

# PROSPECTS FOR ECONOMIC SECURITY AND GROWTH IN UKRAINE

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## **Abstract**

The current economic situation in Ukraine is difficult and deteriorating. Real wages and pensions are low, often below the poverty level. GDP is falling. Barter, arrears, and the informal sector are growing. The superficial appearance of price and exchange stability masks deep fiscal disbalance. Rather than becoming an emerging market economy, Ukraine has transitioned from centrally planned socialism into an economy that is still mostly socialistic in many of its characteristics. Comprehensive reforms are necessary in order to put Ukraine onto the path of true economic development. “New,” market-oriented enterprises should be supported by a substantial reduction in the tax burden, in particular in taxation of value- and job-creating enterprises, and by extensive deregulation. “Old,” state-owned, socialist enterprises should be reformed by changing the environment in which they operate, mostly with measures aimed at hardening budget constraints. Policies should be adopted to open the economy internationally as much as possible to a freer flow of goods, services, currency, and people. The budget-sphere must be radically restructured and downsized. The two greatest threats to Ukraine’s economic security over the next two years are:

- that Ukraine may fail to fundamentally change the ruinous economic policy that has been in place since independence;
- that Europe may close its borders to Ukraine as Central European countries become more integrated into European institutions.

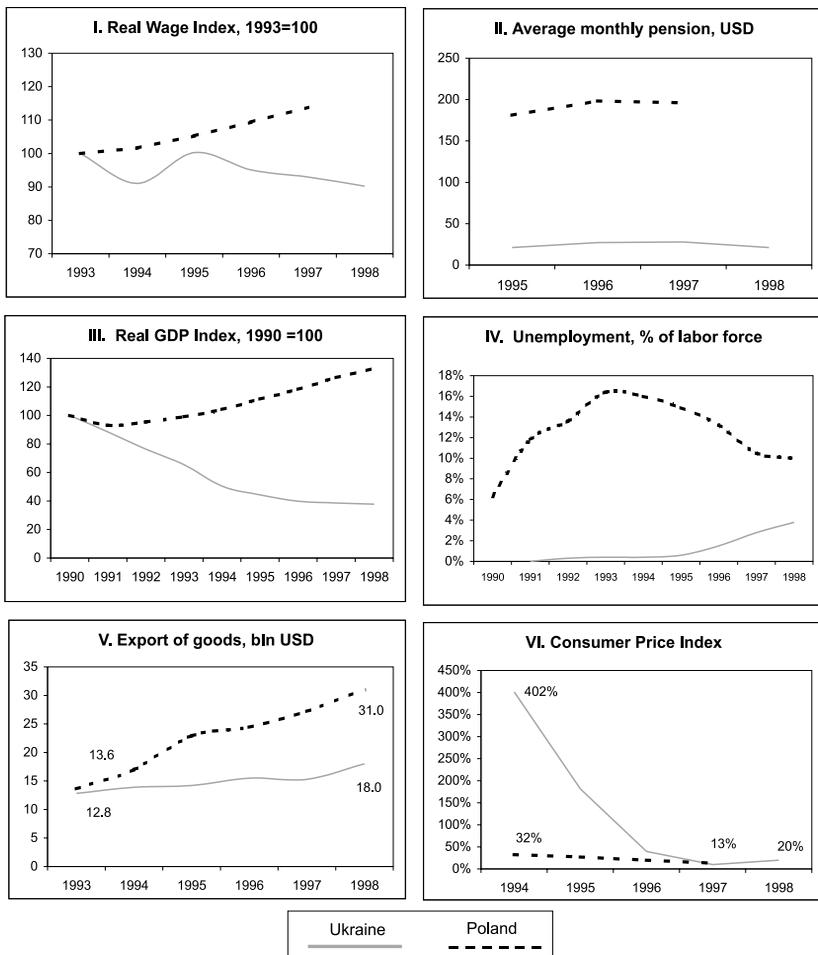
If Ukraine and Europe are successful in addressing these potential threats to economic security, then the next two years may in fact turn out to be a period during which Ukraine builds economic security, solidifies its political independence, and makes great progress in the process of integration into the community of European nations.

## **Current Economic Situation**

The current economic situation in Ukraine is difficult and deteriorating. The following charts compare recent economic trends in Ukraine and in Ukraine’s neighbour, Poland. It is useful to compare trends in Ukraine with those in

Poland because Poland is an example of a successful transitional economy and therefore shows how trends should be going.

### Charts I-VI : Comparisons of Ukraine and Poland<sup>1</sup>



In Poland, once freed from the shackles of socialism and after a brief adjustment period, the economy quickly grew with substantial increases in real GDP, wages, and pensions. In Ukraine, however, GDP, wages, and pensions have fallen quite substantially. Current GDP per capita in Ukraine is approximately US\$820, average wages are US\$52, and average pensions are US\$18.

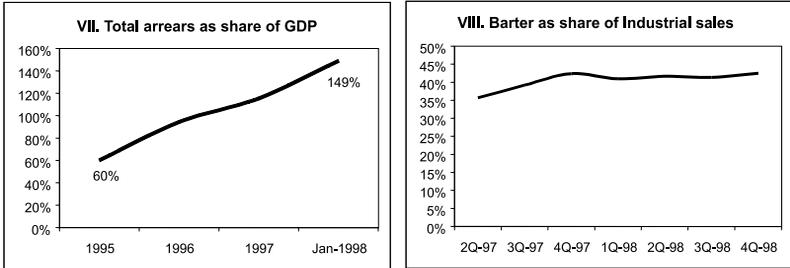
Socialist economies were over-industrialised, while their service and financial sectors were underdeveloped. Part of the transition process therefore requires sectoral restructuring, with a decrease in the relative size of some sectors and an increase in others. This restructuring in the short run can cause much higher unemployment, but in the medium-term most laid off workers eventually find new jobs in a booming reformed economy. In Poland, unemployment at first rose sharply but then fell again. In Ukraine, however, unemployment has hardly moved up. These trends suggest a lack of substantial economic restructuring in the economy.

Despite hyperinflation in the early 1990s, inflation rates in recent years have been quite low and the exchange rate has been even more stable. In many countries, low inflation and a stable exchange rate signify government fiscal discipline and a low budget deficit that does not require any printing of money in order to finance. In Ukraine, however, the experience of low inflation and a stable exchange rate signify no such success with fiscal reform. On the contrary, government expenditure commitments have been quite high, far in excess of revenues. Instead of financing the deficit through printing money (as had been the case in 1992-1994, causing hyperinflation), the government simply runs up high arrears, for instance by not paying budget-sector workers or utility bills. Therefore, the apparent macroeconomic stability is illusory, covering up deep fiscal imbalance. Moreover, price and exchange stability have been maintained for several years largely by spending down national-bank foreign reserves and implementing administrative controls on currency exchange and foreign trade that have had a sharply negative impact on the financial and trading sectors. In sum, stabilisation policy, despite the numbers, cannot be considered to have been a success.

Two problems almost unique to Ukraine and other post-Soviet economies are barter and arrears. Increasingly, rather than paying with money, enterprises pay in-kind, offering goods to workers in lieu of wages, to government in lieu of taxes, and to other enterprises in lieu of payment for inputs. The prevalence of barter to such a degree as one finds in Ukraine suggests deep economic distortions. For some reason, managers prefer to pay in-kind rather than paying in money despite the high transaction costs usually associated with barter trade. Perhaps they are evading high tax rates by circumventing the banking system; or they are hiding profits from weak corporate owners in non-transparent in-kind deals; or they merely are struggling to continue unprofitable production that is allowed by an absence of a functioning bankruptcy law.

Arrears of all kinds continue to mount. Enterprises have more and more past-due debts that they owe to workers in wages, to government in taxes, and to each other for inputs. The total outstanding size of arrears in the economy now it is far greater than GDP.

## Charts VII-VIII<sup>2</sup>



Increasingly, enterprises and individuals hide their income in the informal sector, evading taxes and regulations. From a totalitarian society under Soviet times where little informal economic activity was possible, Ukraine's informal sector has grown to such an extent that many guess it represents around 50% of total output. Net investment (foreign and domestic) is extremely low, perhaps even negative when one takes into account depreciation of existing assets. As a consequence, both GDP and real living standards decline.

In sum, all the economic trends that should be going up are instead going down, and all the trends that should be going down are instead going up. Rather than increasing in size every year through value-adding production, the economy of Ukraine is slowly self-destructing, consuming its own capital stock in order to survive for the short-term. Along its current path, without a radical change in course, the formal economy eventually will just wither away.

The implications of current economic trends for Ukraine's security and stability are clear. A country with an economy that is slowly spiralling downward risks eventual political instability as well, which can then destabilise the region and create immigration pressure in neighbouring countries.

In spite of the current gloomy outlook, however, prospects for Ukraine are not hopeless. Ukraine's potential for development is quite good. Given its highly educated workforce, its internal ethnic harmony, and its proximity to European markets, Ukraine actually has the potential for dramatic, sustained economic growth, perhaps as high as 10% per year for an extended period of time. What has prevented Ukraine from realising its potential over the last eight years has been ruinous economic policy. If Ukraine could be successful in fundamentally changing its economic policy, its economic prospects also will change as fundamentally. Before addressing the question of what economic policies are needed, I turn first to a discussion of the root causes of Ukraine's current problems.

## Root Causes of Current Economic Problems

Ukraine, arguably, is no longer a transitional economy, but rather has reached a new equilibrium path. Like Russia, Ukraine since the break-up of the Soviet Union has evolved from centrally planned socialism into a new type of socialistic economy. This type of economy we might call “oligarchic socialism” to contrast it with centrally planned socialism. Oligarchic socialism - or what others have called a virtual economy<sup>3</sup> - is quite unlike a true market economy, even unlike the emerging market economies of Central Europe. Rather, it is perhaps most similar to Central European economies 25 years ago under what was called reform socialism or goulash socialism - socialism with a few market elements mixed in. The oligarchic socialism that has developed in Ukraine, and also in Russia, with its peculiar characteristics of arrears, barter, and shadow economy, seems quite stable and potentially long lasting. Without a radical change in course, despite prior hopes and expectations, current economic conditions may not be merely a transitional phase in the development of a true market economy but rather a quite permanent state.

The **economic** characteristics of oligarchic socialism are similar to the characteristics of centrally planned socialism, with some important exceptions, as shown in Table 1.

Oligarchic socialism differs from centrally planned socialism most fundamentally in that decision making is not concentrated at the centre. Rather, decisions regarding allocation of resources are decentralised, made by enterprise managers or sectoral and local-government bureaucrats. The breakdown in centralised control, which is related to the end of iron-fist totalitarianism, also has allowed the development of a shadow economy where none would have been tolerated under the past system.

Oligarchic socialism is similar to centrally planned socialism in that: budget constraints are soft; prices are distorted and do not signal relative scarcity; enterprises maximise production and employment rather than profits; and goods and services are “sold” without using money as the means of exchange. These characteristics apply to most enterprises and the budget sphere, but not to some “new” enterprises, often operating in the shadow economy, which are more market-oriented.

In seeking to explain why central European countries have developed into emerging market economies while Ukraine, Russia, and the other large post-Soviet countries have transformed into oligarchic socialism, I suggest the following hypothesis.

In the central European countries, “new,” market-oriented enterprises (mostly small businesses or other enterprises with effective private ownership) became particularly widespread and strong at the early stages of reform, and the economies were open to international trade and contact with the rest of the world. The new enterprises and foreign companies dominated over “old” socialist enterprises

**Table I - Systemic Economic Characteristics**

<b>Soviet period (Centrally planned socialism)</b>	<b>Contemporary Ukraine (Oligarchic Socialism)</b>	<b>Market</b>
Soft budget constraints in budget and enterprise sectors	Soft budget constraints in budget and enterprise sectors	Hard budget constraints in budget and enterprise sectors
Promised state programs exceed available resources	Promised state programs exceed available resources	Promised state programs within available resources
Distorted prices, set arbitrarily by the centre, do not signal relative scarcity	Distorted prices, set arbitrarily by enterprise managers or bureaucrats, do not signal relative scarcity	Prices, set freely by market mechanism, signal relative scarcity
Enterprises, with weak ownership by the state, maximise production and employment	Enterprises, with weak ownership by the state or dispersed private owners, maximise production and employment	Enterprises, with strong private ownership, maximise profits
Allocation of resources is centralised, directed by the government based on political objectives, unconnected to flows of money	Allocation of resources is decentralised, directed by enterprise managers or bureaucrats based on political or rent-seeking objectives, unconnected to flows of money (payment in barter for goods and services; and arrears)	Allocation of resources is decentralised, directed by enterprise managers, based on profit-maximising objectives, connected to flows of money (payment in money for goods and services)
Price distortions and soft budget constraints manifest themselves in shortages	Price distortions and soft budget constraints manifest themselves in hyperinflation when monetary policy is loose and in arrears and barter when monetary policy is tight	No price distortions; hard budget constraints
Totalitarianism does not allow much economic activity outside the state sector	Liberalised political climate allows shadow economy - small enterprises and evasion at large enterprises	General economic liberty

in setting the overall economic environment. That is, because of the relative strength and prevalence of “new” enterprises and openness to the outside world, a market environment prevailed: enterprises maximise profits subject to hard budget constraints and pressure from competition and owners; prices give accurate signals of relative scarcity; and money is used as the medium of exchange. Even “old” socialist enterprises were subjected to this market environment and slowly reformed to conform to new conditions. The prevalence of new enterprises and openness of the economies were due both to initial starting conditions and to positive economic policies that were adopted by reformist governments (eg, deregulation, adoption of market-oriented commercial codes, and general openness).

However, in the large post-Soviet countries, there were far fewer “new” enterprises and far less openness to the West. “Old” socialist enterprises dominated, perpetuating the socialist environment of loose budget constraints, poor corporate governance, distorted prices, limited competition, and barter. A market environment was not created, but even potentially healthy enterprises are corrupted and held back by the prevailing socialist environment. Even potentially profitable enterprises cannot find customers with money and have trouble allocating resources efficiently in the face of distorted prices. Because of tougher starting conditions (fewer “new” enterprises and less openness to the outside world) and failure to adopt reform policies, these countries have remained stuck in a low-level equilibrium of oligarchic socialism.

Similarly, along a **political** dimension, large post-Soviet countries are caught in a Catch-22. In order for economic reforms to succeed politically, there must be interest groups that support them. However, it is hard to imagine how such interest groups for reform (small-business associations, corporate shareholders, etc.) will emerge until after economic reforms are implemented. In contrast, not only did Central European countries at the outset of the reform process have sufficient “new” enterprises to create a predominantly market economic environment, they also had sufficient pro-market interest groups to create a predominantly pro-market political environment.

In Ukraine and other large post-Soviet countries, there are few small businesses, few true private shareholders, few large value-adding enterprises other than those based on natural resources, and few influential academics educated in market economics. That is, there are few clear political allies to fight for reforms. Lined up against reforms, however, are a number of influential groups, including managers and murky figures drawing illicit rents from value-subtracting state-owned enterprises. In addition to those in the enterprises, there are bureaucrats at all levels of government who have a rent-seeking interest in maintaining the current regime of excessive regulation and taxation. These enterprise managers, bureaucrats, and other rent-seekers - all of whom might be called the oligarchs of the economy - use their considerable political power to block reforms. The relative political power of the oligarchs in the large post-Soviet countries compared to in central Europe (or, conversely, the relative absence of political power of pro-reform constituencies) has been a key factor in the slow pace of reforms in these countries.

## **Needed Economic Reforms**

A prescription of policy measures should rest on four pillars:

- support to “new” enterprises (through tax relief for value-added, job-creating enterprises, and through deregulation);

- pressure to reform on “old” enterprises (through strengthening of private ownership in the long run and punishment of value-subtracting activities by the tax system in the short run);
- comprehensive opening of the economy to the outside world in order to “import” market environment (including monetary and exchange policy compatible with growth and integration into the world economy);
- restructuring the budget sector to greatly reduce expenditure commitments.

In order to succeed in getting the economy to jump from a low-level socialist equilibrium to a higher-level market equilibrium, reforms must be comprehensive and far-reaching. The following four sections provide specific proposals that could comprise a comprehensive reform program. They are meant give preliminary ideas in order to orient discussion. Much additional analysis would be needed to construct a program that actually could be implemented.

## **Supporting “New” Enterprises**

“New” enterprises should be supported by a substantial reduction in the tax burden, in particular in taxation of value- and job-creating enterprises, and extensive deregulation. The value added tax rate should be reduced, perhaps to 15%. All payroll taxes other than contributions to the pension fund should be eliminated. Pension reform should be undertaken to introduce capitalised individual retirement accounts in order to draw a tight link between contributions and benefits and to maximise the return on contributions. A ceiling on the tax base used for payroll contributions should be set at roughly two times the average monthly income. For the personal income tax, the non-taxable minimum income should be set at the same level of roughly two times the average monthly income, above which a flat rate of, say, 30% should be applied. Other targeted taxes, for instance to the innovation, roads, and other sectoral funds, should be eliminated.

Deregulation should focus on eliminating the incentives bureaucrats have for harassing businesses by eliminating their potential financial gains. All penalties, fees for licenses, and other payments to government control organs should be paid to central and local government budgets, not to the budgets of the control organs. In cases where control organs assess penalties for violation of law or regulation, all payments should be made through the banking system (as phone and communal services now are paid). No control organ official should have the right to accept any payment in cash. Accepting payment in cash should be grounds for immediate dismissal of any control organ official. These regulations should apply widely, for instance to all inspections of enterprises and even to visa issuance by embassies and to traffic police. Other deregulation, such as elimination of restrictions on domestic trade, also should be implemented.

## **Reforming “Old” Enterprises**

Old, state-owned, socialist enterprises should be reformed by changing the environment in which they operate, mostly with measures aimed at hardening budget constraints. The standard array of policies are needed:

- improvement of bankruptcy procedures and institutions;
- determination of a small number of specific enterprises for first bankruptcy actions;
- continued privatisation;
- strengthening of corporate governance mechanisms;
- improvement and enactment of contract and other commercial law.

These measures, which one might call first-best solutions, seem to have been difficult to implement quickly. Therefore, another set of measures is recommended, which one might call second-best solutions, which can be implemented quickly if there is political will and that would put substantial pressure on old enterprises to reform. The goal of such measures should be to harden budget constraints and to discourage barter, value subtracting production, and other socialistic economic activity. The value-added tax should be applied on an accrual basis with special provisions to prevent excessively high credits when inputs are paid for in barter or when inputs in value subtracting enterprises cost more than finished goods. Most zero ratings should be eliminated from the value-added tax, especially on energy and especially for budget-sphere organisations, to bring more of the economy into the tax web. Absolutely no tax revenues should be permitted in-kind. Only monetary payments should be tolerated. No in-kind payment should be counted toward revenue targets agreed with IFIs. Payment for all energy also should be permitted only in cash, not in-kind or with promissory notes. While in most cases government financial assistance for enterprise restructuring only makes things worse, the government (with foreign assistance) can play an important role in facilitating restructuring of old enterprises by allocating sufficient funds for severance pay of laid off workers.

## **Promoting an Open Economy**

In order to “import” a market environment, policies should be adopted to open the economy as much as possible to a freer flow of goods, services, currency, and people. Administrative non-tariff barriers on trade and all tariffs on exports should be eliminated. A low, uniform, transparent import tariff level should be set. Consideration should be given to contracting out pre-inspection for imports to internationally recognised companies. This would eliminate excessive bureaucracy and corruption in the current customs system. Administrative restrictions on currency trade should be eliminated, and a free, floating exchange-rate should be set, perhaps within a wide, crawling, indicative band. Requirements for visas for citizens of European Union and North American countries should

be eliminated. Foreign banks interested in lending to Ukrainian business activities should be encouraged to open local branches with as little bureaucratic regulation as possible. Certification standards for all products from European Union countries, Poland, Hungary, and the Czech Republic should be excepted automatically without requiring re-certification in Ukraine.

## **Radically Restructuring the Budget Sphere**

A legacy of socialism is that the government promises expenditures on programs far in excess of what available resources will allow, contributing to a high tax burden that stifles enterprises. The budget sphere has swollen so far beyond its means that it is essentially bankrupt. Comprehensive restructuring is essential. The substantial tax cuts recommended earlier would require commensurately deep cuts in expenditures. An overall expenditure level that is reasonable should be determined at the outset of the budget process, spending limits should be set for each broad area, and commitments for hiring staff and other expenditures should be made within these limits. Those who are laid off must be allocated severance pay. In parallel, regulations and rules must be developed for strengthening the budget process and assigning personal responsibility to managers for ensuring that expenditure commitments do not exceed allowable levels.

## **Economic Security**

Military security and economic security are fundamentally different. Military security is defensive - keeping one's enemies out. Economic security is constructive - building a strong economy within. Military security means closing one's borders to prevent one's neighbours from crossing when bearing arms. Economic security means opening one's borders to allow one's neighbours to cross when bearing goods to trade or money to invest in companies and to spend on goods. Military security requires closed borders, but, in a globalise economy, economic security requires open borders.

For Ukraine in particular, open borders will be critical for successful economic development. Ukrainian companies and Ukrainian consumers need access to Western companies, which can pay in cash rather than in-kind and which have capital to invest, high-quality goods to sell, and technology to transfer. Also, competition from Western companies will be an important force for restructuring Ukrainian enterprises.

By way of conclusion, I would suggest that Ukraine faces two significant threats to its economic security over the next two years. The first, and greatest, threat to economic security is that Ukraine may fail to fundamentally change the ruinous economic policy that has been in place since independence. Although little change is possible before fall presidential elections, immediately thereafter

the new administration (even if the same president stays in power) will have an important opportunity to change economic course and implement a comprehensive economic reform program. Failure to take advantage of this opportunity may lead the country into deeper economic malaise and eventually political destabilisation. Successful implementation of comprehensive reforms, however, could put Ukraine onto the same path of rapid economic development that its Central European neighbours have followed over the last eight years.

The second threat to its economic security that Ukraine faces is the possibility that Europe may close its borders to Ukraine, either because of protectionist lobbying from domestic interests in various European countries, or as a by-product of accession of Central European countries into the European Union. (That is, visa regimes and trade policies adopted by Central European countries as they prepare for EU membership may reduce access for Ukraine to these countries.) Given that European countries are Ukraine's most important market-oriented trade partners and most common destinations for Ukrainian tourists, such a closure of Europe's borders would have a significant negative impact on Ukraine's prospects for near-term economic security and development.

If Ukraine and Europe are successful in addressing these potential threats to economic security - that is, if Ukraine is successful in implementing a comprehensive economic reform program after the presidential elections, and if Europe is successful in maintaining open borders with Ukraine - then the next two years may in fact turn out to be a period during which Ukraine builds economic security, solidifies its political independence, and makes great progress with integration into the community of European nations.

### *Notes*

- 1 Based partially on ongoing research comparing Ukraine with Central European countries, by Janusz Szyrmer and Dimitar Mishev, HIID. Data sources include official government statistics organs of Ukraine and Poland, and from Ukrainian Economic Trends (Kyiv: Ukrainian-European Policy and Legal Advice Center). All charts and many calculations in this paper were prepared by Aleksei Sluchinsky, HIID.
- 2 *Ibid.*
- 3 The "virtual economy" is described in Clifford G. Gaddy and Barry W. Ickes, "Russia's Virtual Economy," *Foreign Affairs*, July/August 1998, Vol. 77, No. 5, pp. 53-67. In this paper, I seek to extend their analysis, describing economic characteristics more in detail, in the context of an economy that has transitioned from centrally-planned socialism to a new form of socialisms.