Context

2016 will be the decisive year for determining the fate of reforms in Ukraine.

Firstly, in the winter of 2015-2016, the population is going to bear the price of the absence of reforms in the past, primarily through the gas price hike. Secondly, the main efforts to reach fiscal consolidation are going to take place in 2016 – the public finance deficit will have to decrease from 15% of GDP to less than 4% of GDP. Thirdly, the solid foundation for economic growth has to be laid – the Ukrainian economy rolled back to its 2003 level and the Russian aggression is not the only cause.

In order to regain the trust of Ukrainians, the government has to demonstrate resoluteness and unity. The lack of the decisive breakthrough in the introduction of reforms will lead to laucnhing again the inflation and devaluation spiral, further fall in business activity and its flight into the "shadow", sharp decrease in the quality of life and hence the rising influence of populist politicians. The main threat consists in the return of Ukraine to the old system (based on corruption, rent seeking and oligarchs) and the long-term stagnation of the economy.

There are two primary requirements the Ukrainian state has to meet in order to transform itself successfully; otherwise, no efforts will be sufficient and all successes and achievements will not become irreversible. These are macroeconomic stabilization and the restoration of the rule of law.

Our working group has focused on achieving macroeconomic stability. At the same time, we believe Ukraine will not be able to become a modern economy, based on private initiative, without the establishment of the rule of law. The only way to restore the public trust in law and judicial system is to take decisive and consistent steps aimed at fighting corruption, creating independent and impartial courts, ensuring the equality before the law for everyone, and transforming the Prosecutor's Office and the Ministry of Internal Affairs into modern law enforcement agencies. If the situation does not change in the coming months, the reformers will lose public support.

Macroeconomic stabilization requires coordinated government actions in fiscal and monetary policymaking. The IMF program is generally aimed at achieving these goals, and its implementation will enable the Ukrainian economy to gain a solid foundation for the future.

At the same time, it is very important not to underestimate the risk of recurrence of the finanical meltdown such as that Ukraine witnessed in February 2015. Back then, the insufficient efforts to push reforms forward led to the acute financial and currency crises. In order to successfully implement the IMF program, the government has to set goals that are more ambitious than those stipulated by the IMF.

Having carefully assessed the economic situation in Ukraine the Working Group presents the following recommendations concerning eight key areas of reforms.

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Executive summary

A position of “the leader of reforms” should be set up within the government. This should be the First Deputy Prime Minister with the mandate to make necessary decisions about the content of reforms. He/she has to have trust of President and Prime Minister. He/she has to have vision, will and courage to propose, impose, implement and communicate necessary reform measures.

A unit in charge of coordinating the reforms has to be created within the government.

Coalition leaders have to rearrange coalition cooperation rules to improve significantly the unacceptably low rate of the government legislative proposals passed in Rada.

The National Bank of Ukraine has to prove its independence and ability to withstand political pressure. Support of central bank’s serious commitment to monetary and banking stability by the government must be laud and public.

After achieving fiscal consolidation, the NBU has to immediately lift all currency controls that contradict Article 8 of the Articles of Agreement of the IMF.

In 2016, the consolidated general government deficit in Ukraine will have to decrease from 15% of GDP to 4% of GDP. At the same time, there is an intention and need to adopt a new tax system from the beginning of 2016 that is based on reduction of the overall tax burden, especially taxation on labor. It is very important to achieve political agreement on such a type of tax reform that will change today's unsustainable, unjust and deformed tax system while not threatening the very hardly achieved but still fragile macroeconomic stability. Significant tax rates reduction can be done only after reducing public expenditures, otherwise fiscal and monetary turmoil will return.

Concerning the revenues, in addition to the IMF program measures we recommend to eliminate all special rates, deductions, exemptions in all direct and indirect taxes (including VAT and payroll taxes); to keep special simplified and preferential taxation only for really small entrepreneurs–self-employers; to pass the law on obligatory registration of property.

Concerning public expenditures, we recommend to keep them on the same nominal level in 2016 as in 2015; to stop funding all institutions that are not necessary and inevitable for the public interest and provision of public services; cutting subsidies to state owned companies (and sell them fast), bringing forward the schedule of adjusting retail tariffs for natural gas and district heating that should be completed in April 2016 at the latest (instead of April 2017 as scheduled now). It could be beneficial to offer a bonus or payout (in percentage of savings) to civil servants, other individuals, groups of individuals or even commercial firms, who can suggest an effective budgetary cuts and savings. The bonus is to be paid when their recommendations are really implemented.

We propose to dissolve special extra-budgetary state funds and remove all their resources that are necessary for financing public expenditures to the state budget. We also propose elimination of government’s guarantees for loans to state owned enterprises as well as other entities.

Concerning deficit financing we recommend to establish a reserve fund which would accumulate privatization proceeds, foreign state grants and budget support loans of the World Bank. The fund could then be used to compensate for the fall in the budget revenues due to the decrease of tax rates. We also recommend to set up a single coordination agency responsible for working with decentralized projects of international financial organizations and official donors as well as to develop the country's own vision of the World Bank Strategy in Ukraine for 2016-2019 with the aim of creating an annual project portfolio of $4-5 bln.

Increasing confidence in the fiscal policy requires establishing stable rules for the budgeting process and new tax legislation. In particular, after stabilizing public revenues and expenditures at a lower level (about 37% of GDP in 2017-2018 compared to 52.7% of GDP in 2014), it will be necessary to impose strict limits on tax rate hikes or the introduction of new taxes and on the increases in expenditures and size of fiscal deficit.

Speeding up privatization process is an inevitable precondition for reform success in Ukraine. The government should select the group of large and potentially attractive enterprises to be sold relatively quickly, i.e., by the end of 2016, in a maximally open and transparent manner with no restrictions for foreign investors and based mainly on the price criterion.

It is necessary to introduce the single set of guidelines for means testing related to provision of all kinds of social benefits.

Civil service reform should ensure that only competent and well-compensated civil servants remain in office. The principle of clear responsibility and competency has to be accepted. It is necessary to increase the powers of ministries and other central executive agencies to manage resources allocated to them. This can be achieved by granting them the right to reduce the number of employees, while keeping the remuneration fund unchanged, and to establish a performance based bonus scheme.

In order to allow for effective downsizing of government sector, all extraordinary employment guarantees for civil servants and safety of their jobs should be eliminated. Freedom to choose his/her employees and freedom to use the remuneration fund should be left to the managers at each level of management.

Recommendations

Reform Process

1.1 The position of the «leader of reforms» has to be established within the government. This should be the First Deputy Prime Minister with the mandate to decide on the content of reforms.

This person should have the following characteristics:

He/she has to have the trust of President and Prime Minister

He/she has to have vision, will and courage to propose, impose, implement and communicate necessary reform measures.

1.2 President and Prime Minister are too busy to take part in working meetings where alternatives are discussed and best solutions are searched for. Their main task is to provide political leadership, PR- and GR-support of reforms in the parliament, media, and within society at large.

1.3 A unit in charge of coordinating the reforms has to be created within the government.

1.4 The position of the Deputy Prime Minister in charge of euro-integration has to be established within the government. He/she will, first of all, coordinate the euro-integration related activities of all the government agencies, secondly, engage in continuous dialogue with European and US political and lobbying groups to gain their support for reforms, thirdly, define the strategic goals of reforming political institutions and legislation in order to bring them closer to the European standards.

1.5 Hiring a good PR company to manage the public relations activities (inside and outside of Ukraine) of the whole reform process should be considered.

1.6 Coalition leaders have to rearrange coalition cooperation rules to significantly improve the unacceptably low rate of the government legislative proposals passed in Rada (only 36% during the first 9 months of the new government).

1.7 The communication of reforms cannot be successful and credible if any coalition party leader fights against reform measures. For that case coalition rules have to have respective procedures, otherwise all the reform effort will remain hopeless.

Monetary Policy

The National Bank of Ukraine has to prove its independence and ability to withstand political pressure. The main goal is to restore public confidence in the Ukrainian monetary authority.

In addition to the IMF program measures, we recommend:

2.1 To analyze the influence of the NBU's interest rate on limiting the demand for credit, to formulate its own position regarding the relation between the interest rate and the NBU's inflation expectations

2.2 To create a toolbox for prompt money liquidity management, which would enable the NBU to make good use of the interest rate policy (exchange market for the NBU deposit instruments and government bonds).

2.3 Support of central bank's serious commitment to monetary and banking stability by the government must be laud and public. This will help the cause itself as well as the central bank, because society will understand that fight against inflation and better banking supervision are seriously supported by the government.

Foreign Exchange Control

We recommend:

3.1 To coordinate with the IMF and then publish the conditions and main measures aimed at the foreign exchange regime liberalization (without taking on rigid commitments), which should be implemented within the next 6-12 months and should provide for elimination of the majority of the 1993 Currency Decree provisions. The Letter of Intent contains such conditions, yet the list is far from exhaustive and is not communicated within the country.

3.2 Alternatively, the immediate elimination of all current account controls that contradict Article 8 of the Articles of Agreement of the IMF could be considered.

International experience demonstrates that such restrictions are of limited effectiveness to protect balance-of-payments equilibrium while they are highly damaging for business activity, especially small and medium-size enterprises. They also discourage foreign investors and stimulate keeping capital offshore. Tightening fiscal policy and ensuring prudent monetary policy (without central bank's direct or indirect support to the government, distressed banks or large enterprises) should be sufficient to entrust confidence to hryvna and make administrative restrictions on foreign currency purchases redundant.

Fiscal Policy

In 2016, Ukraine will have to provide a far-going the tough consolidation of public finances: while this year the consolidated general government deficit (budget + Naftogaz + bank capitalization + Deposit Guarantee Fund) could reach about 15% of GDP, the target for 2016 is less than 4%.

This task is complicated by the necessity to implement the tax reform, aimed at decreasing the high payroll tax. The tax reform has to be based on the principles of simplicity, neutrality, efficiency, justice and solidarity and it has to be fiscally sustainable.

Under such circumstances, maintaining macroeconomic stability requires both an increase in budget revenues and a decrease in expenditures.

Concerning revenues, in addition to the measures stipulated by the IMF program we recommend:

4.1 To conduct a comprehensive review of the tax system and eliminate all special rates, deductions, exemptions in all direct and indirect taxes (including VAT and payroll taxes). Apart from providing immediate fiscal gains such an operation can simplify the tax system and tax administration, decrease corruption in State Fiscal Administration, and perhaps create fiscal room for decreasing basic tax rates (especially of direct taxes) but without endangering fiscal sustainability.

4.2 To keep special simplified and preferential taxation only for really small entrepreneurs –self-employers, today's system that is massively misused has to be modified.

4.3 In order to strengthen municipal finances to pass the law on obligatory registrations of real estate property.

Concerning expenditures:

4.4 Keep nominal budget expenditures in 2016 unchanged from 2015. This needs to be done because of disappearance of one-off revenues, which play an imporant role in 2015 (NBU profit transfer and import surcharge), which will offset the planned increase in tax revenues in 2016.

4.5 Stop transfers to all institutions that are not necessary and inevitable for the public interest and provision of public services. For example, there are many "research institutions" that are not doing real research. In Latvia a significant part of public institutions was simply closed down during 2009 crisis. In many cases, it is not necessary to close down an institution itself; it is enough to cut public funding. If the institution is worth anything, it will survive by offering its output on the market.

4.6 To bring forward the schedule of adjusting retail tariffs for natural gas and district heating that should be completed in April 2016 at the latest (instead of April 2017 as scheduled now). Beyond obvious fiscal gains in 2016 budget such a measure would eliminate the socially unjust model when high-income people receive much more subsidies due to energy price regulation in comparison with low-income people, urban people much more than rural population. It also would offer a broad spectrum of other benefits:

a. acceleration of Naftogaz's restructuring (its demonopolization and spin-off of production, transportation, storage and sales units) and reform of the entire energy sector. This is virtually impossible without termination of the energy subsidies;

b. introduction of hard budget constraints (payment discipline) in the entire chain of energy production, transportation, distribution and consumption;

c. fighting corruption in the energy sector;

d. improving incentives for domestic gas and energy production;

e. decreasing the dependence on gas imports from Russia;

f. minimizing political costs of tariffs adjustment (one increase instead of two)

4.7 Cut subsidies to state owned companies and sell them fast. There were about $500 mn. of subsidies to only 30 biggest SOEs in 2014.

4.8 Eliminate the system of provision of state guaranties.

4.9 The government should repeatedly and publicly stress the necessity of reductions of budgetary spending. Expenditure cuts should be associated with the reduction of inflation and the overall tax level.

4.10 It could be beneficial to offer a bonus or payout (in percentage of savings) to civil servants, other individuals, groups of individuals or even commercial firms, who can suggest an effective budgetary cuts and savings. The bonus is to be paid when their recommendations are really implemented. It could help a lot, if the society at large could be made a partner in attempt to reduce government spending, as we already know that special interest groups will fiercely resist.

4.11 See also 7.1-7.7, 8.1-8.2

In order to finance the fiscal deficit we recommend:

4.12 To establish a reserve fund financed with privatization proceeds, foreign state grants and budget support loans of the World Bank, which could be then used to compensate for the fall in revenues due to tax rates decrease.

4.13 To set up a single coordination agency (outside the government) responsible for working with decentralized projects of international financial organizations and official donors with the aim to substantially increase absorption of available resources;

4.14 To develop the country's own vision of the World Bank Strategy in Ukraine for 2016-2019 with the aim of creating a portfolio of projects worth $4-5 bn annually, no less than 30% of which would come in the form of budget support loans.

Budgeting

It is impossible to increase confidence in fiscal policy without firmly establishing strict rules regulating budgeting process and new fiscal legislation.

5.1 After balancing public revenues and expenditures at a lower level (about 37% of GDP in 2017-2018 compared to 52.7% in 2014), strict limits should be imposed on tax rate increases or the introduction of new taxes as well as on the increases in expenditures and public finance deficit size.

5.2 Position of the Government in relation to Parliament as well as position of the Ministry of Finance in relation to sectoral ministries has to be strengthened in the budgetary process.

5.3 Macroeconomic and tax forecasts (for preparing a budget) has to become a matter of professional expertise instead of negotiations in the Parliament. Government and Parliament should than decide on the level of overall expenditures (professional estimate of revenues + deficit /or – surplus/) and structure of these expenditures.

5.4 Planning and execution of the entire public sector (general government) budgets, not only state budget.

Privatization and SOE reform

Speeding up the privatization process is a key precondition for reform success in Ukraine. Today's SOE sector is a source of corruption (including political corruption), rent seeking and illegal incomes of oligarchs and SOE managers, cause of fiscal deficit (in 2014 only 30 biggest SOEs overall financial position was minus 5 billion USD); huge assets are frozen in non-functioning SOE.

6.1 It is necessary to accelerate privatization of small and medium enterprises and minority stakes in large companies. This could be done by transferring all these assets to the State Property Fund for an immediate sell-off. Alternatively, the responsibility for current management of those SOEs can be transferred to managing companies (selected on a competitive basis) with obligation to sell them in the defined period of time, thus freeing the ministries and agencies from operational management.

6.2 Acceleration of privatization process should focus not only on decreasing the number of enterprises remaining in state ownership but also on providing fiscal gains in a near future (proceeds from privatization decrease public sector borrowing requirements and net public debt). This would require selecting the group of large and potentially attractive enterprises to be sold relatively quickly, i.e., by the end of 2016, in a maximally open and transparent manner with no restrictions for foreign investors and based mainly on the price criterion. The potential argument that this is not the best time to sell state-owned assets for a good price (due to the slowdown in emerging-market economies and high perception of security risks in Ukraine) must be confronted with the opportunity costs of preserving the status quo. Acceleration of privatization, apart from direct fiscal gains, will improve Ukraine's international business image, reduce subsidies, increase profitability of privatized enterprises (and their ability to pay taxes), reduce corruption and ability of oligarchs to extract rent coming from special relations or partial ownership in those enterprises.

6.3 Establish the unified system of managing large enterprises (the 1st group in Appendix 2), envisaging the establishment of Boards of Directors, where the majority will be formed by independent directors, selected on a competitive basis. Boards of Directors, formed according to new principles, will be endowed with the responsibility to determine corporate strategy and appoint CEOs.

6.4 For a more detailed plan see Appendix 2.

Social Policy

It is necessary to concentrate social protection on the neediest. For this we recommend:

7.1 To revise eligibility and tighten income and wealth criteria the provision of social benefits to the victims of Chernobyl disaster, compensations related to higher natural gas and district heating tariffs, family benefits, etc;

7.2 To introduce the single set of guidelines for means testing related to provision of all kinds of social benefits.

7.3 To introduce means testing for beneficiaries of state-funded healthcare.

7.4 To introduce means testing for beneficiaries of state-funded higher education.

7.5 To transfer all the social benefits from the Pension Fund budget to the Ministry of Social Policy budget

7.6 To tighten criteria for granting disability pensions, to re-examine the already granted benefits, transfer the responsibility for establishing the system of medical commissions in charge of disability verification to the Pension Fund (see Appendix 1 for details).

7.7 Merge the Pension Fund and the Social Insurance Fund.

Civil Service Reform

Civil service reform should ensure that only competent and well compensated civil servants remain in office. It will mean serious downsizing in numbers of the civil service employees. The principle of clear responsibility and competency has to be accepted.

It is necessary to expand the powers of ministries and central executive agencies to manage their resources:

8.1 Only Minister has to have the right and responsibility to appoint (and also to fire) his direct deputies or directors of Agencies or Offices under his / her hierarchy and competency. As well as Deputy Minister has to have the right and competency to appoint his / her direct subordinates. Freedom to choose his/her employees and freedom to use the remuneration fund should be left to the managers at each level of management. Perhaps, to keep some safeguards, the managers must be obliged to get approval from their superiors, one level above, before making major employment and compensation related decisions;

8.2. Ministers (central executive agencies CEOs) should be granted the right to reduce the number of employees, without decreasing the remuneration fund, and the permission to establish a performance-based bonus scheme.

8.3 The managers at each level must be allowed to grant (within the defined remuneration fund limits) considerable bonuses and salary increases to the best performing employees; salary/bonus of the manager himself must be decided by higher-level manager, following the same general guidelines;

8.4 In order to allow for effective downsizing of government sector, employment safety guarantees for civil servants should be significantly reduced;

8.5 It is necessary to empower central executive agencies and the Pension Fund with the roght to close down/establish their territorial units (currently only the government has the right to do that).

APPENDIX 1
Pension reform

It is necessary to discuss and decide on the directions of the pension system reform, including the comprehensive reform of the first (PAYG) pillar of the pension system, which will possibly focus, in particular, on:

• transition from the defined benefit to defined contribution scheme of the PAYG pillar (which, by definition, can ensure the Pension Fund balance in long-term);

• further elimination of various sectoral and professional privileges in terms of early retirement entitlements (including the right to retire based on a number of work years instead of age), higher benefits, more generous indexation schemes, etc. (it would lead to increase of the effective retirement age, which is still one of the lowest in Europe);

• increasing the minimum number of years entitling to receive minimum pension (minimum subsistence level);

• further limitations on the right to receive pension benefits for pensioners who continue employment;

• taking in advance decision and determine schedule of further increase in the statutory retirement age after 2021 (up to 65 for both women and men at 2030).

The suggested measures should allow not only stop increasing (and, in the nearest future – decrease) public pension expenditure (one of the highest in Europe and in the world) but also make pension system more socially and economically fair as well as eliminate various pathologies and sources of corruption (for example, in granting disability pensions). In particular, they would:

a. increase incentives to pay pension contributions and limit free-riding behavior;

b. create economic incentives to work longer (through stronger link between contribution and benefit):

c. create fiscal room for full price indexation of pension benefits and, therefore, eliminate discrimination against pensions granted in previous years (the so-called ‘old portfolio’);

d. limit shadow economy and shadow employment.

Working closely with international experts (World Bank) and academic circles on pension reform design could prove very helpful. Perhaps, a public tender can be announced, asking for best proposals from general public and organized groups. Even if it will not produce tangible results, society and academia will feel engaged.

APPENDIX 2
Privatization

Ukraine has 3350 SOEs, only 1833 of them being operational; the rest is non-functioning.

Privatization has to be speeded up by following process:

As soon as possible all SOEs should be divided into 5 groups:

1. Companies that will remain in state ownership (natural monopolies or companies that have strategic importance for some reasons). The law decreasing the number of state companies that are not to be privatized (the draft law No 1567) has to be passed by the parliament as soon as possible.

2. Big, important and strategic companies that will be privatized but have to be restructured prior to privatization (for instance big energy companies that need to be unbundled into production, transit and distribution units before privatization)

3. Big and important companies that can be and will be privatized as fast as possible, i.e. by the end of 2016

4. Small and medium size operating enterprises

5. Non-functioning SOEs

The first group will remain in state ownership and there is necessity to change managers, to implement new corporate governance rules and create professionally strong supervisory boards that will decrease risk of rent seeking behavior and motivate companies to stay effective, transparent and profitable and to act in public interest.

For the second and third groups there is necessity to hire advisors as soon as possible, for the second group for restructuring and then privatization, for the third group - for privatization. Privatization of companies belonging to these two groups has to be transparent and professional, hence experienced foreign advisors are inevitable for that. Hiring advisors takes usually at least a few months (if process is transparent and competitive) and then restructuring of a big company takes at least one year as well as privatization of this kind of company. Therefore, if the process will not start in coming months, we cannot expect visible results within the current political cycle.

For the fourth group privatization process can be started immediately by public auctions with only criterion – price. The list of privatized companies has to be broadly published and companies should be sold with all liabilities and receivables. All information about a company will be available for any potential buyer. Then public auction with the only criterion of price will offer clear and transparent competitive conditions for buyers.

For the fifth group also public auctions with price as the only criterion will be organized but in this case only physical assets of companies will be sold. It will be selling of assets by liquidation.

In the groups 2, 3, and 4 privatization proceeds will go to the state budget, in the group 5 - to repay creditors (usually only partially).