

Background

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Time to Relaunch Ukraine's Economic Policy

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Ukraine is an important American geostrategic priority in Eastern Europe. Many U.S. policymakers and experts believe that Ukraine's integration into the global economy, and Europe in particular, will change the geopolitical balance in Eastern Europe and could trigger positive changes in other post-Soviet states. Above all, it will benefit the people of Ukraine. Therefore, the outcome of Ukrainian reforms is important for U.S. foreign policy.

Since the events leading to the Orange Revolution in Kiev, the U.S. government has supported Viktor Yushchenko, who became president of Ukraine in January 2005, and his political allies. The Bush Administration has spent over \$60 million on Ukrainian democratic transition, and the fiscal year 2005 supplemental budget includes a similar amount. However, Ukraine's economic policy has been derailed since Yushchenko took power, for the following reasons:

- The lack of a free-market vision at the highest level of the Ukrainian government;
- The breakdown of governmental economic decision-making mechanisms;
- An inadequate judiciary and a corrupt and inefficient bureaucracy;
- Continuous violation of property rights and excessively complicated taxation, which is implemented in an arbitrary fashion;
- Anti-market and protectionist policies pursued by Prime Minister Yulia Tymoshenko; and

Talking Points

The Ukraine government should:

- Execute and implement President Yushchenko's economic reforms and create a positive investment environment.
- Initiate a review of its decision-making and policymaking process and work with a management consultant to implement the recommendations and improve the current situation.
- Reduce the tax burden and enhance property rights protection and the rule of law. This should include repealing the Soviet-style economic code, improving the court system, and significantly reducing social insurance taxes as one of the ways to entice business out of the shadow economy.
- Increase integration in the global economy. The Bush Administration should work with the Ukraine government to facilitate recognition of Ukraine as a market economy and Ukraine's entry into the WTO.

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- Insufficient integration into the global economy due to the parliament's reluctance to pass the necessary laws.

The conflict between President Yushchenko's pro-market declarations and his cabinet's centralizing instincts and confused performance has resulted in an economic policy that appears to be statist and populist in nature. This year's track record lags behind 2004 economic achievements, which included gross domestic product (GDP) growth of 12 percent and an over 200 percent increase in the Ukrainian stock market.

Lackluster Performance

Key indicators of the Ukrainian economy have deteriorated since the beginning of 2005, endangering the future of the Yushchenko Administration.

Macroeconomic Indicators. The results of the populist policies have been immediate. In the first four months of 2005, GDP growth plunged to an annual rate of 5 percent while inflation surged to 15 percent.¹ Construction contracted significantly, by 5.9 percent per year in the first quarter of 2005 compared to the first quarter of 2004. Metallurgy also declined by 3.6 percent in the first quarter due to increased input costs, especially energy costs.²

Privatization. The new government has promised a new privatization deal that has prompted lengthy discussions about what should be reprivatized and how it should be done. The government has drafted a broad law that could undo much of Ukraine's privatization. This has endangered the property rights of thousands of enterprises.

The new government has not executed its controversial plans for renationalization and subsequent reprivatization of Kryvorizhstal, Ukraine's

biggest steel mill. In an apparent exercise in corruption and nepotism, the giant plant was originally bought for 10 percent of its fair market value by a consortium that included then-President Leonid Kuchma's son-in-law and close supporters of then-Prime Minister Viktor Yanukovich.

President Yushchenko has also appointed Valentina Semenyuk as the new privatization "czarina." Semenyuk hails from the Socialist Party and is on record as opposing privatization.³

Budget and Taxation. In the first quarter of 2005, the consolidated budget had a surplus of 3.85 percent of GDP. Budget revenues increased by 31 percent, and expenditures rose by 23 percent. However, concerns remain about the government's ability to collect enough revenue to finance its debt payments and social expenditures, including those promised by Yushchenko during his presidential campaign. These include increased benefits for the newborn and the disabled, as well as raising pensions and minimum wages by 42 percent in the first quarter of 2005.⁴

In March, the Rada (Ukraine's parliament) adopted amendments to the 2005 budget envisioning a budget deficit equal to 1.86 percent of GDP. The budget accounts for the ambitious increases in pensions and the minimum wage but uses overly optimistic estimates of revenue growth.⁵ In reality, the government is scrambling to find more revenue. Discretionary tax exemptions have been abolished in a hurried and incompetent fashion. This has forced tens of thousands of small entrepreneurs to close their businesses or to shift operations into the black market economy.⁶

Policy Discord. The government does not speak with one voice. First Vice Premier Anatoly

1. Anders Aslund, "Betraying a Revolution," *The Washington Post*, May 18, 2005, p. A17, at www.washingtonpost.com/wp-dyn/content/article/2005/05/17/AR2005051701326.html (July 5, 2005).
2. Iryna Piontkivska and Edilberto L. Segura, "Ukraine Macroeconomic Situation," SigmaBleyzer, May 2005, at sigmableyzer.com/files/Ukraine_Ec_Situation_05_05_2.pdf (June 22, 2005).
3. "Semenyuk Prefers State Property to Private Ownership," BBC Monitoring Service, May 18, 2005, quoted in *The Action Ukraine Report* No. 487, May 19, 2005.
4. Iryna Piontkivska and Edilberto L. Segura, "Ukraine Macroeconomic Situation," SigmaBleyzer, April 2005, at sigmableyzer.com/files/Ukraine_Ec_Situation_04_05.pdf (June 22, 2005).
5. *Ibid.*

Kinakh is one of the vocal critics of the prime minister's policies. He has publicly criticized the introduction of price controls and the imbalance between social and economic policy in the 2005 national budget.⁷

Inflation and Prices. Ukraine has the highest inflation rate in the Commonwealth of Independent States. The inflation increased from 13.3 percent annually in February to 14.7 percent in April.⁸ According to the State Statistics Committee of Ukraine, the annual inflation rate for January–May 2005 was 14 percent, compared to 7.2 percent for the same period in 2004.

Relaxed fiscal policies and falling savings rates have encouraged greater consumption, which has led to higher food prices, including prices for meat. The government responded by imposing price controls on food items. Prime Minister Tymoshenko also issued a decree requiring every region to develop, present, and implement a meat production self-sufficiency program—an approach reminiscent of Soviet-style central planning.

Ukraine is also suffering from an oil shortage, which some blame on the Russian government for blocking delivery of crude oil. However, high oil prices worldwide influenced Russian shipments.

Ukraine's oil price controls, which order state oil companies to deliver gasoline at prices below market levels, have had disastrous effects, leaving Ukrainians queuing fruitlessly for fuel. While the price controls were in effect, only Russian-owned stations had gasoline. On May 18, President Yushchenko signed into law a bill intended to ease a

fuel supply crisis by canceling customs duties and taxes on fuel and to allow Ukraine to reduce its energy dependence on Russia. Canceling duties on imported fuel allows Ukraine to purchase oil from other exporters, such as Kazakhstan, Iran, and Iraq, at higher prices without increasing the cost to consumers. After his trip to Azerbaijan, Foreign Affairs Minister Borys Tarasyuk announced that Ukraine would be willing to buy fuel from Azerbaijan. This is in line with the president's statement about diversifying Ukraine's crude oil market and seeking three to four sources of crude oil for Ukraine—specifically, Russia, Kazakhstan, Azerbaijan, and Libya.⁹

Trade. First quarter exports increased by 16.8 percent over the previous year, while imports grew by 18.5 percent. Metals were the major contributor to export growth. However, the trade balance is likely to become negative due to the appreciating hryvnia (the Ukrainian monetary unit) and cheap imports.¹⁰

Monetary Policy. Strong exports and foreign exchange inflows led to nominal appreciation of the hryvnia in April. In a step toward liberalizing the foreign currency market, the National Bank of Ukraine rescinded the regulation requiring the mandatory sale of 50 percent of export proceeds.¹¹ This is a welcome step, but more needs to be done in other areas of economic policy.

Business Reforms. The government does not seem to have a clear legislative, regulatory, or administrative strategy for the development, approval, passage, and implementation of major

6. Aslund, "Betraying a Revolution," p. A17, and "Polish Investors in Ukraine Preparing Indictments for Breaches in Contracts Regarding Special Economic Zones," *Polish News Bulletin*, June 14, 2005, quoted in *The Action Ukraine Report* No. 503, June 16, 2005.
7. Ukrainian News Agency, "PM Tymoshenko Asking Kinakh to Be More Measured in His Comments About Cabinet of Ministers Actions," May 18, 2005, quoted in *The Action Ukraine Report* No. 487, May 19, 2005, and Interfax-Ukraine, "Kinakh Calls for Restoring Lures for Investment to Maintain Industrial Growth," June 10, 2005, quoted in *The Action Ukraine Report* No. 501, June 13, 2005.
8. Piontkivska and Segura, "Ukraine Macroeconomic Situation," April 2005 and May 2005.
9. A. Vasovic, "Ukraine Seeks to Reduce Energy Dependence on Russia," AP Worldstream, May 18, 2005, quoted in *The Action Ukraine Report* No. 487, May 19, 2005.
10. Piontkivska and Segura, "Ukraine Macroeconomic Situation," May 2005.
11. Piontkivska and Segura, "Ukraine Macroeconomic Situation," April 2005.

business reforms. Every week, there is a new plan for a new vertically integrated business company to be owned and run by the Ukraine government, and this includes the energy sector.¹² The Tymoshenko cabinet does not discuss the reform of state monopolies, but instead talks about their reinforcement.

Lack of reform discourages American investment, as does widespread violation of intellectual property rights. Ukraine's software piracy rate (90 percent) is one of the highest in the world, comparable to the software piracy rates of Vietnam, China, and Zimbabwe.

On May 31, the Rada voted down a package of amendments to Ukraine's intellectual property rights laws. As a result, U.S. economic sanctions, imposed in 2002, will remain in place, affecting \$75 million of Ukrainian imports. In 2004, the U.S. reaffirmed the sanctions, citing Ukraine's poor efforts to fight optical media (CDs and DVDs) piracy and trademark counterfeiting as the main reasons for sanctions. Failure to pass this legislation will also delay Ukraine's entry into the World Trade Organization (WTO), block the U.S. Department of Commerce from granting the coveted market economy status to Ukraine, and send more negative signals to foreign investors.¹³

On July 6, overcoming the rowdy opposition of the Communist and Socialist Parties, the Rada passed a law making it a crime to distribute compact disks, equipment, raw materials for their production, and moulds illegally. This law brings Ukraine

closer to WTO membership. However, the Rada has adopted only five of 15 WTO-related reform bills. Three more passed the first reading, but five have failed, and two have been postponed.¹⁴

What Is at Stake?

The United States has much at stake in Ukraine, but it will be difficult to implement a policy of economic reform in the context of the constitutional changes that take effect in September—which shift power from president to prime minister in September—and parliamentary elections in March 2006. If the economic policy fails, Russia will try to relaunch its own candidates for the March 2006 parliamentary elections and will attempt to bring to power its own Ukrainian prime minister, who will have more power than President Yushchenko under the new constitutional arrangement.

Economic deterioration will also discredit U.S.-supported democratization in Ukraine, and this will have repercussions beyond Ukraine. If Ukraine fails, so also may Georgia, Kyrgyzstan, and other countries of the former Soviet Union. Moreover, current economic policies discourage Western investment while allowing corrupt Ukrainian and Russian interests, accustomed to the murky waters of government-regulated transitional economies, to thrive.

What Should Be Done

The Bush and Yushchenko Administrations need to take action to relaunch Ukrainian economic reforms.¹⁵ The main effort to turn the tide, how-

12. Ukrainian News Agency, "Pres Yushchenko States Need to Create Vertically Integrated Ukrainian National Oil Company," May 18, 2005, quoted in *The Action Ukraine Report* No. 487, May 19, 2005.
13. E. Morgan Williams, "Ukraine Parliament's No Vote a Major Setback Regarding Possible New Major International Trade Agreements," *The Action Ukraine Report*, June 13, 2005; "Verkhovna Rada Shoots Down the Law Against CD Piracy," *New Europe*, June 6, 2005, quoted in *The Action Ukraine Report* No. 501, June 13, 2005.
14. "Ukrainian Government Stalled over WTO Legislation," One Plus One TV (Kiev), July 5, 2005, quoted in *The Action Ukraine Report* No. 516, July 6, 2005; Associated Press, "Ukraine: Rada Fails to Vote on Bills Needed to Join WTO," July 5, 2005, quoted in *The Action Ukraine Report* No. 516, July 6, 2005; Ukrainian News Agency, "DPM Rybachuk: Changes of Laser Disks Legislation Compulsory Precondition for Ukraine's Accession to WTO," July 6, 2005, quoted in *The Action Ukraine Report* No. 518, July 7, 2005; Tom Warner, "Unruly Ukraine Deputies Impede Passage of WTO Legislation," *Financial Times*, July 7, 2005, p. 6; Interfax-Ukraine, "Ukraine President Yushchenko Laments Parliament's Failure to Pass WTO Bills," July 6, 2005, quoted in *The Action Ukraine Report* No. 518, July 7, 2005; Interfax-Ukraine, "Ukrainian Parliament Adopts Law on CD Piracy for WTO Entry," July 6, 2005, quoted in *The Action Ukraine Report* No. 518, July 7, 2005; and "WTO Obstructionists," *Kyiv Post*, July 7, 2005, quoted in *The Action Ukraine Report* No. 518, July 7, 2005.

ever, must come from the Ukrainian side. The U.S. can supply technical assistance and moral support, but the leadership and management of the economic reform process can come only from the Yushchenko Administration.

Specifically, the Yushchenko Administration should:

- **Create a uniform public vision of the president's economic reforms.** The government should execute and implement President Yushchenko's vision for economic reform and creation of a positive investment environment. The plan of action should include a timetable with specific and achievable benchmarks. It should designate specific officials who will be responsible for implementing the plan. The Yushchenko Administration should formulate a single business and legal strategy, improve the institutional capacity to absorb and manage international assistance, and centralize the process for requesting and coordinating technical assistance.
- **Engage an outside management consulting firm to review the current government decision-making and policymaking process.** This could be funded as part of existing U.S. technical assistance. The government, working together with such a consultancy, should use this assessment to implement a comprehensive government reform to improve the decision-making process in the economic, financial, fiscal, and investment policy fields. Improving the government's institutional capacity to implement stable and lasting reforms will foster an environment and infrastructure that attracts foreign and internal investment.

- **Reduce the tax burden and enhance property rights protection and the rule of law.** The Rada should begin by repealing Ukraine's Soviet-style commercial code (also known as the economic code), adopting the Joint Stock Company Law, and abolishing all price controls. Significantly deregulating the economy, including removal of hidden charges and obstacles to start-up and small and medium businesses, is also necessary.

Ukraine should reform the judicial and legal system so that it can enforce court decisions in a transparent and timely manner. It should also undertake comprehensive legal reform to facilitate economic competition and reform the administrative legislation and procedural code as recommended by the United Nations Development Programme's Blue Ribbon Commission for Ukraine.¹⁶ Such a reform would include facilitating enforcement of foreign judgments, including arbitration awards and improving bailiff service. On June 23, the Rada voted to remove the state bailiff service from the Ministry of Justice to ensure its independent function, which is a step in the right direction.¹⁷ Finally, it should consolidate and significantly reduce social insurance taxes, as one of the ways to entice business out of the shadow economy.

- **Integrate Ukraine into the global economy.** The Yushchenko Administration should reconstitute an interdepartmental working group on market economy status to guide Ukrainian efforts to secure market economy status from the United States. The Ukraine government should also appoint a high-level official responsible for completing this task within a certain time frame.

15. Recommendations have been formulated by the U.S.–Ukraine Policy Dialogue Economic Task Force. Co-Chairs: Ariel Cohen, Senior Research Fellow, The Heritage Foundation, and Ihor Shevliakov, International Centre for Policy Studies (Kyiv). Members: E. Morgan Williams, Director, Government Affairs, Washington Office, SigmaBleyzer Private Equity Investment Group; Sergiy Kruglyk, Director of Economic Department, Ministry of Foreign Affairs; Valeriy Pyatnitskiy, Senior Adviser, Office of the Vice Prime Minister/European Integration; and John Kun, U.S.–Ukraine Foundation.

16. United Nations Development Programme, Blue Ribbon Commission for Ukraine, *Proposals for the President: A New Wave of Reform*, 2005, at www.un.kiev.ua/brc/report_e/brcreport040305eng.pdf (July 7, 2005).

17. Interfax-Ukraine, "Ukraine Parliament Votes to Make Bailiffs Independent of Justice Ministry," June 23, 2005, quoted in *The Action Ukraine Report* No. 515, July 5, 2005.

The government should complete, by the end of 2005, negotiations for entry into the WTO.

On the U.S. side, the Bush Administration should:

- **Promote Ukraine's integration into the global economy.** The Bush Administration should ask Congress to exempt Ukraine from the Jackson–Vanik Amendment.¹⁸ The amendment was proposed and enforced against the Soviet Union for a different purpose, and U.S.–Ukraine relations have changed radically since the collapse of the Soviet Union.

The Bush Administration should also support Ukraine's bid to join the WTO and achieve market economy status, provided all U.S. concerns are resolved. The recent arrival of the U.S. government interagency delegation to Ukraine—which has been holding a series of meetings with top Ukrainian officials on Ukraine's European and WTO integration, its market economy status, safety of the Chernobyl nuclear power plant, and HIV/AIDS—is an encouraging step forward.¹⁹

Conclusion

Despite time lost since the beginning of this year, it is not too late to relaunch the effort to put Ukraine on the road to economic reform, increased domestic and foreign investment, and prosperity.

This effort will require bold leadership, commitment to economic freedom, and qualitative improvement in the rule of law and protection of property rights. If done right, U.S.–Ukrainian cooperation on economic policy will greatly benefit the peoples of both countries.

The Yushchenko Administration needs to start speaking with one voice and taking the necessary steps to make Ukraine as competitive and attractive as its Central European and Baltic neighbors. Anything less will be a huge disservice to the people of Ukraine who won and celebrated their freedom in Independence Square at the end of 2004. They deserve not just political liberty, but also economic freedom. The U.S. should continue to help and support Ukraine in this quest.

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18. The Jackson–Vanik Amendment denies normal trade relations to certain countries with non-market economies that restrict emigration rights. It was originally targeted at the Soviet Union. See Wikipedia, s.v. “Jackson–Vanik Amendment,” at en.wikipedia.org/wiki/Jackson-Vanik_amendment (July 7, 2005).

19. E. Morgan Williams, “Top US Government Interagency Delegation Arrives in Ukraine for a Series of Important Meetings,” *The Action Ukraine Report* No. 516, July 6, 2005.