost levels, the overall low payment discipline, and generous privileges for a wide

range of consumers.[56] As a result, household tariffs for water supply, wastewater treatment and heating almost never cover all the costs of service supply (see for example Graph 9.2 for water tariffs). In an attempt to compensate, utility providers cross-subsidize services to households through higher tariffs for industrial consumers. This is a highly inefficient way of supporting the population since it puts an extra burden on industries while failing to provide targeted benefits to poor households. In extreme cases, it even creates incentives for industrial consumers to avoid centrally supplied services and to build up their own systems instead.

Graph 9.2
Average tariffs and cost of water supply by regions, 2002, UAH/m^3



As a result of this distorted tariff setting, almost no utility provider is able to break even. Since the central and local governments fail to compensate utility providers for the resulting losses, utility providers are forced to not pay their input suppliers[57] and/or to reduce service provision. At the same time, firms can neither invest in improving their technology and infrastructure, nor have they sufficient funds for the maintenance of existing facilities, so that service quality further deteriorates while costs increase.[58] In addition to below-cost tariff levels, the financial situation of

[56] As discussed in Chapter 2, these privileges are provided in lieu of a sustainable and targeted social policy in Ukraine.

[57] For example, in the beginning of 2004 the gas supplier Gas of Ukraine (Gas Ukrajiny) limited supply of natural gas to Kyiv's Kyivenergo utility due to non-payments. See Chapter 10 on the energy sector in Ukraine.

[58] Even for utility services and regions where average tariffs appear to be cost-covering it is still questionable whether enterprises have sufficient funds for

utility providers is further worsened by low payment discipline by service consumers and weak payment enforcement policy. In 2003, the total receivables of utility providers amounted to UAH 8.6 b. The main debtors are households with outstanding debts of UAH 7.32 b in mid 2004. As a result, utility enterprises themselves accumulated debts to their suppliers of around UAH 8.3 b in 2003.

9.3.3 Technical problems

Since utility service providers have been operating under non-cost-covering tariff levels for many years, their current technology is obsolete and characterised by deteriorated equipment and very low levels of energy efficiency. Besides the depletion of existing equipment and networks, the biggest technical problem is very low energy efficiency. For example, the energy efficiency of heat production is substantially below its reference level in Western Europe.[59] For water, energy consumption in about a third of all regions in Ukraine exceeds the internationally relevant threshold of 1 kWh per m^3 of water. Only in three oblasts[60] can it be considered sufficiently efficient (<0.7 kWh per m^3). Consequently, energy consumption accounts for the largest share of utility providers' total costs, with shares of 57.2% for heating, 32.1% for water supply and 30.7% for wastewater.[61] Given the unstable regulatory environment and the lack of cost-recovery in most regions, considerable investments in energy-saving technologies have not yet been undertaken.

9.3.4 Recent reform measures

Recently, the state has started to pay more attention to the utilities sector. The Parliament of Ukraine has adopted a national program of reforms and development of the housing and utilities sector for the period from 2004 to 2010.[62] This program provides a general framework for the development of all utilities services, in particular, for the water and waste-water sectors. In general, it correctly identifies the main technical problems and suggests the right general direction for economic and institutional reforms. In particular, it promotes cost-covering tariffs and regulatory improvements. However, while the goals are mostly worthwhile, the program does not develop a concrete agenda to satisfy the necessary preconditions for attracting private capital.[63]

The recently adopted law 'On utilities services' makes several progressive steps such as the obligation for local governments to compensate utility

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investments in infrastructure since the reported costs only include operational expenditures and do not include other costs such as reserves for investment.

59 In Ukraine 171 tons of coal equivalent is needed to produce 1 Gkal, while in Western European countries only 145 tons are needed.

60 Donetska, Dnipropetrovska, Kirovogradska.

61 State Committee for Housing and Communal Services.

62 No 4235, registered on July 10, 2003.

63 The role that private capital and public-private partnerships (PPPs) could play in investments such as those that are required in the utilities sector is discussed in Chapter 4.

providers if their tariffs are set below cost-covering levels.[64] However, it is unclear how local governments can be forced to compensate for such losses and how they will be punished in the event of non-compliance. Furthermore, it is questionable whether local budgets will have enough funds for this. At the same time, the law provides for state control and regulation of utility prices, while objectives, subjects and method of the regulation in Ukraine remain unclear. Thus, there is still a risk that the prices will continue to be an important political rather than economic instrument.

9.4 Policy recommendations

Solving the institutional and economic problems of the sector requires separating social problems from the general task of balancing the economic interests of all stakeholders. Only in this way can a flexible, self-governing system be generated to ensure profitable operation of service providers and sufficient incentives to improve efficiency, while prices for all consumers are set at reasonable levels. In particular, such a strategy requires the following measures:

To balance the interests of all stakeholders, **regulatory power must be transferred** from local government authorities to a separate central institution that is responsible for price setting and performance control for all utility providers in Ukraine. This institution must be independent from political interference (both from central Ministries as well as from local governments and other authorities), endowed with the legal power necessary to implement its instructions on the market, and obliged to make its decisions in a clear and transparent way so that they are accepted as fair and legitimate. Endowed with such support, this central regulator would balance the interests of consumers and service providers by guaranteeing economically justified cost-covering tariff levels and providing sufficient incentives for improving efficiency through appropriate regulation schemes.[65] Only this establishes reliable conditions for future operations of utility provision, which is the main precondition for attracting investments from the private sector.

Solving the social problem of providing essential services such as drinking water and heating to poor households requires an effective mechanism to ensure well-targeted support for households in need at minimum economic costs. At best, this can be achieved through direct transfers to households below a certain income threshold.[66] At the same time, utility providers and

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64 This article will come into force after January 1, 2005.

65 For example, fixing cost levels plus a normative profit rate ('profit cap regulation') provides no incentives for reducing costs. However, a fixed maximum price ('price cap regulation') stimulates cost-reducing investments in order to increase profits. Also, competition between locally separated providers can be stimulated by comparing relevant performance indicators and imposing concrete measures to improve their levels ('yardstick competition'). For more information on regulatory schemes see GAG-IER (2003): Development of Domestic Markets in Ukraine: Welfare through Competition. Kyiv, May 2003, http://www.ier.kiev.ua/English/books/dev_of_dom_eng.pdf.

66 Reform proposals for the social security system are made in Chapter 2.

local industries will no longer have to cover all costs alone, and direct monetary transfers to households will stimulate an economically responsible use of utility services. If direct income targeting is not (yet) possible, a 'lifeline consumption scheme' is an alternative. In this case, tariffs for a pre-specified 'essential' amount of services are cross-subsidised by higher tariffs for consumption in excess of the essential minimum. Of course, such a scheme would be much less precise in targeting the truly needy households. Hence, if at all, it should be seen as a temporary scheme only.

Based on the above recommendations we suggest reforming the public utility sector in two stages.

a) In the first stage:

- Set up an independent regulator to supervise the activities of all three utilities (water supply, wastewater and heating) as outlined above.[67] Since the privatisation of utility providers is currently not an option, only the shift of regulation to an independent institution can guarantee a sufficient balance between the interests of all stakeholders. The regulator sets specific tariffs for all enterprises at 'reasonable' price cap levels relative to initial costs. This gives incentives for cost-reducing (= energy-saving) investments that – if necessary – are supported by initial investment provisions during the first years of regulation. The saved 'tariff-costs' difference will make utilities provision more attractive for private investors, while the independence of the regulator ensures a reliable long-run perspective.
- The burden of having to provide social services through tariffs at below-cost levels must be removed from utility providers. Instead, central and local governments must be held responsible for providing direct transfers to needy consumers via social policies. Initially, such measures might be supplemented by 'lifeline consumption schemes'.
- The state should actively promote investments in energy-saving technologies. In this respect, state should inform enterprises about different energy-saving projects initiated by international institutions, and encourage municipalities to apply for investment ratings. Moreover, the state can provide guarantees for the loans that utilities apply for.

b) In the second stage:

- The regulatory method should be changed to more advanced techniques that stimulate competition on the market (e.g. yardstick competition, benchmarking schemes). In this way, the regulator can transparently revise the established price caps and thereby stimulate competition.

[67] Although a general regulator cannot have as in-depth knowledge of a particular industry as an industry-specific regulator, it is less vulnerable to branch-specific vested interests. Moreover, it is cheaper to set up a single regulator.

- The state should further stimulate private participation in the sector, for example through PPP schemes.[68] This can be done by open discussions of PPP initiatives to avoid public resistance, institutional and legal support of such initiatives, assistance in the preparation of tenders for private investment etc. The range of PPP options in water supply, wastewater treatment and district heating is quite broad and runs from service and management contracts with the lowest risk for private investors, to lease, concessions and divestiture where the risk is higher. The most popular PPP option in the utilities sector is concession contracts. Concessions are attractive to governments since they place full operational and investment responsibilities with the private sector, maximising potential benefits from efficiency gains and access to private sector financing. Service and management contracts are less risky for private investors and might represent a better option for Ukraine. However, all PPP options require substantial government commitments to build stable regulatory environment.

[68] See also Chapter 5 on supporting private investment. For more information on PPPs see GAG-IER: Public Private Partnership as Alternative to Privatisation, With an Application to OJSC "Ukrtelecom", Kyiv, January 2003, http://www.ier.kiev.ua/English/papers/s20_en.pdf.

10 Reforming Ukraine's Energy Sector

10.1 Introduction

The energy sector is important for two main reasons: it supplies a crucial input for the overall economy and it has a strong direct impact on the population's standards of living. With economic growth expected to continue, the energy sector will not only have to maintain its current volume of energy services, but also be prepared for further expansion.

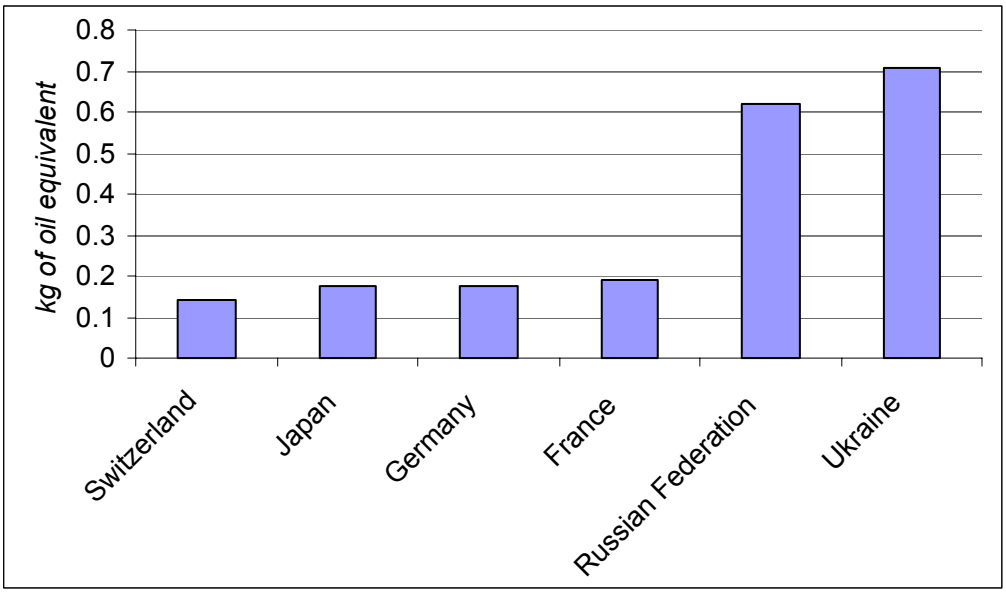
Key criteria for the development of the energy sector are tariff and price policy, sustainability of operation, as well as access to and quality of services. Tariff setting in the energy sector remains one of the main concerns for Ukrainian policy-makers. Price distortions can be detrimental for the economy and households alike, regardless of whether prices are 'too high', or 'too low'. If monopolistic price setting persists in the energy sector, prices will be set above the 'reference' levels determined by costs, competition and international prices, and provision of energy services would fall short of the economically optimal. This would hurt Ukraine's industry and as a result the competitiveness of the Ukrainian economy. Ukrainian households would also suffer as lower affordability of energy services for households would negatively affect standards of living.

On the other hand, keeping prices artificially below 'reference' levels would not benefit industry or households either. First of all, scarce energy resources would be utilised uneconomically, worsening Ukraine's energy-dependence and increasing higher environmental pollution. Supply of energy services would become unsustainable and of lower quality in the long-term, since incentives for investments in maintenance and extension of operations would be diminished. This in turn would also hinder economic growth, as such an energy sector would not be able to serve the growing needs of the economy. Hence, while prices that do not cover costs may increase the competitiveness of the Ukrainian economy and provide welfare gains for households in the short run, these gains will evaporate in the long run as the capital stock in the energy sector deteriorates and costly investments are merely procrastinated. Artificially low energy prices in an exporting country can also be used by foreign competitors as a justification for anti-dumping charges. This can lead to additional entry barriers for exports.

Comparing the energy-intensity per GDP of various countries (Graph 10.1), it is evident that Ukraine operates a highly energy-intensive economy. The problems of the sector, which were alleviated, but not solved in recent years, include persisting cross-subsidisation of household and public utility tariffs for energy services via higher prices for industry, under-investment in network maintenance and lowering of electricity losses in grids, continuing indirect subsidies of gas consumption by households, subsidies to the coal mining industry, growing intra-industry debts and payments below 100% for consumed energy resources. Together, these are

symptoms of serious distortions in tariff setting policies. To guarantee sustainable provision of quality energy services with improving access and affordable prices it will be necessary to eradicate these distortions as soon as possible.

Graph 10.1
Energy use per GDP in selected countries (kg of oil equivalent per USD of GDP at constant 1995 purchasing power parity US dollars)



Source: World Bank, World Development Indicators 2004

Professionals in the energy field in Ukraine typically think in terms of energy supply, rather than energy services. As a consequence, current consumption of primary energy in Ukraine is taken for granted and is used as a basis for projections of future consumption growth under the assumption of continued economic growth in Ukraine. However, recalling that Ukraine is one of the most energy inefficient countries in the world, it is wiser to change the paradigm of 'energy supply' to 'supply of energy services', which can be generated not only with primary energy, but also with energy saving technologies. As will be discussed below, the pricing of energy resources in Ukraine does not account for the costs of production and ignores externalities. This inhibits the realisation of many energy saving projects and stimulates wasteful energy use.

10.2 A benchmark for a sustainable energy sector

To ensure sustainable operation of the energy sector and its continued contribution to the improvement of standards of living in the country, it is necessary to transform state policy in the areas of tariff-setting and contract enforcement, improvement of the regulatory climate, as well as commercialisation, private sector participation and stimulation of competition. Only the progress in all of these areas will lead to sustainable development of the energy sector.

10.2.1 Tariff reform and contract enforcement

Prices must provide market participants with incentives that ensure an efficient allocation of resources. Tariff reform should allow energy service providers to recover their long-term costs, and should ensure the availability of the funds necessary to conduct investments. Tariffs for all customer groups should reflect costs and encourage efficient energy use. As argued above, prices for energy services that are either 'too low' or 'too high' will be sub-optimal for industry and the population in the long run. In the present situation in Ukraine, tariff reform also requires solving the subsidisation problem since energy use by households is cross-subsidised by other consumer groups. Cross-subsidisation distorts patterns of consumption and leads to inefficient use of resources. Businesses that otherwise would pay lower prices for energy services subsidise households and divert resources from production or investments, while households are not motivated to reduce energy consumption and use energy less efficiently than they otherwise would.

Strict contract enforcement should also be guaranteed by the state, and the issue of intra-industry debt accumulation should be solved using market-based mechanisms.

10.2.2 Improvement of the regulatory climate

Since the energy sector typically contains network segments, it requires regulation to control the misuse of market power and to ensure outcomes that are comparable with what would be achieved under competition. The goal of the regulator is to ensure free access to the network for all players at a tariff that is just high enough to attract capital for necessary investments in network maintenance, but not so high that network owners earn monopoly 'rents'.

Tariffs in the energy sector usually consist of various components. For instance, the tariff for electricity can usually be broken down into generation, transmission, distribution and retail components. While tariff components for transmission in networks (which have natural monopoly traits) should be set by the regulator, the generation part of the tariff in the case of electricity (or e.g. supply prices in the case of gas) should be determined through unregulated competition on the market. Moving to competitively determined prices within the tariff structure for electricity (generation and retail) as well as for other types of energy should be an objective of reform in the energy sector. Hence, a 'regulated-competitive pricing policy' with free price setting in the competitive segments of the industry and regulated tariffs in cases of bottlenecks and network access should be the primary goal of tariff reform.

When pursuing this goal, experience has shown that the regulator's independence from political and economic influence is of crucial importance. The regulatory body is also required to create a framework that provides the regulated business with incentives to cut costs, improve efficiency and undertake necessary investment.

10.2.3 Promotion of competition in the marketplace

There are various ways to stimulate competition in the energy sector, especially in the generation of electricity, the retail supply of energy resources, and the extraction of primary energy resources. State policy in the energy sector must clearly distinguish between potentially competitive sub-sectors and network ones. One of the ways to ensure competition is to 'unbundle' enterprises by separating potentially competitive and network segments. However, competition can be supported even within vertically integrated structures if the independent regulator and anti-monopoly authorities provide a policy framework that guarantees third-party access to networks, such as distribution grids for gas and electricity.

Regulation in the network segments, e.g. gas and power distribution grids, creates opportunities to stimulate competition, for example by allowing third-parties to access the distribution grids and compete with regional service providers such as 'oblenergos' in the retail markets. Even in less obvious situations – for example in the case of vertically integrated and regionally separated structures under full state ownership – stimulating competition is still possible through 'benchmark competition' schemes in which operators from different regions compete on the basis of performance indicators. This makes it possible to compare the efficiency of regional entities and to judge their successes and failures. Based on this assessment, an independent regulator can be empowered to enforce improvements in enterprises/regions that are performing poorly.

10.2.4 Commercialisation and private sector participation

Monolithic state-owned structures in the energy sector have proven to be very costly to operate throughout the world. In contrast, private property and the opportunity to benefit from reduced costs and innovations have widely proven to lead to the provision of higher-quality services at lower prices. In fact, it is private firms – driven by the ultimate goal of maximising private profits – that typically pioneer the developments that improve productivity and efficiency, not state-owned firms. Moreover, providing and maintaining necessary infrastructure in the energy sector requires large investments. Financing these out of the public purse means not having those funds available for other public obligations such as provision of social services.

Thus, it is important to guarantee access of private capital in the form of investments and ownership in the energy sector. The most direct approach is to privatise the existing assets and provide a framework for private capital participation in the sector. A wide array of forms of cooperation such as concessions, private-public partnerships and partial privatisation, can be used in the cases where complete privatisation is undesirable for some reason.

The first transition step towards increasing efficiency is the 'corporatisation' of formerly state-owned utilities and the commercialisation of their economic behaviour in order to achieve sustainable operations without government subsidies. More sophisticated plans foresee unbundling of various chains in the energy sector (for instance the separation of

generation, transport, distribution and retail in the electricity sector) and privatisation or other forms of cooperation with the private capital.

Separation of economic activity from policy-making functions is achieved through corporatisation of the existing utilities and commercialisation in the sector, with an emphasis on profit making. In part, this is required to insulate businesses from having to pursue political goals at the expense of the efficient conduct of operations. However, the main goal of introducing market mechanisms into the sector (e.g. hard-budget constraints, bankruptcy procedures, etc.) is to create an environment that can attract capital for long-term investments in the sector.

10.3 Ukrainian energy policy: achievements and failures

10.3.1 Tariff reform and contract enforcement

During the last 10 years significant progress in Ukraine's energy tariff policy has been achieved. Overall, full cost-coverage has been achieved in the power sector. Payments to generation capacities for the generated power increased in 2003 to 91.7% in monetary terms, with barter operations becoming progressively rarer. Overall, 95% of the heat and power provided to final consumers was paid for.

Nevertheless, households continue to receive electricity and gas for prices that do not cover costs and that reflect cross-subsidisation through higher tariffs for the industrial sector. Gas received by state-owned NAK Naftogaz as payment for transit services still serves as an indirect subsidy to internal gas provision, although the ongoing shift from payment in kind towards cash payments for transit services is increasing the pressure on gas prices in Ukraine.

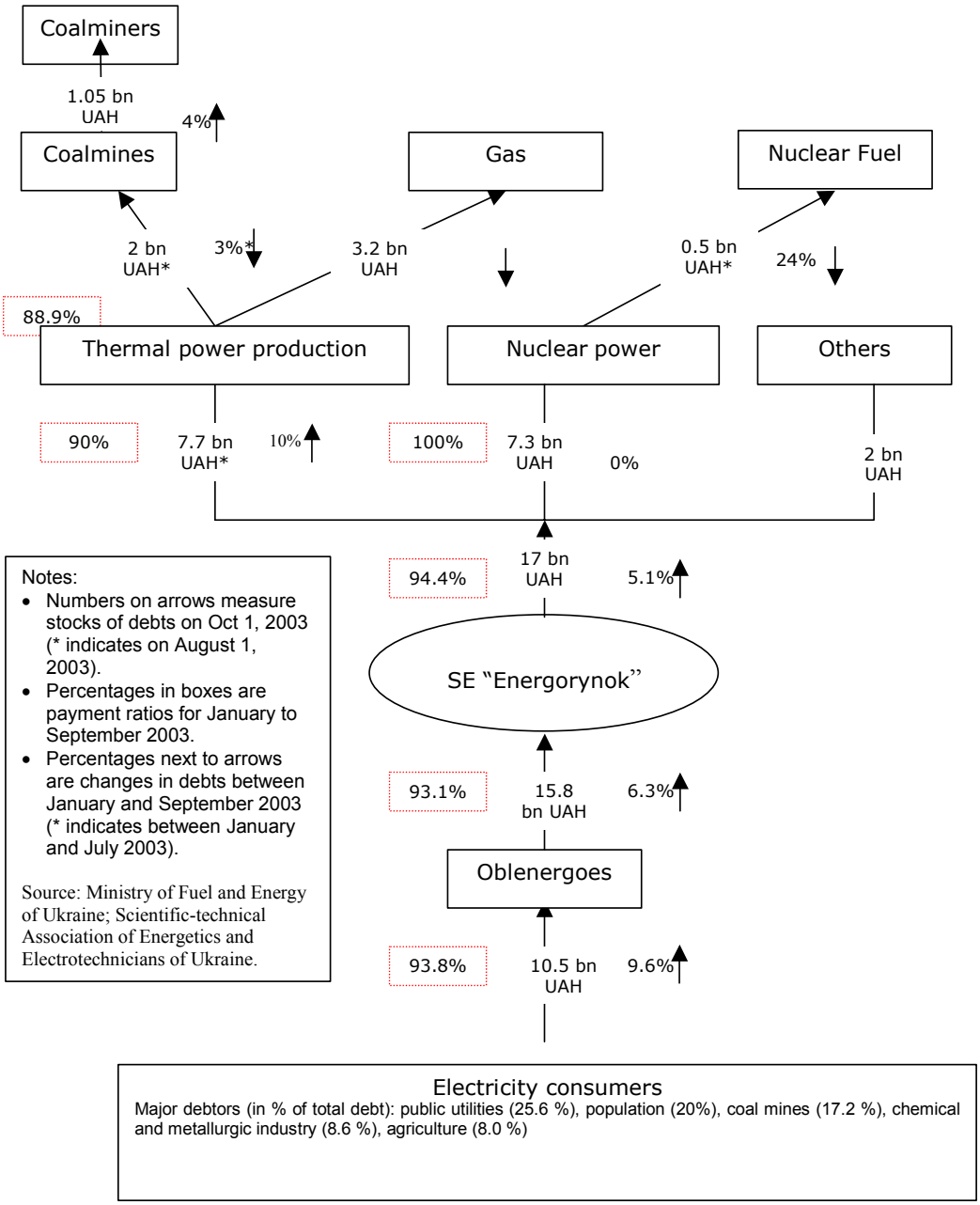
Contract enforcement in the gas, power and coal sectors is inhibited by a ban on bankruptcy in the power sector. State involvement in the gas and coal sectors does not stimulate companies to either demand or display payment discipline. Non-payments and lack of debt restructuring in these sectors still lead to mounting intra-industry and external debts. Lack of regulatory bodies and short-sighted tariff policies in the area of public utilities lead to cross-subsidisation of household water, heat and electricity use and also negatively affect the energy sector.[69]

The combination of tariffs that do not cover costs for provision of electricity to households and flawed enforcement mechanisms with payment rates below 100% has negative consequences throughout the production chain. On the electricity market, for example, 'oblenergos' that charge below-cost tariffs accumulate debts vis a vis the wholesale market, which in turn becomes indebted to generation plants. As a result, generation plants cannot pay the providers of primary energy sources fully. Hence, non-payments and below-cost tariffs for public utilities and for electricity provided to households are translated into an inability to pay salaries to coal miners, which is compensated through state budget support to the

[69] This is explained in detail in Chapter 9 on utilities in Ukraine.

coal industry.[70] Graph 10.2 demonstrates this chain of intra-industry debt in the power sector.

Graph 10.2
Payments and debts in the energy sector January-September, 2003



[70] See http://www.ier.kiev.ua/English/papers/t19_en.pdf for more detailed discussion.

10.3.2 Regulatory reform

The NERC, an independent regulatory authority, was created in the power sector. Due to the monopoly position of NAK Naftogaz in the gas market, NERC also regulates gas tariffs. NERC also sets the tariffs for oil and gas transportation in Ukraine, while the international treaties determine the tariffs for the transit of oil and gas through Ukraine. However, NERC still lacks a sound legislative basis, as the law 'On NERC' has not yet been passed and the authority continues to be regulated by presidential decree. This obviously reduces the independence of the regulator because its decisions and rules of operation can fairly easy be overruled. NERC also depends on political forces because it is financed directly by the state rather than by industry profits.

Furthermore, NERC's approach towards regulation does not motivate enterprises to cut costs. At present, the regulator is guiding its actions by limiting the profits of the enterprises in the sector (the so-called 'cost plus approach'). Instead, NERC should focus on creating a framework for competition in the energy sector and concentrate on the regulation of network access and tariffs for the network segments. The retail and generation components of electricity and gas tariffs should be determined in the course of competition and should not be regulated.

Some success has been achieved with transparency in the energy sector through corporatisation, auditing and the publication of companies' financial statements. However, the level of transparency in the sector remains far from satisfactory. Not all state-owned firms are obliged to publish detailed audits, financial results and performance indicators in a manner that would permit objective assessment of their successes and failures.

10.3.3 Promotion of competition in the marketplace

The energy sector with its potent vested interests, natural monopoly conditions in network segments, large rent-seeking opportunities and high political importance has proven to be especially resistant to reforms, in particular where market entry and competition are concerned.

In the gas sector there is almost no competition as gas extracted, transported and traded is almost exclusively by NAK Naftogaz. Small companies are active in extraction and gas sales, but the lack of clear rules on the division of production and the lack of clear regulations on third-party access to pipelines inhibit the growth of competition in this sector. Generally, concentration of state assets in the gas and oil extraction, transit and in gas supply has improved the management of this property. Investment has grown, and overall cost-recovery has been achieved. However, NAK Naftogaz has formed strong vested interests, which inhibit further reforms that would open up markets for competition.

Some competition in the power sector has been achieved in the segment of thermal power plants, which are to compete through bidding. Nuclear and hydropower plants' tariffs are regulated. Generally, the trend towards uniting all state assets in the energy sector — as is currently the case in the power industry — might improve the efficiency of state property

management, as has been the case in the gas sector. However, the example of NAK Naftogaz also shows that with a lack of competition, organisational inertia will lead to suboptimal outcomes in the long run, when newly created firms form strong, vested interests which prove even more difficult to reform in the future. Therefore, in both the gas and the power sectors the state should try not only to preserve the current instances of competition, but also to open up new markets for competition.

In coal mining growing competition between producers has been observed lately, as the practice of rigorous production and price planning on behalf of the Ministry of Fuel and Energy of Ukraine has been officially discontinued. This however can be only seen as a first step and further measures are badly needed.

In the oil refining business some promising signs of competition were observed immediately after privatisation and during the establishment of the service station chains affiliated with the companies owning the oil refineries. However, there is still a large degree of state influence over prices with the intention of securing low price levels for consumers. The recent price increases have demonstrated that such state protection has failed and that it has only led to delayed and correspondingly drastic adjustments of prices to international levels.

10.3.4 Commercialisation and private sector participation

The process of corporatisation has been completed throughout the energy sector with the recent corporatisation of state assets in coal mining and the power sector. Separation of policy functions and economic activities in the power sector is nominally complete; however, further steps in this direction are necessary to increase the role of profits in the operation of the firms and to reduce the social burdens transferred by the state to the enterprises in the sector.

Ukraine has achieved notable success in the unbundling and partial success in the privatisation of the electricity sector. This sector has been split vertically into generation, transport, sales and distribution, and split horizontally as well. The pool model has been developed to allow for competition in the generation of electricity through bidding between thermal power plants, while other types of generators operate subject to regulated tariffs. The power sector has been partially privatised in the areas of distribution and thermal electricity generation. However, it is likely that privatisation will halt with the recent transfer of all state assets in the sector to NAK Energy Company of Ukraine.

The gas sector has developed in the reverse direction, with most of its activities monopolised under NAK Naftogaz. The oil refineries have been almost completely privatised, with minor stakes and capacities remaining in state hands. It has also proven difficult to reduce state influence in the coal sector. Mines were separate enterprises, but they have recently been united in NJSC Vygillja Ukrainy. Several coal mines have been privatised and others rented out, but most capacity remains in state ownership. The success in selling Pavlohradvuhillja and the performance indicators of the mining enterprises that have been rented out demonstrate that coal mining

can be attractive to the private sector and that the industry's problems lie mainly in the low quality of asset management.

In the oil sector, transit and transportation services remain fully controlled by the state through the NAK Naftogaz subsidiary Ukrtransnafta. However, the oil refining business is horizontally unbundled and has been largely privatised.

10.4 Policy recommendations

Given the crucial importance of energy supply for sustaining economic growth and improving standards of living, the previous discussion demonstrates that reforms in the energy sector to date are insufficient. Continued reform efforts should clearly aim at creating the necessary conditions for Ukraine's energy companies to operate profitably and efficiently. This in particular means that reforms in the energy sector should accomplish the following:

First, tariff policy should allow firms to make profits on the services provided. Second, contract enforcement should be guaranteed by the state. Accompanying these steps, an efficient regulator must be put in place to regulate access to the network segments in the energy sector. To enable fair competition in the market, all implicit and explicit state subsidies should be rethought. Only after these steps are taken can significant introduction of private capital into the industry be expected. If they are not taken, the lack of regulation will continue to lead to undesired outcomes and create loopholes that generate rents. We recommend that the following reforms, in order of priority, be implemented:

Tariff reform and contract enforcement. Most importantly, the government must stop trying to determine the prices for energy supplies. Instead, it should introduce a 'regulated-competitive pricing policy', under which energy tariffs are set by the companies involved, and subject to hard-budget constraints. At the same time, a mix of competition and regulation is needed to rule out the possibility of extraction of monopoly rents (see recommendation on Regulatory reform below). Only in this way can cost-recovery and incentives to improve efficiency be provided at the same time. If hard budget constraints lead to the default of inefficient structures, bankruptcy procedures should be allowed to separate profitable, productive assets from indebted structures. The current moratorium on bankruptcy simply allows inefficient structures to prevail without solving any problems at all.

The move to tariffs that cover costs will make it impossible to sustain universal subsidies to all households. Instead, targeted subsidies for low-income households are called for. This, however, is a task for social policy[71] and not the responsibility of the energy sector. Indeed, increased profitability in the energy sector (since firms will no longer suffer the losses that stem from artificially low tariffs and servicing privileged consumers) will lead to an increase in tax collection, and hence to increased budget revenues. Thus, the government's capacity to deliver help to the truly

[71] See Chapter 2 on the social security system in Ukraine.

needy will increase, and 'regulated-competitive pricing policy' will deliver more social justice.

Tariff reform should be accompanied by stimulating contract enforcement with respect to payments for energy and energy-intensive public utility services.[72] Contract relations should be established with all users of energy services, and it should be possible to enforce each contract in case of non-compliance, regardless of whether the customer is a business client or a private household. Furthermore, ensuring contract enforcement implies settlement of the issue of accumulated debts in the sector. These should be restructured and repaid according to an agreed schedule which does not allow for manipulations of payments for current consumption

Regulatory reform. Current practices and principles of price regulation in the energy sector must be rethought. In particular, NERC – the regulating authority – should seek to create a framework for competition in the energy sector. At first, regulatory efforts should be concentrated on tariffs for network access (e.g. to power and gas grids) rather than on tariffs for final services. Instead, the formation of other components (such as retailing of power and gas or power generation) can be left to competitive market forces. Second, NERC's regulation should be designed to provide more incentives for cost reduction and increased efficiency. This in particular means changing from the current system of cost-plus (profit cap) regulation with normative profit rates, to 'price cap' regulation where reduced costs also mean higher profits for the operating company. This would increase efficiency in the sector and generate incentives for investments (because of higher profits), leading to increased quality and reliability of service provision.

In addition to such changes in the modes of operation of NERC, its legal foundation also needs to be improved. Until now, NERC only operates on the basis of presidential decrees. Hence, its independence is rather limited and its decisions can fairly easily be politically overruled. To improve this situation, the relevant laws "On the NERC" and "On the wholesale electricity market" should be enacted by parliament. Rules for ensuring the NERC's financial independence should also be included. NERC could be financed out of a special fund in addition to direct state financing. This fund would receive a fixed percentage of the revenues of the market operators. Financing the NERC from two sources would increase its independence from political influence and avoid incentives for the NERC to unduly increase tariffs for market participants. A law on the functioning of the wholesale market is also necessary, as the current system is not sustainable and continues to accumulate debts. It also allows for arbitrary decisions with regard to the management of financial flows, and the present piecemeal approach to limit arbitrary decisions only brings more complications and does not guarantee sustainable wholesale market operation.

Finally, it is vital to introduce regulatory norms or a national regulator in the public utilities sector (e.g. water, wastewater, heating), since these utilities are among the largest consumers as well as debtors of the energy

[72] See Chapter 9 on the utility sector in Ukraine.

sector.[73] Without meaningful reforms in the utilities sector, the sustainability of the energy sector is seriously endangered.

Promotion of competition in the marketplace. In line with the 'regulated-competitive pricing policy' proposed above, competition should be encouraged wherever possible (e.g. retail competition in the electricity and gas markets). This increases efficiency at much lower costs than regulation, and it also allows new independent providers to compete with existing distribution companies, spurring innovation and increased efficiency.

To increase the (currently low) efficiency in power generation, it is necessary to preserve competition between thermal power plants, even though they have been united into a single holding *United Energy Company of Ukraine*. The same argument holds for the coal mines that are united under the *Coal of Ukraine* holding. On the assumption that price distortions in the primary energy sub-sectors will be eradicated, the next step would be to introduce competition between various fuels to achieve an optimal allocation of resources.

As for the domestic extraction of fossil fuels, it would be beneficial to allow for exports of these resources, once the issue of tariff policy is solved. Then, provided the exported energy resources are valued at world market levels, there will be increased incentives for more efficient use of energy fuels, and entry into the extraction market will be stimulated. This will bring investment into these fields and contribute to a reduction of Ukraine's energy dependence.

Commercialisation and private sector participation. The Ukrainian energy sector is in dire need of investments and the capacity of the private sector to undertake these investments should be tapped to the full extent. Although privatisation in the energy sector was recently frozen, it is still possible to invite the private sector to participate in public-private partnerships and other forms of cooperation which do not involve property rights transfers. In order to create a favourable investment climate it is necessary to allow businesses to operate profitably in the sector, which presupposes the reforms steps mentioned above.

Rethinking the approach to energy sector. Finally, it is also advisable to embark on a full-fledged public awareness campaign to save resources and increase energy efficiency. Local governments can step up, e.g. with initiatives to create energy saving companies (ESCOs), which implement energy-saving projects and finance their operations out of the fuel savings realised by their clients.

As mentioned in the introduction, the approach to energy should be changed in Ukraine. Growth in primary energy consumption should not be taken for granted or considered a goal in and of itself. The growing Ukrainian economy requires not the growth of primary energy, but rather of energy services, which can also be achieved through energy saving

[73] See Chapter 9 on the utility sector in Ukraine.

projects. A new and serious approach to the issue of renewable energy resources is also required, as these are currently being ignored or wasted in Ukraine.

About the Institute for Economic Research and Policy Consulting

The Institute for Economic Research and Policy Consulting (IER) was founded in October 1999 by top-ranking Ukrainian politicians and the German Advisory Group on Economic Reforms with the Ukrainian Government. The IER is jointly financed by the Ukrainian and the German Governments.

Aims of the Institute:

- Work as an independent research organisation that provides decision-makers, inside and outside the Ukrainian government, with analyses of the Ukrainian economy and economic policies;
- Support economic training and analytical capacity of Ukrainian scholars;
- Provide policy advice on the basis of sound economic research.

Principles of work

The IER is dedicated to the principles of democracy and free market economy. Political independence is a prerequisite for the IER if it is to find appropriate answers to questions of economic policy and avoid the manipulation of results. At the same time, close contacts to political decision-makers are needed in order to implement political advice. While the IER develops its own long-term research agenda, it is responsive to short- and medium-term policy issues in Ukraine.

The structure of the Institute and research team

The IER is directed by Igor Burakovsky, Professor at the National University "Kyiv-Mohyla Academy". The Institute is working in close co-operation with the German Advisory Group on Economic Reforms. An intensive know-how and information transfer between the Institute and numerous international and foreign universities and research institutions is pursued. The IER consists of the following Departments:

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- Ukraine and world economy (trade, trade policy, capital flows, competitiveness, WTO accession);
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- Monetary and exchange rate policy, development of financial markets and the banking sector.

2) Department of structural reforms

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- Development of small and medium-sized enterprises;
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Publications

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- German Institute for Economic Research (DIW) – Berlin (Germany)
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- Simon Fraser University (Canada)
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- Ministry of Economy and European Integration
- National Bank of Ukraine (NBU)
- The World Bank
- United Nations Development Program (UNDP)
- Department for International Development (DFID)
- International Renaissance Foundation
- East West Institute Kyiv Centre
- Institute for European and Regional Studies
- Charles Mott Foundation
- KfW - Bankengruppe
- International Labour Organisation (ILO)
- European Bank for Reconstruction and Development (EBRD)
- Organisation for Economic Co-operation and Development (OECD)

The IER research team

Prof. Dr. Igor Burakovsky, Director, Research especially on international trade, and European integration. E-mail: burakovsky@ier.kiev.ua

Iryna Akimova, Ph.D.(Economics): Senior Economist. Research on structural policy, corporate restructuring, and development of small business sector in Eastern Europe. E-mail: akimova@ier.kiev.ua

Oleksandra Betliy: Research associate. Research on social policy, labour markets, and tax reform. E-mail: betliy@ier.kiev.ua

Vitaliy Bigdai: Research associate. Research focus on fiscal policy.
E-mail: bigdai@ier.kiev.ua

Olena Bilan: Research associate. Research on monetary policy issues, inflation, and exchange rate. E-mail: bilan@ier.kiev.ua

Anna Chukhai: Research associate. Research on infrastructure development and regulation. E-mail: chukhai@ier.kiev.ua

Serhiy Demyanenko: Doctor of Sciences in Economics, Research Professor. Research on agricultural economics, agricultural reforms, and farm restructuring. E-mail: demyanenko@ier.kiev.ua

Halyna Herasym: Research associate. Research focus on financial sector.
E-mail: herasym@ier.kiev.ua

Oksana Kuziakiv: Research associate. Quarterly Enterprise Survey. Specialisation in surveys of business tendencies, business development, and the business climate in Ukraine. E-mail: kuziakiv@ier.kiev.ua

Natalie Leschenko: Research associate. Research on fiscal system.
E-mail: leschenko@ier.kiev.ua

Veronika Movchan: Research associate. Research focus on macroeconomic analysis and forecasting, monetary policy issues, international trade, especially trade restrictions. E-mail: movchan@ier.kiev.ua

Oleg Nivyevskiy: Research associate. Research focus: productivity and efficiency analysis; international trade with concentration on agricultural and food markets. Assessment of agricultural reforms and rural area development in Ukraine.
E-mail: nivyevskiy@ier.kiev.ua

Katerina Onishchenko: Research associate. Research focus on international trade, trade policy, and influence of integration process on industrial activity.
E-mail: onishchenko@ier.kiev.ua

Ivan Poltavets: Research associate. Concentrates on energy sector reform, infrastructure development and regulation. E-mail: poltavets@ier.kiev.ua

Oleg Sheremet: Research associate. Specializes in infrastructure reforms and development. E-mail: sheremet@ier.kiev.ua

The German Advisory Group on Economic Reforms with the Government of Ukraine

Prof. Dr. Stephan von Cramon-Taubadel: Team Leader

Dr. Richard Frensch: International economics, fiscal policy, investment policies

Dr. Ricardo Giucci: Macroeconomic policy and financial sector

Dr. Lars Handrich: Labour markets and social policy

Dr. Arnim Kuhn: Agriculture and regional development

Dr. Ferdinand Pavel: Trade policy, structural reforms, and infrastructure