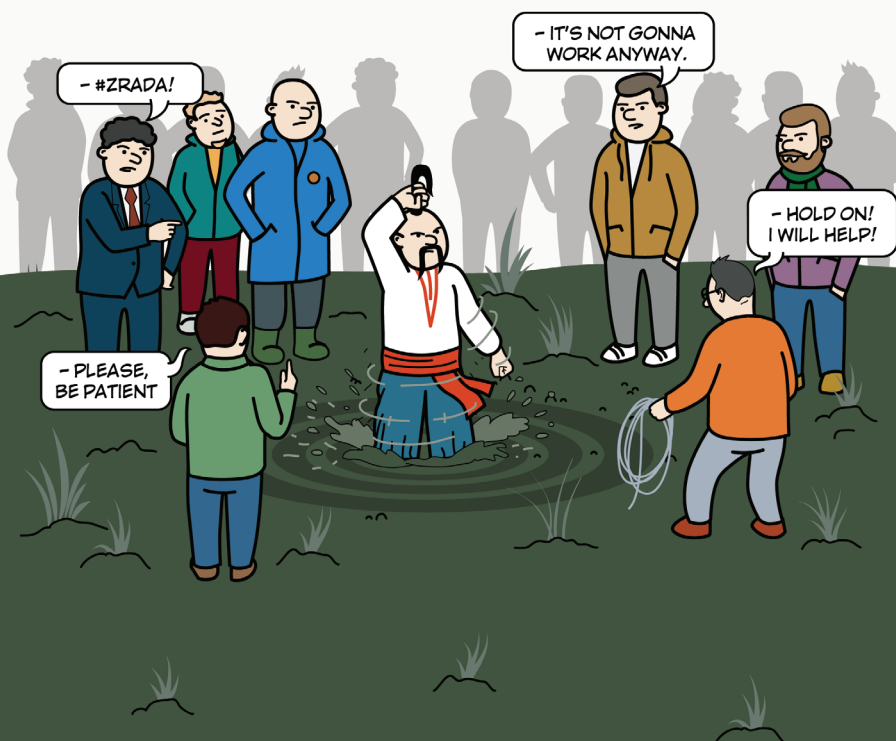


**WHITE BOOK
ON
REFORMS**

Kyiv School of Economics (KSE), founded in 1996, is a world-class academic institution with a reputation for excellence both in Ukraine and internationally. KSE offers programs in Economics, Management and Public Administration, educating the future generation of world-class economists, business leaders and policy-makers. In doing so, it helps to improve the economic, business and policymaking environments of Ukraine and its neighbouring countries.

“Ukraine Economy Week: People. Finance. Innovations” is a series of events organized by the Kyiv School of Economics jointly with ICU. The week is centered around two conferences - International Academic Conference “People Matter: Quality of Life and Wellbeing of Individuals, Families and Communities in Post-Transition Economies” in Kyiv and Ukrainian Financial Forum in Odesa.

Introduction



During the last four years, was Ukraine reforming or was it mostly talking about reforms? This paper provides food for reflection rather than a straightforward answer to this question. But before digging into the subject let's establish the definition.

What is 'a reform'? A famous 2014 survey¹ showed that over a half of Ukrainians thought that 'reforms' mean raising salaries and pensions, and 26 percent believed that it is nationalization of oligarchs' property.

Oxford dictionary defines² 'reform' as *the action or process of changing an institution or practice **in order to improve it***. We agree with this definition and believe that this is exactly what Ukraine needs.

Institutions are important³ since they shape social and economic interactions. Sound institutions create correct incentives on the micro level – so that overall economic efficiency is improved.

Sustainable economic growth cannot be expected if production is less profitable than extortion and lying dominates telling the truth. Thus, 'good' institutions encourage honest business practices and minimize expected gain from rent-seeking or fraud.

Current Ukrainian institutions do this job rather poorly, which should be expected – one cannot reform in a few years what had been cemented for decades, if not centuries. However, we do see important changes – at the central bank (page 9), in public procurement (page 23), energy sector (page 35), on the level of local government (page 13). These reforms allowed to stabilize macroeconomic situation and considerably improve public finance management. Meanwhile, state assets are still poorly managed (page 29), and in the case of land (page 43) the regu-

¹ See publication in Dzerkalo Tyzhnia: <https://dt.ua/ECONOMICS/ukrayinci-plu-tayut-reformi-z-populizmom-politikiv-opituvannya-160351.html>

² <https://en.oxforddictionaries.com/definition/reform>

³ See Acemoglu, Daron, and James A Robinson (2012). *Why Nations Fail: The Origins of Power, Prosperity and Poverty*. 1st ed. New York: Crown, 529.

lation prevents efficient allocation not only of state-owned but also of privately-owned asset.

This paper focuses on economic reforms but we keep in mind that necessary prerequisites for their success are (1) civil service reform – so that 'rules of the game' are developed wisely; and (2) judicial reform – to ensure that these rules are enforced. As for now, the progress in these spheres is very modest, which hinders potential effect of more advanced changes.

The most important reforms – our investment into the future – also lag behind (pages 49, 55, 59).

With the help of civil society and international partners, Ukraine struggles to get rid of its largest “twin troubles” that inhibit business development and constrain economic growth – excessive regulation (page 19) and corruption (page 65). Reforms in these spheres progress very slowly,⁴ which is to be expected – too many people do not want to leave their cozy workplaces where they have to do little apart from collecting rents. Outside of these workplaces they are not competitive since they do not have relevant qualifications. Thus, a vicious circle of corruption and incompetence is formed.

For example, think of a low qualified person who works at a poorly paid but rich in rent-seeking opportunities position with the government. Since she cannot find a higher or even equally paid job elsewhere, this person will use all means to preserve her position, including bribing of a higher-level official. If her efforts are successful, more honest and competent people will be effectively prevented from entering this government office.

Likewise, imagine a firm that produces some gadgets and can lobby for a legislative ban on imports of similar goods. Then, instead of investing into functionality, design and creative ways to sell its product, this firm will bribe authorities to preserve the ban.

⁴ In fact, the anti-corruption component is “hidden” within all other reforms – health-care, education, SOE etc. Probably, one can guess the depth of corruption in a sector by the strength of opposition to a relevant reform.

It is clear that very soon both the person and the firm from our examples will devolve in the same way as Zoo animals lose their hunting skills.

Thus, the speed of reforms largely depends on the answer to the question “What do we do with all those people – government employees fired when an unnecessary state function is cut, workers laid off when an uncompetitive Soviet era plant is modernized or shut down, professors dismissed from a university which has not attracted enough students etc.? Can we offer some win-win solution or at least sweeten the pill for them?”

There is no quick and easy answer to this question. In fact, this question is a part of a bigger problem – gradual erosion of Ukraine's competitive advantages, the main of which are (1) geographical position (proximity to the EU), (2) natural resources (including the black soil), and (3) human capital (educated and comparatively cheap labor force).

Geographical position is useless without infrastructure – which is obsolete and quickly depreciating. Modern technologies make resource endowment of a country ever less relevant. But most importantly, the quality of Ukrainian education system is low and falling. It does not equip⁵ graduates with skills and knowledge required by modern labour market,⁶ and in the absence of opportunities for lifetime learning skills of current workers quickly become outdated. Thus, Ukraine risks losing its human capital advantage faster than the other two.

Today, the primary task for Ukraine is establishment of high quality life-long education system – from pre-school and primary school to postgraduate education and career training. If we start working on it today, then maybe in a few decades the majority of people will know that 'reforms' mean enhancement of institutions rather than anything else.

⁵ Certainly, one can find examples of very highly qualified graduates of Ukrainian universities, but we are talking about the general situation here.

⁶ See the Worldbank (2017) report "Skills for a modern Ukraine" by Ximena Del Carpio, Olga Kupets, Noël Muller, and Anna Olefir

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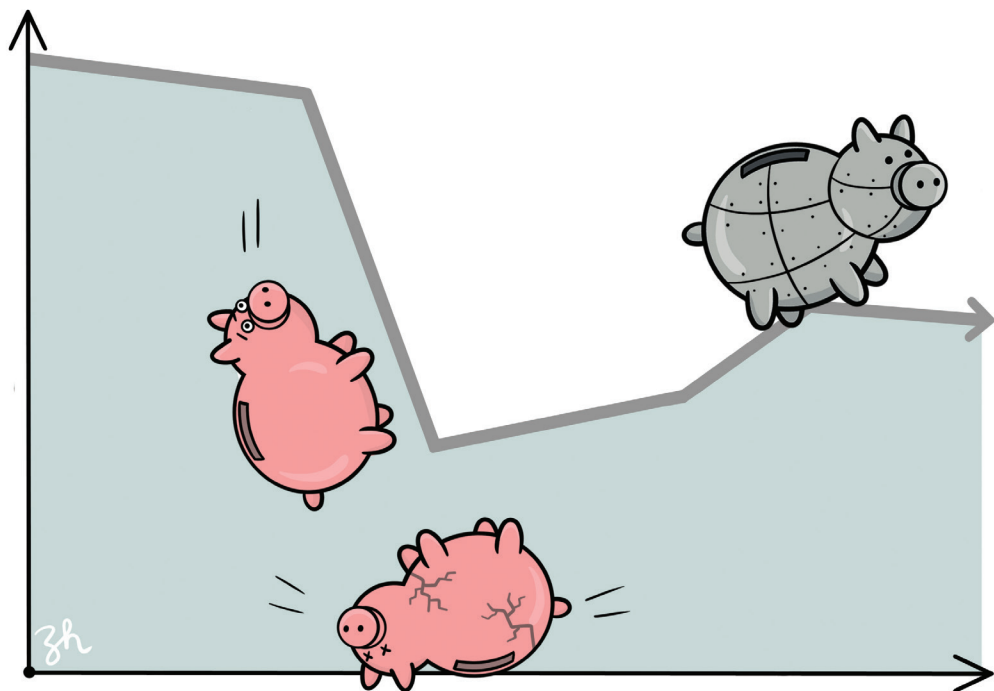
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Chapter 1.

Banking sector and the National Bank of Ukraine



The National Bank of Ukraine (NBU) and the entire banking system entered 2014 in a poor shape. Although the Revolution of Dignity and the war in Eastern Ukraine exacerbated perennial ills of the Ukrainian economy and the financial industry, the economy was already in bad health. For example, the current account deficit reached approximately 10 percent of GDP at the end of 2013, which reflected a grossly overvalued hryvnia. While inflation was relatively low, it was not a sign of a well-functioning economy; instead, it was an omen of a coming contraction.

The banking sector had not really recovered from the Global Financial Crisis of 2007-2008 and many banks were plagued not only by large portfolios of non-performing loans but also by pervasive related-party lending. Finally, the leadership of the central bank lacked competence and was perceived as corrupt. Thus, the new team at the helm of the NBU had to clean the Augean stables in most difficult circumstances.

The key reforms at the NBU can be put into three groups.

The first group of new policies focused on ensuring macroeconomic stability. A key element in this group is the change of policy regime from fixed exchange rate to inflation targeting. In a nutshell, this reform means that the central bank concentrates on maintaining stable and low inflation and adjusts interest rates and other policy instruments to ensure that this target is met. In this new regime, the exchange rate is floating and the central bank intervenes in FX market only occasionally. Because the exchange rate is determined by market forces, the economy has a better ability to absorb shocks to prices of Ukrainian imports and exports, which is a very important consideration given that prices for Ukrainian imports (e.g. oil and natural gas) and exports (e.g. steel and grain) are highly volatile.

Another key element of this group is implementation of new macroprudential policies to limit related-party lending and to ensure sufficient bank capital. This block of reforms effectively required banks to restructure their loan portfolios and to raise more capital. Doing so is difficult in the best of times but challenging macroeconomic conditions and poor management at the bank level made this task impossible for many financial institutions. As a result, these banks were declared bankrupt and left the market. The largest private bank had to be nationalized by the government and the NBU played a critical role in ensuring a smooth transition of ownership. Today the NBU works on implementation of Basel III banking supervision standards.

The second group of new policies focused on improving governance in the NBU. Apart from attracting top talent to lead the bank, the new management team restructured operations of the bank to remove activities that were not core to its mission (e.g. the bank used to own and manage resorts, a clinic, a university etc.). The bank also changed its organizational structure to emulate best practices and to minimize corruption risks. For example, policy decisions are now made by committees rather than unilaterally by a single official. Furthermore, appointments of top management are staggered to reduce the risk of political capture. More generally, the NBU has increased its political independence not only via legislative process but also by actively combatting requests for political favors (e.g. generating greater seniorage revenue for the government). To further build its institutional capacity, the NBU actively invests into hiring highly qualified staff, creating a research department, and organizing conferences and other events to integrate the bank into the international community.

The third group of policies is mainly about transparency and communication strategy of the NBU. Compared to oth-

er central banks, the NBU used to be a relatively secretive organization. The process of policy making was not publicly known, future policy steps were not explained or announced in advance, the management of the bank rarely appeared in mass media. This previous practice limited the effectiveness of the bank and undermined its credibility as an institution acting in public interest.

Following best practices, the NBU now publishes its calendar of policy meetings, quickly announces decisions, and makes significant effort to communicate policy to the public. This new outreach approach reinforces the first two groups of reforms. For example, effective inflation targeting requires management of inflation expectations and hence proactive communication of the bank's policies. To this end, the NBU started publishing its "Inflation Report" to not only report inflation dynamics but also provide analysis of factors moving inflation and rationale for policy steps.

It is remarkable how much progress has been made in the course of the last three years both in the banking sector and within the NBU. The effect of these reforms will be felt at many levels by Ukrainians of all walks. Indeed, one may expect further reduction in inflation and interest rates, growing credit, and macroeconomic stability. All of these factors should stimulate economic growth. However, the NBU remains potentially vulnerable to political pressures. All Ukrainians should guard the central bank's achievements and independence.

Chapter 2.

Taxation and fiscal decentralization



By 'Paying Taxes' indicator of the Doing Business ranking, Ukraine moved from the 164th place in 2014 to the 84th place in 2017 –because the number of tax payments per year was cut from 28 to 5, time for compliance reduced from 390 to 356 hours per annum, and overall tax burden decreased from 59.4% to 51.9% of profit.

In early 2015, a package of laws⁷ aimed at expansion of the tax base and simultaneous reduction the tax burden was passed. The main changes introduced by these laws were as follows:

- 1) The number of taxes reduced from 22 to 9;
- 2) An experiment with reduced rate of Single Social Contribution (SSC) for eligible enterprises (in early 2016, SSC rate was cut from over 40% to 22% for all firms);
- 3) Electronic VAT refund (however, the single registry of VAT invoices was launched only in 2017);
- 4) A moratorium on tax inspections for small and medium-sized enterprises;
- 5) Mandatory use of cash registers for all business entities except for the smallest ones (this provision was never implemented);
- 6) In line with transition to the means-tested social support the list of categories of people entitled to privileges and the number of privileges were substantially cut.

A significant reduction of opportunities for corruption at VAT refund is a definite achievement of the tax reform. De-shadowing of wages expected as a result of SSC rate cut did not happen, hence the Pension Fund deficit increased from UAH 96.5 billion (4.9% of GDP) in 2015 to UAH 142.6 billion (6% of GDP) in 2016. The minimum wage was doubled in 2017 to force de-shadowing, which had both positive effects (increased SSC revenues), and

⁷ Amendments to the Tax Code: <http://zakon4.rada.gov.ua/laws/show/71-19>, amendments to the social insurance laws: <http://zakon4.rada.gov.ua/laws/show/77-19>, liquidation of numerous benefits: <http://zakon4.rada.gov.ua/laws/show/76-19>, law on transfer pricing: <http://zakon4.rada.gov.ua/laws/show/72-19>.

negative ones (higher cost for business and lower wage differentiation, especially in the public sector).

In late 2016, tax administration procedures were further simplified⁸. Among other, tax militia is being replaced with financial police.⁹

The simplified taxation system (STS) has become a “stumbling block” for the tax reform. Business community opposes STS reform, while international organizations, in particular, the IMF, call for liquidation of the simplified system. On the one hand, simplified taxation system significantly reduces compliance cost for small businesses and protects them from abuse by tax authorities. On the other hand, STS is very often used by big businesses to “optimize” taxation. Considerable differences between simplified and general taxation systems restrict enterprise growth.¹⁰ Thus, “complication” of the simplified taxation system should occur simultaneously with simplification of the general tax regime and reform of the State Fiscal Service.

Decentralization is one of the very first and most important reforms introduced by the government.¹¹ Its basic element was fiscal decentralization. At the end of 2014, the Budget Code was amended to introduce medical and educational subventions, redistribute taxes between budgets of different levels¹² and provide for direct relations of amalgamated territorial communities (ATCs) with the State Budget. Although the share of local bud-

⁸ <http://zakon3.rada.gov.ua/laws/show/1797-viii>

⁹ Draft law “On the financial police” (No. 4228) is being considered by the parliament.

¹⁰ Unwilling to switch to the general taxation system, small enterprises often grown-out “vertically” (small-medium-large), but “horizontally”, forming a network of small enterprises. This makes the system of ownership complicated and does not allow to attract loans or public resources for development.

¹¹ The concept of decentralization was approved as early as April 1, 2014. The reform has its own page on the governmental portal: <http://decentralization.gov.ua/>

¹² In particular, local budgets have become entitled to introduce property taxes, 10% of profit tax, part of excise duty on the sale of alcohol, tobacco and fuel, and, since 2017, part of the royalty from oil and gas extraction. At the same time, the share of personal income tax payable to the local budgets was cut from 90% to 60%.

gets in the total budget has barely changed,¹³ it is crucial that local authorities gained more freedom in deciding how to use these funds and, hence, more incentives to use them effectively.¹⁴ In addition, the new mechanism for redistribution of income between “poor” and “rich” territorial units provides local authorities with incentives to create favorable business environment on their territory.

As of end-2016, there were 414 ATCs in Ukraine. Not all representatives of local authorities are enthusiastic about the reform: both heads of “rich” villages that do not want to merge with “poor” ones and many of rayon officials¹⁵ (silently) block ATC formation, since eventually rayon administrative level should disappear.¹⁶ Moreover, people traditionally distrust central government initiatives, despite the fact that forming an ATC provides a lot of benefits, e.g. financing of infrastructure projects by the Regional Development Fund. Another problem is a deficit of human capital in the newly established ATCs. They lack competent people who could compile an investment projects and effectively manage a community budget. Finally, it is necessary to fine-tune the mechanisms for inter-budgetary settlements to ensure full and timely payment for services received by residents of one administrative unit at facilities of another unit.

¹³ 22% in revenues both in 2014 and 2016, 43% in expenditures in 2014 and 41% in 2016

¹⁴ However, at the moment, not all local authorities are able to use these funds wisely, which leads to considerable balances on their accounts at the Treasury (thus, in late 2016, the local authorities had 57 billion UAH of unused funds, of which 16 billion UAH were kept on bank deposits).

¹⁵ For example, in one district the communities transferred the medical subvention they received to the district level. In return, the district hospital committed itself to provide primary healthcare services to these communities (in the areas where the Primary Healthcare Centers are yet to be established, primary care facilities are run by district hospitals). However, the district authorities closed down the outpatient departments in the respective communities.

¹⁶ The communities that do not want to amalgamate voluntarily will sooner or later be forced to do so, as it happened, for example, in Poland. In the end, there will be three administrative levels: the central, the regional, and the community level.

To overcome these difficulties, more than twenty international projects work on the decentralization reform together with the government. They organize regular awareness campaigns and trainings for managers, social activists and community residents.

The ultimate goal of decentralization is not to bring about lots of local “kinglets” instead of the supreme “king”, but to levy the responsibility for development of a community (town, village, neighborhood) onto the residents of this community, engage them in everyday decision-making. This will lay the ground for emergence of a new type of politics in Ukraine where national level politicians will be ‘self-made’ people who achieved success at the local level rather than products of political technologies.

The decentralization reform will not be complete without Constitutional amendments¹⁷ that would clearly define the distribution of powers and areas of responsibility of central and local authorities. To day one of the most important questions is: *“What should be the responsibilities of a Ministry local office and what issues should be decided by local authorities?”* Unfortunately, this question is not in the agenda of a public discussion.

¹⁷ Draft constitutional amendments on decentralization (http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=55812) were preliminarily approved in August 2015, but the provisions on the “special status” of the occupied territories of Donetsk and Luhansk regions prevented their adoption as a whole.

Chapter 3. Deregulation

DOING BUSINESS IN UKRAINE



Since 2015, the Ukrainian government has been implementing deregulation reform under the objective of achieving the TOP 30 ranking in Doing Business by 2020.¹⁸ In Doing Business-2017 Ukraine ranks 80th up from 112th in 2014 –mainly due to the progress in the areas of starting a business, paying taxes and protecting rights of minority investors, despite worsening conditions for obtaining construction permits, getting credit, and contract enforcement. Still, Ukrainian regulatory environment is rather complicated, sometimes contradictory and preserves a lot of “relic” clauses that have no economic or common sense¹⁹ but increase compliance cost for business. Therefore, deregulation is one of the key economic growth reforms.

Between the two types of deregulation –radical, i.e. regulatory guillotine suggested by foreign experts, and selective deregulation – Ukrainian government has chosen the latter. Both approaches have advantages and disadvantages and international experience is mixed. Some countries, like Croatia, Macedonia and Armenia went through regulatory guillotine, the majority of countries adopted partial or selective deregulation.

Ukraine has made quite a few deregulatory steps²⁰ – halved the number of licenses, considerably reduced the number of certificates, simplified tax administration,²¹ imports and exports of services. Other important deregulation measures include outsourcing of registration services from the Ministry of Justice to local governments and private sector, and launching of

¹⁸ According to the Ukraine-2020 Strategy approved by a President's Decree #5/2015 of 12.01.2015 <http://zakon3.rada.gov.ua/laws/show/5/2015>

¹⁹ As a prominent example, regulation of prices on certain products in Ukraine was finally cancelled only in mid-2017, while in other transition countries price liberalization was a key element of the package of initial market reforms. Other examples –a number of Soviet-time sanitary norms and standards (not used anymore) were cancelled in 2015-2016.

²⁰ One of the most important documents for deregulation bringing Ukrainian legislation in line with the EU legislation is the Cabinet of Ministers Resolution #42, ‘On Some Issues of Business Deregulation’ which came into effect on February 11th, 2015.

²¹ <http://zakon3.rada.gov.ua/laws/show/1797-viii> and <http://zakon4.rada.gov.ua/laws/show/655-viii>

MinJust online service (simultaneously with opening registries) which greatly simplified registering property rights for business and real estate.

In August 2016, the Cabinet of Ministers of Ukraine approved the updated Action Plan for Deregulation of Economic Activities²² in Ukraine for 2016-2017. Action Plan sets a number of objectives to improve and simplify the regulatory environment in such strategic areas as agriculture, construction, oil and gas and mineral resources, power, information technology and telecommunications, food industry.

Overall, 112 measures in 11 sections are foreseen in the Plan. They are aimed at simplifying procedural business issues, in particular, administrative procedures and procedures of state supervision (control) for regulation of economic activity, expansion of opportunities for business to participate in the provision of public services, simplification of customs, tax regulation etc. These measures are expected to reduce the regulatory burden and improve the business environment in Ukraine.

The State Regulatory Service of Ukraine (DRSU) is responsible for coordination of the implementation of the Action Plan. In particular, every month all government bodies mentioned in the Plan have to submit reports to the DRSU on implementation of the measures for which they are responsible.

As of end-July 2017, out of 112 measures foreseen in the Plan 38 were implemented, 28 were under implementation and the rest were either not implemented or information was not provided by the designated government agencies.²³ These numbers imply that the Plan is unlikely to be fully implemented by the end of 2017.

²² <http://www.kmu.gov.ua/document/249273249/R0615.doc>

²³ Problems with deregulation implementation are typical for all central government bodies: <http://www.drs.gov.ua/deregulation/plan-deregulyatsiyi-2016-2017-rr/>

The deregulation reform is not limited to the implementation of the Action Plan. The Reform Concept note developed by the Ministry of Economic Development and Trade and donor funded projects stipulates other steps in this area. They include:²⁴

- Prevention of new ineffective regulations by introduction of the mandatory regulatory impact assessment (RIA) and small business test (M-Test) for all new regulatory acts produced by central executive government branches.
- Promotion of self-regulation by business.

Despite of the undertaken efforts, the Ukrainian economy remains heavily and often inefficiently regulated. To improve the situation, first, the government needs to speed up the implementation of the deregulation plan.

Second, Ukraine has to adopt legal provision for regulations revisions or period of their validity, which are a common practice in the EU countries. Many regulations in the EU have “expiration” date, and the effectiveness of those which do not have this date has to be evaluated after a specified period (usually 3-5 years). Based on this evaluation, a regulation can be revised, amended or abolished.

Third, the regulatory impact analysis (RIA) should become a real instrument for stopping “bad” regulations and not just “red tape” documents as it is now.

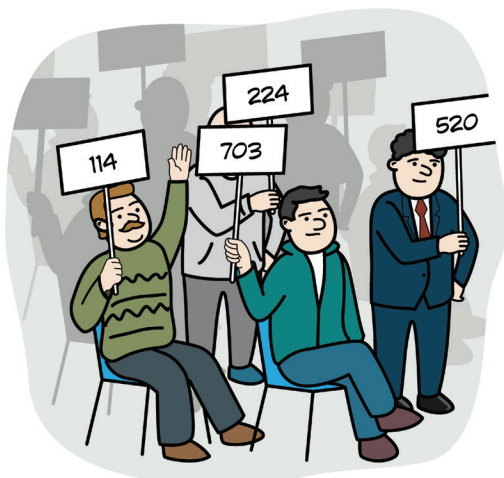
²⁴ http://reforms.in.ua/sites/default/files/docs/deregulation-reform-presentation-ua-20151007_0.pdf

Chapter 4. Public procurement reform

BEFORE



NOW



Public procurement constitutes a considerable share of GDP in every country. In Ukraine in 2013 expenditures on public procurement amounted to USD 28 billion (16% of GDP).²⁵ 45% of these procurements in terms of value were 'below the threshold',²⁶ i.e. they were not regulated by public procurement legislation. The rest 55% were 'above the threshold' procurements but a half of these were conducted via 'direct negotiations with one supplier', the procurement procedure most favorable for corruption. High share of uncompetitive procurements was made possible by the previous public procurement legislation that contained 43 types of public contracts²⁷ exempt from competitive tendering. According to the evaluation of EBRD experts,²⁸ public procurement system was plagued by structural nepotism, bribery, and corruption. The situation radically changed with the implementation of electronic public procurement system ProZorro²⁹.

ProZorro project began as a startup: it relied on technical ingenuity and was not financed by the state. In spring of 2014 a group of volunteers interested in reforming public procurement system formed in Kyiv. The majority of them did not have previous experience with the public sector and had a background in financial markets, electronic services, data analysis, software development etc.

In contrast to politicians, the level of trust to volunteers after the Euromaidan was extremely high³⁰ which allowed them to initiate productive discussions between business and officials, Parliament

²⁵ UKRSTAT

²⁶ Their value was less than USD625 thousand for goods and USD1250 thousand for works

²⁷ EBRD report p.77 <http://www.ebrd.com/documents/legal-reform/guide-to-e-procurement-reform.pdf>

²⁸ EBRD "Are you ready for e-Procurement? Guide to Electronic Procurement Reform-2015"

²⁹ Meaning transparent in Ukrainian, the name also hints at Zorro, a fictional defender of common people against the tyranny of evil men.

³⁰ For example, according to the survey performed at the end of 2014, volunteers were in the first place with 7.3 points out of 10: <https://dt.ua/UKRAINE/naybilshe-ukrayinci-dovirayut-volonteram-ta-dobrovolcyam-naymenshe-sudam-i-gpu-160339.html> Today the level of trust to volunteers, although lowered a bit, remains rather high.

and the Ministry of Economic Development and Trade (MoEDT). In August 2014 the group of procurement volunteers in cooperation with MoEDT Department of Public Procurement Regulation and experts from the EU³¹ and Georgia developed the Concept of Public Procurement System Reform in Ukraine. The concept envisaged implementation of a pilot e-procurement project³² for 'below the threshold' procurements. These procurements were not regulated by law, so public companies and institutions could voluntarily participate in the project. At first, development of the pilot project was financed by private companies that seized the opportunity to enter the emerging e-market (see Box 1).

Box 1. Architecture of the ProZorro system

Electronic public procurement system ProZorro includes central database owned by the state and a number of "commercial marketplaces" owned by private or public companies. Both procurement announcements and auctions are processed by the auction module of the central database which stores all the data on current and past procurements. To access the central database, both procurers and bidders use authorized commercial marketplaces.

Procurers do not pay for using services of the marketplaces, while bidders pay \$0.7–\$67 depending on the procurement value to participate in a tender. About 76% of this fee (as of 2017) is retained by a marketplace, and the rest goes to the public company that administers the ProZorro system. Thus, marketplaces compete by improving front-end access and providing better services to bidders. Marketplaces also actively advertise their services and thus promote the entire electronic procurement system.

Seven companies that provided initial investment for the project became the first marketplaces. At the time of writing, there were 20 certified commercial marketplaces in the ProZorro system. Any company can become a commercial marketplace after proving that its system satisfies the minimal requirements for providing access to the central database.

³¹ Project Harmonisation of the Public Procurement System of Ukraine with EU Standards

³² voluntary participation by the public companies and institutions in the pilot project was made possible by Government Decree 501-2015-p: <http://zakon3.rada.gov.ua/laws/show/501-2015-%D1%80>

The pilot project became functional in February 2015. The first procurers were State Administration, Kyiv City Administration, Ministry of Defense and the National Nuclear Energy Generating Company of Ukraine.

In March 2015 Oleksandr Starodubtsev, a principal representative of the volunteer team, became the head of the Department of Public Procurement Regulation at MoEDT. Dedicated work of the Department employees and political support of the new Deputy Minister Max Nefyodov resulted in the adoption of amendments to the procurement legislation in December 2015.³³ According to the new version of the law, since April 1st 2016 all central executive bodies and state-owned natural monopolies had to conduct procurements exclusively through ProZorro. Since August 1st 2016 *all* public procurements are performed only through ProZorro.

As a result of ProZorro implementation, a huge portion of previously hidden data was revealed. For instance, in the period from December 2016 to September 2017 more than 500 thousand of 'below the threshold' procedures with total reserve value of USD 2.5 billion were registered in the system. For each of these procedures there is publicly available information on the good procured, supplier and contract value. Previously the only information disclosed was procurement plan of a government agency published in the beginning of a year. ProZorro also greatly increased the extent of information available on 'above the threshold', especially competitive, procurements. This wealth of data can be used by public procurers to assess the quality of their procurement function, by prospective suppliers to find business partners, and by controlling authorities and whistle-blowers to monitor public procurements.

Thanks to new rules, the share of competitive procurements increased threefold –from 26%³⁴ of total expenses³⁵ in 2015 to

³³ <http://zakon3.rada.gov.ua/laws/show/922-viii>

³⁴ 2013 –28%, 2014 –21% - Ukrstat data

³⁵ both above and below threshold

78% in September 2017. More trust worthy procurement procedure attracted new companies to the procurement market, and increased competition in it benefits procurers.

Finally, more efficient and competitive procurement mechanism resulted in additional savings of public funds. For instance, in the natural gas procurement final price of an auction is on average 7% lower than the reserve price. According to more precise KSE estimates,³⁶ average savings on gas procurements in 2016 equaled 3.5% of the reserve price (USD 485 m of total savings).

To further advance the reform, MoEDT strategy foresees:

- 1) **Centralization.** The pilot Centralized Procurement Office (CPO) has been functioning during 2017 to develop the model of centralized procurement. Upon its full launch, the CPO will conduct procurement of standardized goods on behalf of other procurers. This will further decrease administrative burden on them, narrow opportunities for corruption and thus increase efficiency of public funds use. Centralization will be complemented with development of the e-catalog of standardized bids. This catalog would further reduce the administrative load on public procurers because they will no longer need to create tender specification for each new purchase. At the same time, it will reduce opportunities for discrimination of suppliers ('exotic' tender specification is one of the most popular ways to exclude 'outsiders' from a tender).
- 2) **Professionalization.** Kyiv School of Economics and Education Center of SOE 'ProZorro' are running a mid-term professionalization program for procurement managers of large purchasers and short-term wide-scale programs on legal and technical aspects of public procurement for members of tender committees. ProZorro Center maintains a network of regional agents, administers InfoBox,

³⁶ <http://cep.kse.org.ua/gaz-i-economiya/>

an online portal with life hacks for procurers, and online courses on the use of ProZorro.

- 3) **Technical advancement.** SOE 'ProZorro' which administers the system is working on integration of the ProZorro system with state registries, implementation of electronic document flow, removal of technical bugs and inconsistencies of the system with the law.
- 4) **Legislation development.** A number of amendments to legislation are needed for harmonization with EU standards and procurement procedures and introduction of framework agreements.³⁷ In addition, the legal basis for introduction of e-catalogs, procurement centralization and monitoring has to be developed.

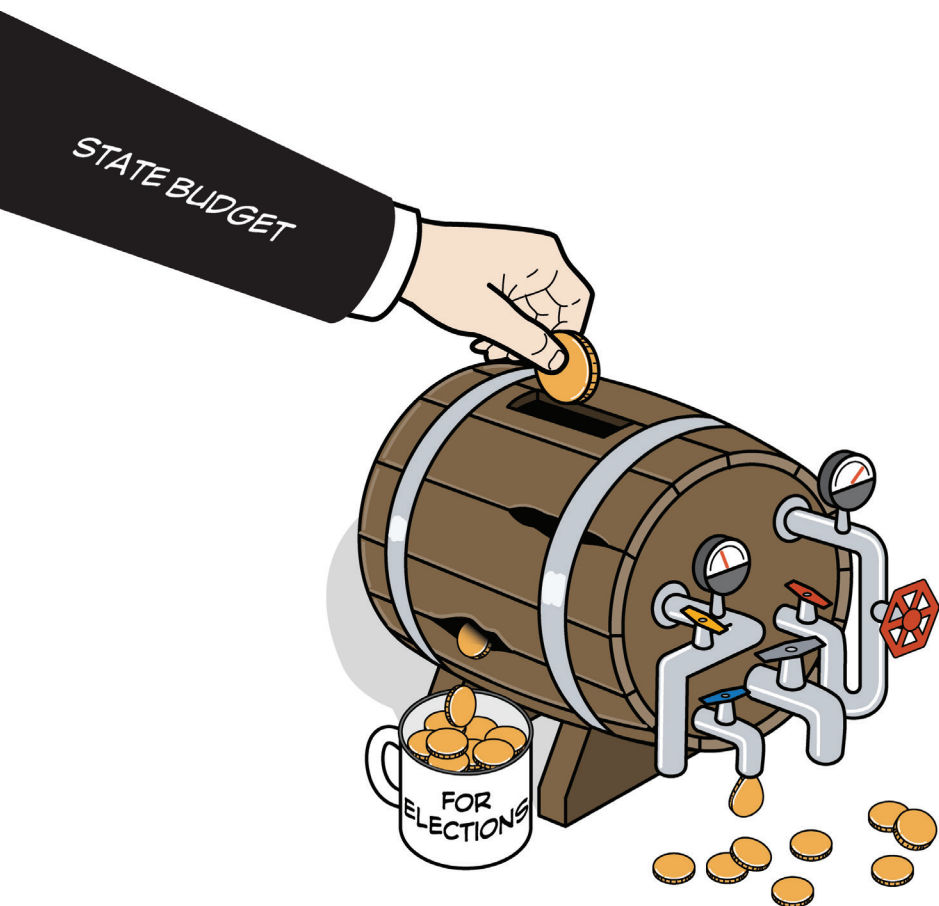
ProZorro system can be used not only for procurement but also for sale of state-owned assets. The State Deposit Guarantee Fund has started selling assets of resolved banks via ProZorro. Sales,³⁸ and the State Property Fund plans to use this system for small-scale privatization.

³⁷The mechanism that allows a Central Procurement Organization to be an intermediate procurer or procurement agent on behalf of other entities.

³⁸KSE developed an innovative design for these auctions –see „Selling Toxic Assets in Ukraine. Overview of the Current Situation and Suggestions for Improvement of the Auction Design“ by Tymofiy Mylovanov, Natalia Shapoval, Andrii Zapechelnyuk, David Huffman, Rakesh Vohra, and Oleksii Soboliev

Chapter 5.

State property management



The objective of a private firm manager is straightforward – profit maximization. The objective of a state enterprise manager is much less clear. Should a state-owned enterprise (SOE) maximize profit and/or dividend payments? Should it aim at providing some public good instead? Should it act as a "supplier of the last resort" or deal with market failures? Should this enterprise remain in the state property just for national security reasons?

Economic research shows that on average a private owner is more efficient than the state, especially when the state is institutionally weak. For this reason international advisors recommend Ukraine to sell as much state-owned assets as possible to finally find an efficient owner for them. In particular, current IMF program foresees so called triage³⁹ and streamlining of privatization procedures.

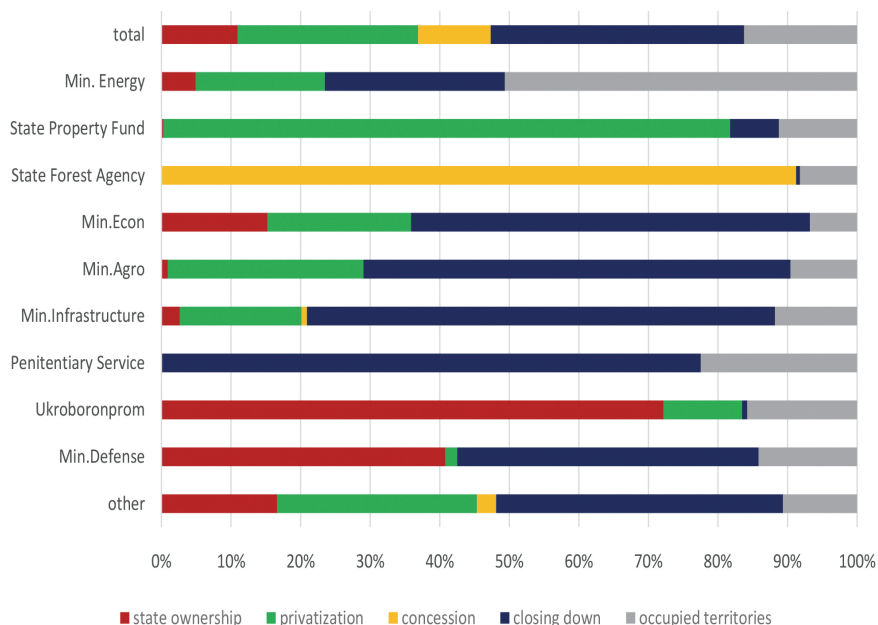
Triage⁴⁰ procedure has recently been completed. As a result, 3444⁴¹ SOEs (of which only about 1200 are actually operating) have been classified into 5 groups (Figure 1). The government does not control 16% of SOE – those located in the occupied territories. 36% of SOEs will be shut down, 26% – privatized, and about a half of the remaining 21% will be leased via concession.

³⁹ Triage is the procedure of distribution of SOEs into three groups. (1) strategic enterprises which cannot be privatized. At these enterprises best corporate government practices should be introduced, including independent supervisory boards. (2) SOE aimed for privatization (privatization should be performed via competitive auctions, in case of large enterprises international advisors should be involved into the process) and (3) SOE that should be liquidated.

⁴⁰ See information on the web-site of the Ministry of Economic development: [me.gov.ua/SOE reform/ strategic vision for SOE management](http://me.gov.ua/SOE_reform/strategic_vision_for_SOE_management)

⁴¹ The asset value of 2044 of these firms is unknown or not reported.

Figure 1. Distribution of SOE by their future fate, by largest SOE managers (number of SOE)



Data source: MoEDT web-site

In addition to these SOE, the state owns minority stakes at many other enterprises but the exact share of state ownership in the economy is unknown.

State-owned enterprises have been one of the largest and most easily accessed sources of rent in Ukraine. Until 2015 no one knew what was going on inside them –they did not even have to publish financial reports. It is no wonder then that SOE reform is the one most fiercely opposed by vested interests, including at the highest level.

Nevertheless, some progress has been achieved by the new team that entered the Ministry of Economic Develop-

ment and Trade (MoEDT) in 2014. SOE reforms proceed along three main lines:

- 1) **Transparency.** Since 2015 MoEDT produces regular (quarterly) publications on financial indicators of top-100 state-owned enterprises. Totally, over 500 SOE publish their financial reports on the MoEDT web-site. In summer 2015 the Cabinet of Ministers obliged⁴² 146 largest SOEs to go through audit⁴³ by internationally recognized firms. Audit results are also available online. Since fall 2015 SOE transactions are published on the *e-data.gov.ua* web-portal, and since August 2016 some SOEs are obliged to perform procurement via ProZorro system;
- 2) **Corporate governance.** In early 2015 the Cabinet of Ministers adopted a new open competitive procedure for appointment of SOE management, formed a nomination committee that included people with internationally recognized reputation and considerably raised the salaries of SOE top-managers to attract talent from the market. Despite opposition to these changes at all levels, there are a few success stories –among them Naftogas, Ukrghasvydobyvannya and Ukrposhta. MoEDT has even managed to appoint independent supervisory boards for a few largest SOEs before the process was blocked.
- 3) **Privatization.** This part of reform has so far been a failure.⁴⁴ A 'sage' of the sale of Odessa Port Plant was a blow to the investment image of Ukraine. It took the parliament

⁴² CMU Decree #390 of 04 June 2015: <http://www.kmu.gov.ua/control/uk/cardnp-d?docid=248248066>

⁴³ In 2015, only 28 of them did that, in 2016 –24.

⁴⁴ In 1991 the state was weak and unable to effectively manage its assets –thus it aimed for quick and massive privatization –partly through sale of assets to individual investors, partly through vouchers or distribution of an enterprise shares among its workers. However, weakness of the state also implied that it could not properly accomplish either scheme. E.g. voucher privatizations resulted in 85% of enterprise shares concentrated in hands of their management, large privatization of 2000s mostly placed assets in the hands of people close to the government (the only proper case of 'large' privatization at the moment is the sale of "Kryvorizhstal" steel mill to Mittal Steel in 2005).

almost a year to somewhat simplify privatization procedure (i.e. to cancel necessary prior sale of 5–10% of stake) and to allow foreign advisors to take part in facilitation of sales. In summer 2017 the Cabinet of Ministers drafted the law aimed at further streamlining of privatization procedures.⁴⁵ If this draft law is adopted, which remains to be seen, 99% of SOE designated for privatization will be sold via an electronic auction (ProZorro.Sales), and for sale of the remaining largest enterprises international advisors will be hired. Starting price for an auction will be defined as the value of assets less liabilities or UAH 1 if this value is negative, which indicates that the aim of privatization is finding a strategic investor rather than filling the budget.

To proceed with SOE reform, Ukrainian government needs to:

- 1) Define a strategic goal for each enterprise (this goal need not necessarily be profit maximization, it may well be some social or national security function);
- 2) Sell all enterprises for which this goal is profit maximization; and
- 3) Establish sound corporate governance in the rest of SOEs. With regard to this, international experience is vast,⁴⁶ so no wheel should be invented.

⁴⁵ See CMU release: http://www.kmu.gov.ua/control/uk/publish/article?art_id=250107797&cat_id=244276429

⁴⁶ An example is OECD Guidelines on Corporate Governance for State-Owned Enterprises

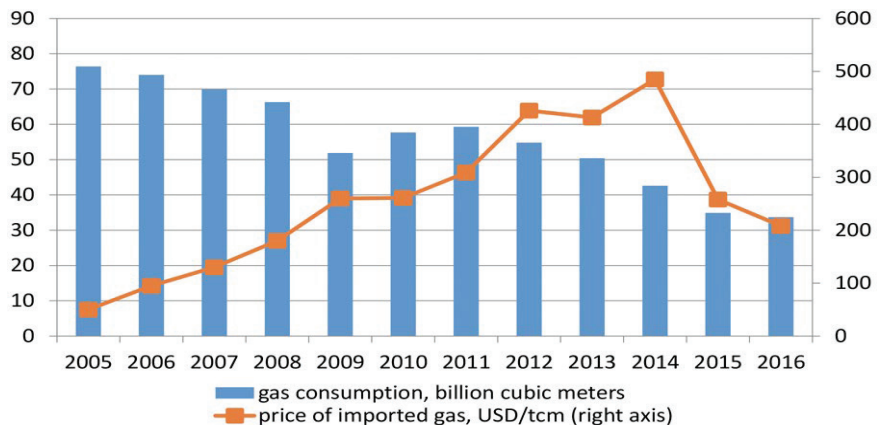
Chapter 6. Energy sector



For a long time the Ukrainian economy has been suffering from a quasi-Dutch disease⁴⁷. Low price for imported energy (see Figure 2):

- provided no incentives for producers or households to save energy or to invest into energy-efficient technologies; therefore, Ukraine has been and remains an extremely energy-inefficient country (see Figure 3);
- limited investment into domestic extraction of energy resources and energy production, including development of alternative energy sources;
- became a fertile ground for corruption schemes and a source of enrichment of some oligarchs;
- finally, were used for geopolitical purposes (recall “gas wars”, “Kharkiv agreements”, “Yanukovych's credit” etc.).

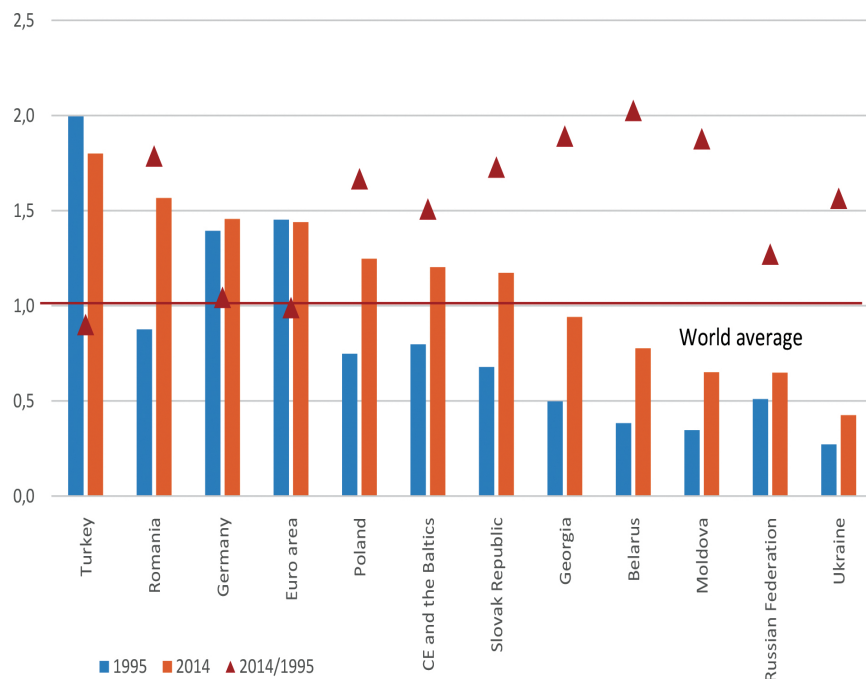
Figure 2. The price of imported gas and natural gas consumption in Ukraine



Source: Naftogaz of Ukraine. Until 2005, Ukraine imported gas at the price of 50 USD/thousand cubic meters.

⁴⁷ Dutch disease – a state of the economy when it derives the largest part of revenues from export of raw materials; at the same time, the demand for consumer goods is satisfied through imports, while domestic production (other than the extraction of those raw materials) does not develop. The term was first used to describe the economic situation in Netherlands after the discovery of large natural gas fields in 1959. In Ukraine, cheap energy was a hidden subsidy to producers, in particular, the metallurgical and chemical industries, which allowed them to compete in foreign markets despite exporting low value added goods produced with obsolete inefficient technologies.

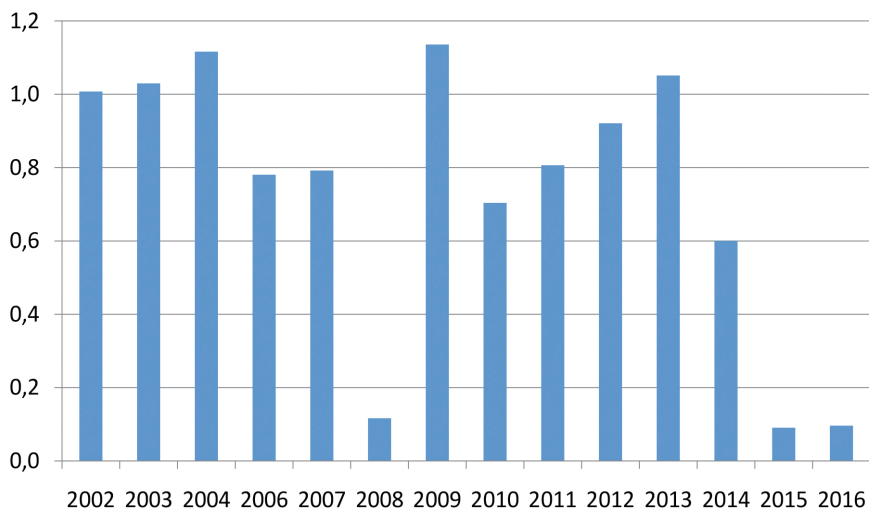
Figure 3. GDP per unit of energy use (constant 2011 PPP\$ per kg of oil equivalent) in Ukraine and selected regions, normalized by world average



Data source: World Bank

To this, add cross-subsidization (low tariffs for households compensated by high tariffs for industrial enterprises), monopolization of the sector under a weak regulator, absence of metering devices (except for electricity) in the majority of households and meager investment into infrastructure (hence, significant energy losses on the way from producer to consumer), as well as subsidies to the chronically loss-making coal industry (Figure 4) –and you get a full collection of economic mistakes in one sector.

Figure 4. Subsidies to coal-mining industry, % of GDP



Data source: State Statistics Service, Treasury reports

The situation with the NJSC “Naftogaz of Ukraine” was critical. The company purchased expensive gas from Russia, sold it at a low price to Ukrainian consumers, and the resulting losses were covered by the state.⁴⁸ As a result, at the end of 2014 “Naftogaz” deficit reached 5.4% of GDP⁴⁹ exceeding State Budget deficit.

In addition to losses for “Naftogaz”, a few times difference between industrial and household tariffs generated huge corruption risks. For example, gas extracted in Ukraine could be “written off” as consumed by households but in fact sold to industry at a much higher price.

Energy sector reforms, in particular levelling tariffs for different categories of consumers, have routinely been included as

⁴⁸ The mechanism was as follows: the government issued domestic bonds, state banks were forced to buy them, monetize through the NBU and later provide loans to the “Naftogaz.”

⁴⁹ 85 billion UAH, according to the results of the “Naftogaz” audit: http://www.naftogaz.com/files/Information/NAK%20NAFTOGAZ%2014fs_UKR.pdf

a condition into Ukraine's programs with the IMF. Despite that, none of the governments was ready to implement these conditions, let alone carry out other market reforms, since this would have affected too many vested interests (and would of course have slashed popularity of a current government). However, in 2014–2015 there was no room for maneuver (the Ukrainian economy could not have withstood without the IMF assistance), so the government started to reform the energy sector.

The reforms include three key elements:

- Levelling energy tariffs for all categories of consumers (which implied a multiple times increase of tariffs for households);
- Liberalization of markets for energy supply services;
- Introduction of a full-scale metering of all types of consumed energy.

The first element – unified tariffs. Since 2015, energy tariffs for residential consumers were raised on average by 3.5 times until they reached the market level. In 2016, gas tariffs for district heating companies (DHCs) were increased by 2.2 times and the price of heating for residential consumers rose accordingly. Finally, gas tariffs for population and DHCs were set at par with the price of imported gas.⁵⁰

However, these measures only partially reached their goals. Over 2016–2017, the National Commission for State Regulation of Energy and Utilities (NCSREU) raised electricity tariff for commercial consumers several times, and now the price for them again exceeds that for households, so “subsidy certificates”⁵¹ are still in place.

⁵⁰ At the same time, subsidies for residents have been introduced to cover the cost of public utilities. In 2015, the total amount of subsidies reached up to 18 billion UAH (0.9% of the GDP), in 2016 – up to 44 billion UAH (1.8% of the GDP). Currently, these subsidies are provided in a cashless form, but there are ongoing discussions concerning monetization of subsidies. It should allow the households to invest into energy-saving.

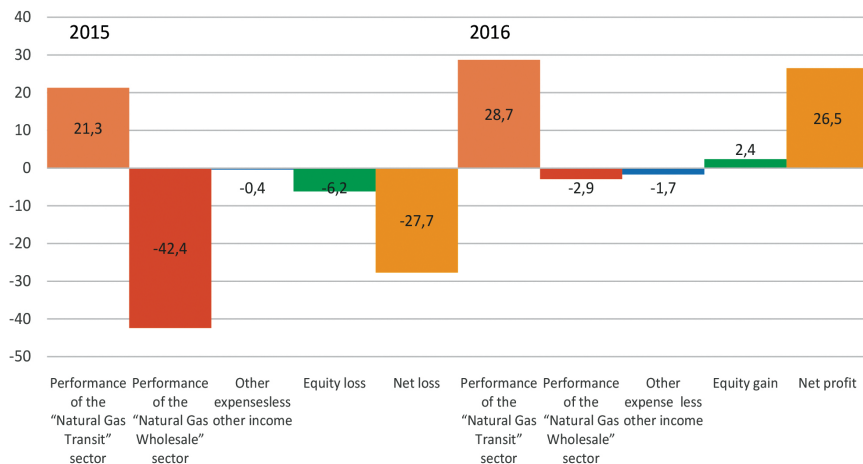
⁵¹ Funds paid by businesses for household consumers, i.e. cross-subsidies.

The same thing happened with natural gas. The Cabinet of Ministers set a uniform price for all consumers –6,900 UAH per 1 thousand cubic meters since May 1, 2016, but the market price of gas has increased since then, making it necessary to further increase gas tariffs for households. At the moment the government refuses to do this, which results in tense relations with the IMF.

The gas market was liberalized only for non-residential consumers. For households, “Naftogaz” remains “the supplier of last resort”, i.e. it supplies the population with gas at lower than market price⁵² and thus accumulates losses which the government refuses to compensate to the company.

Nevertheless, the above measures together with corporate governance reform at the “Naftogaz” resulted in financial revitalization of the company. In 2016, it finally made profit after many years of losses (Figure 5).

Figure 5. Comparative analysis of the company performance in 2016 and 2015, billion UAH



Source: “Naftogaz” web-site

⁵² See CMU Resolution of 22.03.2017 No. 187: <http://zakon3.rada.gov.ua/laws/show/187-2017-%D0%BF>

The second element. Introduction of competition into energy markets. In spring 2015, a new Law "On the natural gas market"⁵³ was adopted, and in early 2017 –the law "On the electricity market."⁵⁴ The main objective of these laws is fulfillment of the requirement of the European Energy Community that network owner and services provider(s) cannot be the same legal entity. For consumers this means that they will be able to choose their preferred supplier of energy (gas, electricity etc.) on price vs quality grounds.

The reform has been partially implemented in the gas market – with respect to public procurement of natural gas it was quite successful. However, the reform is not yet working for residential consumers because of the gap between market prices and tariffs for households set by the government.

The effect of the new law "On the electricity market" will be seen not earlier than in 2019, when it is fully enforced.

A necessary part of the reforms success is trust to the market regulator, i.e. the NCSREU. In autumn 2016, a new law⁵⁵ on the regulator was adopted, and its independence of executive power branch was significantly strengthened. However, this law will fully come into force since 2019. In the same year new NCSREU members will be elected.

The third element is accountancy. Here, systemic changes have just started. Thus, the new law "On commercial metering of heating and water supply"⁵⁶ came into force on August 2, 2017. As Sophia Lynn, the head of the World Bank District Heating Energy Efficiency Project in Ukraine, aptly remarks⁵⁷, *"without this document, the package of draft laws on housing and utility services sector would turn into useless paper."*

⁵³ <http://zakon2.rada.gov.ua/laws/show/329-viii>

⁵⁴ <http://zakon2.rada.gov.ua/laws/show/2019-viii>

⁵⁵ <http://zakon2.rada.gov.ua/laws/show/1540-19>

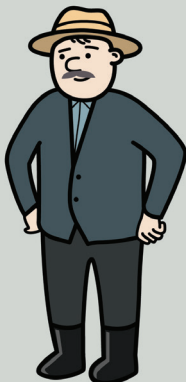
⁵⁶ <http://zakon2.rada.gov.ua/laws/show/2119-19>

⁵⁷ <http://www.eurointegration.com.ua/experts/2017/08/17/7069841/>

Chapter 7. Land market

- WOULD YOU SELL
YOUR LAND PLOT?

- SURE!



- THEN YOU THINK LAND
SALE SHOULD BE ALLOWED...

- NO WAY!



Ukraine's natural resources are well suited for agricultural production. 69 per cent of the country territory, much of which is the especially fertile black earth soil, is allocated to agriculture. Ukraine is already the world's largest sunflower oil exporter and a leading wheat and poultry exporter. At the same time, a persistent shortage of financial resources at enterprise level, underdeveloped infrastructure and restrictive state regulations hold back productivity growth. Average yields of wheat, corn and rapeseed are lower⁵⁸ than in neighboring Poland despite better natural endowment of Ukraine. A sound agricultural policy could unleash the vast potential of Ukraine's agricultural production. First and foremost among these reforms is abolishment of the moratorium on agricultural land sales.

During 1991-2001, the land of former collective farms was distributed among their workers and rural employees. In January 2001 the government imposed a moratorium on the sale of agricultural land. The moratorium was supposed to be lifted immediately after adoption of the Land Code (passed in October 2001), but instead it was prolonged eight times (the last time at the end of 2016). The current version of the moratorium is in force until January 1, 2018. To open the land market, not only the moratorium should not be extended but also the law 'On agricultural land circulation'⁵⁹ should be passed by the Parliament.

Opinions of stakeholders – politicians, farmers, agriholdings, experts –about key provisions of this law are rather different. The most debatable issues are:

- 1) **ownership restrictions:** maximum size of a land plot that can be owned by one entity; the right of legal entities to buy land; the right of foreigners to buy land;

⁵⁸ By 24%, 7% and 36%, respectively. Source: Food and Agriculture Organization of the United Nations

⁵⁹ Draft Law #5535: http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=60724

2) timing of land market opening: one stage (all agricultural land can be sold regardless of the current owner) vs two stages (first to allow sale of land owned by the state and local communities and in a few years –sale of individual land plots).

Restriction of the maximum plot size, exclusion of foreigners and/or legal entities as well as two stage implementation of land market are all proposed as means of safeguarding against large-scale buying up of land by large agricultural companies. Fear of such a scenario, stirred up by some politicians, is widespread among Ukrainian citizens, and in fact 63% of population disapprove the moratorium lifting.⁶⁰

In 2019 Ukraine will go through both the parliamentary and presidential elections. The dangers of opening the land market is a traditional scarecrow used by politicians to inflate their ratings. So, if the Parliament does not adopt the Law 'On agricultural land circulation' till the end of 2017, there is a high probability that land moratorium will be prolonged again until after the elections.

The biggest losers from the current situation are private owners of land plots. As of 2017, there are 7 million of private landowners with average plots of 2.5 hectares. All of them have limited access to credit because of high interest rates, undeveloped system of agricultural loans and lack of collateral.⁶¹ As a result, the majority of owners do not cultivate the land themselves but rent it to enterprises –approximately 60% of cultivated agricultural land is leased by private businesses from plot holders. Inability to freely sell their land weakens the bargaining power of landowners. According to the estimates,⁶² allowing land sales

⁶⁰ <https://voxukraine.org/2017/08/22/what-political-parties-say-about-the-land-reform-and-what-the-voters-hear/>

⁶¹ Since they cannot use land as collateral, they can collateralize loans either by future harvest or by agricultural machines –things on which banks do not put too much value.

⁶² <https://voxukraine.org/2016/04/13/economic-return-to-farmland-in-ukraine-and-its-incidence-ua/>

would sharply increase the average land rent from current 37 USD/ha to 455 USD/ha.⁶³

Despite failing to open the land market itself, since 2014 the Parliament and the Government made several smaller steps necessary for smooth transition to the open market:

- Information about all the property rights is stored in one register established in 2013.⁶⁴ In September 2015⁶⁵ its content was made publicly available. In December 2015⁶⁶ private notaries were given the right to register property rights for real estate and land;
- In February 2016 the Parliament cut⁶⁷ the list of instances when state-owned and communal-owned land can be rented under uncompetitive procedures. As a result, in most cases land tenant will be defined via an auction;
- In July 2016, State Service of Ukraine on Geodesy, Cartography, and Cadastre responsible for management of the state-owned land became⁶⁸ subordinate to the Ministry of Agricultural Policy and Food of Ukraine (previously it was subordinate to the Ministry of Regional Development). This change allows for better coordination of legislative initiatives of the agricultural Ministry and Geocadastre;
- Up to 1 million⁶⁹ owners of land died since 2001 when the moratorium was imposed. Some of the deceased owners

⁶³ Thus, low rental price of land which results from the ban on its sales is a shadow subsidy to agricultural companies –at the expense of land owners.

⁶⁴ However, many property rights established prior to 2013 are still not included in the registry. Currently it includes only 20% of all property rights (see <https://vox-ukraine.org/2017/08/09/ekonomika-139-denis-nizalov-zemelnyaya-reforma-nevygod-na-tem-kto-rabotaet-po-tenevym-shemam/>)

⁶⁵ <http://www.kmu.gov.ua/control/uk/cardnpd?docid=248533169>

⁶⁶ <http://zakon2.rada.gov.ua/laws/show/1127-2015-%D0%BF>

⁶⁷ <http://zakon2.rada.gov.ua/laws/show/1012-viii>

⁶⁸ <http://minagro.gov.ua/node/21857>

⁶⁹ <http://costua.com/ru/news/432-moratorium-on-land>

did not have heirs. As a result, a large amount of “no one’s land” emerged. In September 2016 the Parliament adopted a Law⁷⁰ according to which this land became the property of local communities.

According to KSE experts, implementation of the land market in 2018 should be preceded by the following steps:⁷¹

- Mandatory use of an e-auction platform for transfers of state or communal land;
- Mandatory registration and publication of land prices (publication of prices for land rental at the moment of registration is already mandated by law, though currently not practiced);⁷²
- Establishing collection and regular publication of systemic data on Land Governance Monitoring;⁷³
- Enhancing access to justice and recourse in case of rights violations;
- Completing registration of state and communal land (now only about 25% of state and communal agricultural land has been registered in the Cadaster, and registered lease contracts exist only for about 2.5 million ha or 10% of agricultural land)

⁷⁰ <http://zakon3.rada.gov.ua/laws/show/1533-19>

⁷¹ <https://voxukraine.org/2017/05/31/beyond-lifting-the-moratorium-preconditions-for-success/>

⁷² According to the Law of Ukraine ‘On state registration of rights on immovable property’ and Article 22 of the Order for administration of the State Register for Rights for Immovable Property

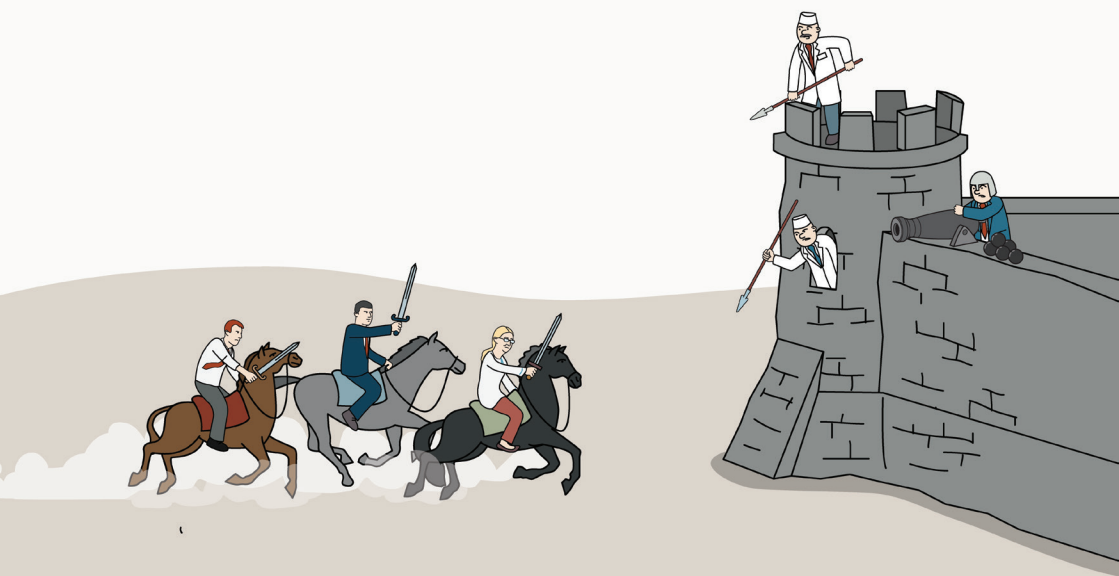
⁷³ The concept of the Land Governance Monitoring was developed and tested in 2015 by the Project “Capacity Development for Evidence-Based Land & Agricultural Policy Making in Ukraine” (<http://land.kse.org.ua>) jointly with an inter-agency government Working Group. Recently, the Ministry of Agricultural Policy and Food and the State Geocadastre have submitted a proposal of a Resolution on the Land Governance Monitoring (<http://www.minagro.gov.ua/uk/node/23860>) to the Cabinet of Ministers of Ukraine that would establish the normative base for the monitoring.

- Defining legal status of the formerly collective land;⁷⁴
- Operationalizing deferred payment schemes for acquiring state or communal land. Such schemes can be a powerful tool to allow key stakeholder groups such as youth or veterans of anti terrorist operation to access land and use it as a catalyst for development. While the legal basis for this is set,⁷⁵ it lacks clear eligibility criteria;
- Allowing banks to own foreclosed land for a limited time and mandate e-auctions for its disposal.

⁷⁴ This issue has been unresolved since the initial land privatization and dissolution of collective farms. As a result, some 8% of all agricultural land (more than 2 mn ha), particularly forest belts and field roads, have no owner. Most is cultivated illegally. Unless the legal status of such land is clarified by law, neither registration nor assignment of responsibility for land management is possible and such land continues to be vulnerable to misuse, fails to contribute to local and state budgets, and slows demarcation and registration of adjacent state, communal and private land. Legal drafts for doing so exist and should be adopted as soon as possible.

⁷⁵ The Land Code and Cabinet resolution #381 of 22 April 2009 (signed by Yulia Tymoshenko) provide all necessary normative base for using this instrument after the moratorium is lifted.

Chapter 8. Healthcare



Ukraine is one of the last countries of the former USSR in which systems of public healthcare functioning and financing have barely changed since the Soviet times. Numerous attempts of different governments and ministers to reform the industry ended, at best, at the stage of pilot projects never scaled up to the entire country. Occasional changes in specific sectors of the industry were implemented –for example small-scale health insurance schemes⁷⁶ were launched in some oblasts, a list of fee-paid services was approved, family healthcare partially introduced etc.⁷⁷ but the basic principles of healthcare functioning remained intact.

Absence of comprehensive healthcare reforms can be explained by lack of political will and little financing of their development and implementation by the governmental (for example, the above-mentioned pilot projects were usually developed and implemented in close cooperation with international organizations). However, the real reason is the resistance of healthcare managers at all levels who sabotage changes for the fear of losing control over shadow cash flows in the industry.⁷⁸ Pharmaceutical companies also oppose the reforms since they divided the market for public procurement of drugs and medical goods between themselves, which allowed them to receive abnormal profits.⁷⁹

Development of comprehensive documents on healthcare reform started back in 2014. At the end of 2014, the Strategic Advisory Group (SAG) formed of Ukrainian and international ex-

⁷⁶ Called *likarniana kasa*. These insurance schemes usually cover only expenses for drugs, operate within just one oblast, and participation rate in them is rather low.

⁷⁷ See, for example, an overview of reforms on "Medexpert" web-site

⁷⁸ According to the World Bank estimates, out-of-pocket expenses on healthcare in Ukraine almost equal public expenses, reaching 3.5% of GDP. Formally, healthcare in Ukraine is free (there is a very limited list of fee-paid services), so state-financed healthcare institutions cannot (and often do not want to) receive this money officially.

⁷⁹ In Ukraine prices of drugs are higher than in other CIS countries and even higher than in the EU –see article "Why drugs in the EU are cheaper than in Ukraine" of 19.01.2016: <http://www.eurointegration.com.ua/articles/2016/01/19/7043410/>

perts presented the National Health Reform Strategy for Ukraine for 2015 –2020.⁸⁰

The strategy envisaged among other:

- autonomization of healthcare facilities (their transformation from budgetary institutions into state-owned or municipal enterprises);
- establishment of the National Healthcare Financing Agency responsible for procurement of healthcare services and supervision of pharmaceutical procurement in the country;
- setting a guaranteed level of free healthcare and introduction of paid services; provision of targeted benefits to low-income patients. In the long run, implementation of healthcare services financing on the basis of diagnosis-related groups;⁸¹
- linking physicians' salaries to their performance;
- development of primary healthcare, scaling-up of drug reimbursement practices in outpatient treatment;
- updating medical treatment standards on the basis of international clinical protocols;
- establishment of the public health system;
- implementation of an electronic system for information storage and exchange.

In the mid-2015, the SAG prepared three draft laws that laid the legal ground for the autonomy of healthcare facilities. However, the parliament did not pass those draft laws because of political ambitions and, probably, economic interests of some MPs. Another draft law on autonomization of healthcare insti-

⁸⁰ <http://healthsag.org.ua/strategiya/>

⁸¹ I.e. payment for the services of a healthcare facility based on the results of treatment.

tutions⁸² was finally passed in April 2017. However, in this law autonomization is *optional* rather than mandatory.

Still, despite resistance of stakeholders, some steps to reform the healthcare have been taken. First of all, medical subvention was introduced in 2015, which allows local authorities to manage subordinate facilities more effectively. However, the mechanism of mutual payments between different territorial units for healthcare services provided to their residents needs fine-tuning.

In March 2015, public procurement of drugs was temporarily (till 2019) transferred from the Ministry of Health to international organizations.⁸³ While this law is in force, Ukraine has to develop its own effective procurement procedures. Thus, in August 2017 a procurement agency that will overtake this function since 2019 was created.⁸⁴

In the mid-2015, the compulsory renewal of licenses for medical drugs was canceled⁸⁵ and in early 2016 the procedure for importing generic drugs was simplified,⁸⁶ which should lower prices in Ukrainian drug stores. In 2016, the Ministry of Health Order No. 33 which linked staffing of healthcare facilities to their size and the number of bed was cancelled (however, the majority of facility managers are still using this Order⁸⁷). In early 2016, new licensing conditions⁸⁸ for starting private medical practice were approved. They simplify launching of private clinics and at the same time introduce quality standards for them.

⁸² <http://zakon3.rada.gov.ua/laws/show/2002-viii>

⁸³ <http://zakon4.rada.gov.ua/laws/show/269-viii>

⁸⁴ See release on the MoH web-site: http://www.moz.gov.ua/ua/portal/pre_20170823_b.html and presentation of the main changes: <https://www.slideshare.net/MOZukr/ss-79082549>

⁸⁵ <http://zakon2.rada.gov.ua/laws/show/z1210-15/paran7#n7>

⁸⁶ <http://zakon4.rada.gov.ua/laws/show/981-viii>

⁸⁷ According to the research conducted by the Kyiv School of Economics and the World Bank.

⁸⁸ <http://www.kmu.gov.ua/control/uk/cardnpd?docid=248955651>

In 2017, primary healthcare reform was revived: today, every citizen shall choose a family doctor and sign a contract with him/her. Physicians will get a fixed annual payment from the state for each patient they supervise,⁸⁹ which means that patients, at least in cities, will have an opportunity to “vote with their feet” for a better doctor.

A government program on drugs reimbursement was launched in April 2017.⁹⁰ It allows patients to get medicines for cardiovascular diseases, type II diabetes and asthma for free or with a small surcharge. The list of medicines will be gradually expanded.

To provide more patients with the most necessary and efficient drugs, the National List of Essential Drugs was recently updated in line with the WHO Model List of Essential Medicines. From now on, budget-financed institutions can procure medicines not included into the National List only if the demand for drugs included into the National List is fully satisfied.

Two draft laws changing the system of healthcare financing were submitted to the parliament in April 2017.⁹¹ They introduce the “money follows the patient” principle and recognize the fact that there is no free healthcare in order to pull informal payments out of the shadow.

These draft laws divide healthcare services into three groups –financed by the state, co-paid by patients and fully fee-paid. The state will guarantee primary, emergency, and palliative

⁸⁹ However, one physician cannot “take on” more than 2,000 patients

⁹⁰ According to the State Statistics Service, in 2016 23% of households could not buy needed drugs or medical goods because they were too expensive. In 2015, there were 29% of such households. It quite often happens that a patient does not take drugs prescribed to him/her by a primary care doctor because s/he cannot afford them, which leads to complications of a disease and, consequently, to a more expensive treatment. The Affordable Medicines program aims to prevent such cases.

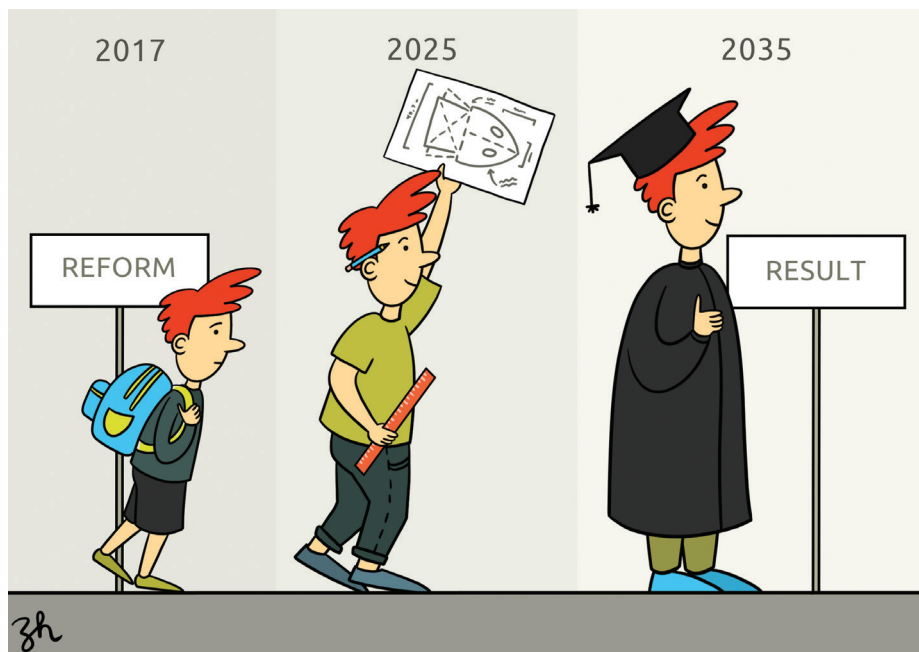
⁹¹ Draft law No. 6327 “On governmental financial guarantees of healthcare services provision” (adopted in the first reading) and Draft law No. 6329 “On amendments to the Budget Code of Ukraine” (not adopted).

care, basic outpatient and inpatient services on referral from a family doctor, and drugs prescribed for out patient treatment which are included into the National List of Essential Medicines. Aesthetic medicine and dentistry (except for emergencies) will be completely fee-paid. For other services, (official) co-payments of patients will be introduced. If these draft laws are adopted, state financial guarantees for primary healthcare will be introduced already since 2018, at other levels –by 2020.

To maintain a reliable database of services provided to patients and medicines prescribed to them, the Ministry of Health is implementing e-Health electronic system. The key task of this system at the initial stage is to collect the data on treatment of patient sand keep record of provided services to be covered from the state budget. Draft laws suggest making e-Health system mandatory for use of doctors and patients since April 1, 2018.

Unfortunately, the parliament has not approved the draft law No. 6329, while to the draft law No. 6327 approved in the first reading more than 800 amendments have been submitted – some of them completely destroying the ideology of healthcare financing system reform. For example, some amendments remove the notion of co-payment for medical services, thus preserving a “freemium” healthcare system. Other amendments dismiss the mechanism of financing primary care physicians based on the number of their patients, making primary healthcare dependent on medical subventions instead. If this amendment is approved, family doctors would not be interested in providing high-quality services or early detection and prevention of illnesses. In the fall 2017, the parliament will resume discussions of these draft laws which means that political fighting about healthcare reform continues.

Chapter 9. Education



Higher Education and Research

Higher education reform was launched in 2014 when the new law 'On Higher Education' was passed by the Parliament after five years of intense debates. The reform was designed to address key challenges to Ukrainian higher education, such as outdated content, inefficient governance model, corruption, massive plagiarism and other violations of academic integrity, the gap between higher education and research and isolation of universities from the international context. To address these issues, three main ideas introduced by the law were:

- 1) **more competition and transparency.** This was achieved by the new procedure of budget seat allocation among universities. While previously the allocation was decided at the discretion of the Ministry of Education and Science (MES), since 2016 the formula allocates more budget seats (and respectively more public funds) to universities with 'better' applicants (i.e. those with higher grades). To ensure proper use of public funds, universities are obliged to publish their financial reports online;
- 2) **more autonomy.** The universities received autonomy in academic and administrative matters. Now they are free to decide on the content of their educational programs as long as they adhere to the educational standards set by the Ministry. Today, MES is developing a new generation of educational standards which will describe expected learning outcomes. Students received an additional degree of freedom as well – now they can select at least a quarter of their courses;
- 3) **more integrity.** Since 2015 all PhD dissertations defended in Ukraine are published online. This made the plagiarism check easier and has resulted in several major scandals when plagiarism was detected in dissertations of some high-level officials or members of their families.

In March 2015 Ukraine joined Horizon-2020, the European Union research and innovation funding program, which allowed

Ukrainian researchers, businesses and innovators to receive support for joint or individual research projects.

About two years ago the Parliament passed the new version of the law 'On Science' aimed at launching the reform of research and innovations sector in Ukraine. In 2017 National Science Council under the Prime-Minister of Ukraine was created. Members of the Scientific Committee of the Science Council are internationally recognized Ukrainian researchers selected by independent international Identification Committee exclusively on their academic merit. Previously, R&D policy-making was dispersed among several Ministries and government agencies, Academies of Science and universities. The Council is to serve as a single platform for development of strategic vision and respective policies for Ukrainian research and innovations sector.

National Academies of Science remained largely intact, yet opportunities for promotion of younger researchers to higher positions in the Academies were opened up.

Schools

The mission of secondary education is different from that of higher education. While an important task of higher education is screening (providing 'quality marks' to the best students), the primary role of secondary education is to ensure equal opportunities –so that children of different background have the same chances to enter further education. Thus quality of secondary schools should be more or less uniform across the country. Naturally, this implies improvement of schools that lag behind rather than lowering quality of the top schools.

Thus, in 2015 the government started to invest in schools equipment, specifically for science classes, in order to raise the quality of science education which has declined dramatically in the past 20 years. In the same year the process of creation

of hub-schools started to address the problem of small rural schools. Ukraine still has several hundred schools with less than 10 students. Although such small schools are very expensive (in terms of cost per student), they provide very low quality of education –hence children from rural areas have considerably lower results on national exams, particularly in foreign languages. Hub-schools are designed to attract kids from neighboring small schools, typically starting from Grade 5. More than 200 such schools have already been created and equipped.

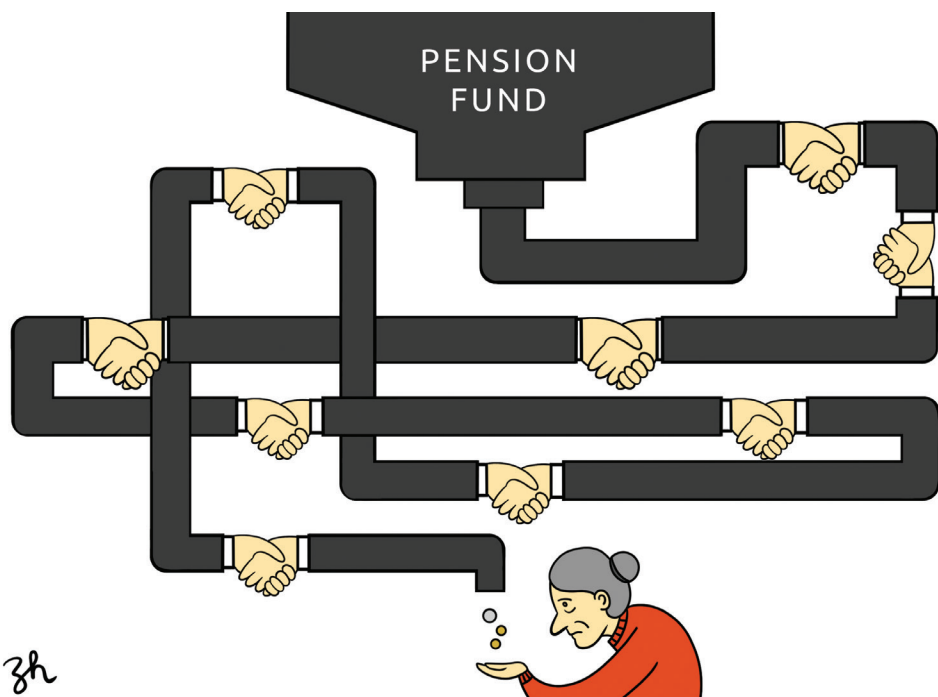
Another element of ‘equal opportunities’ is inclusion. Today, only 10% of 700,000 children with disabilities are studying in inclusive classes of regular schools. New approaches to inclusive education are now tested in a pilot project in Zaporizhzhia oblast. Later, these approaches will be extended to other regions.

On September 5, 2017 the Parliament passed the new law ‘On Education’, which is expected to launch a comprehensive secondary education reform in Ukraine. The main change is prolongation of compulsory secondary education from 11 to 12 years. This automatically implies revision of the core curriculum. In fact, this process has slowly started in 2016, when some changes to primary school curriculum were passed. Yet, a more in-depth transformation is expected. The goal is to update educational content and teaching methods to make schools friendlier to children.

To help primary school teachers adapt to the new curriculum, more than 20,000 teachers have been trained in summer 2017.

Results of the education reform will not be observed immediately, nor in the 5-10 years. However, if we want Ukrainian economy alive and capable to support us in our 50s, 70s and 90s, education should be the focal point of our effort today.

Chapter 10. Pension system



Current state and recent developments

Attempts to reform Ukrainian pay-as-you-go (PYG) pension system started back in 2003, when two laws⁹² envisaging a three-pillar system were adopted. The PYG was supposed to be complemented by mandatory (second pillar) and voluntary (third pillar) personal pension savings accounts. However, the second pillar was never launched (although discussions about it continue), and the third pillar is in its initial stage.

Given the history of wrong macroeconomic policies and poor property rights protection, it is no wonder that financial instruments suitable for long-term investment, which are required for accumulative pillars of the pension system, have never developed in Ukraine. The very small sector of voluntary pension savings was hit hard by the economic crises of 2008-2009 and 2014-2015. Today its total assets stand at about UAH 2 billion (~USD 77 million), it has low coverage and does not play an important role in pension provision. Thus, pension system in Ukraine remains a pay-as-you-go scheme.

Some professions (public employees, MPs, prosecutors, judges, military, journalists, scientists) have the right to additional pension payments, so called "special" pensions covered by the State Budget. Coverage by "special pensions" as well as the rights for early retirement⁹³ have been substantially narrowed during the last two years, which reduced PFU expenditures from about 16% of GDP in 2014 to less than 11% of GDP in 2016. Still, at the moment the Pension Fund is unsustainable and runs a high deficit.⁹⁴ In 2016 the PFU deficit constituted 3.6% of

⁹² The law On Compulsory State Pension Insurance. № 1058-IV of 09.07.2003. <http://zakon2.rada.gov.ua/laws/show/1058-15/>; The law On Non-State Pension Provision № 1057-IV of 09.07.2003. <http://zakon2.rada.gov.ua/laws/show/1057-15/>

⁹³ At the end of 2014, the effective retirement age in Ukraine was 55 years –due to early retirement options for a number of occupations.

⁹⁴ Partly this deficit is a result of reduction of the Single Social Contribution (SSC) from 43-47% to 22% of the wage bill. On the other hand, there is anecdotal evidence that some firms increased salaries because of this tax cut (and thus increased their SSC

GDP (compared to State Budget deficit of 2.9% of GDP), while overall transfers from the State Budget to PFU amounted to 5.5% of GDP.⁹⁵ This situation is caused by the fact that the number of Pension Fund contributors nearly equals the number of its beneficiaries (Figure 6).

Figure 6. Population of Ukraine by employment status

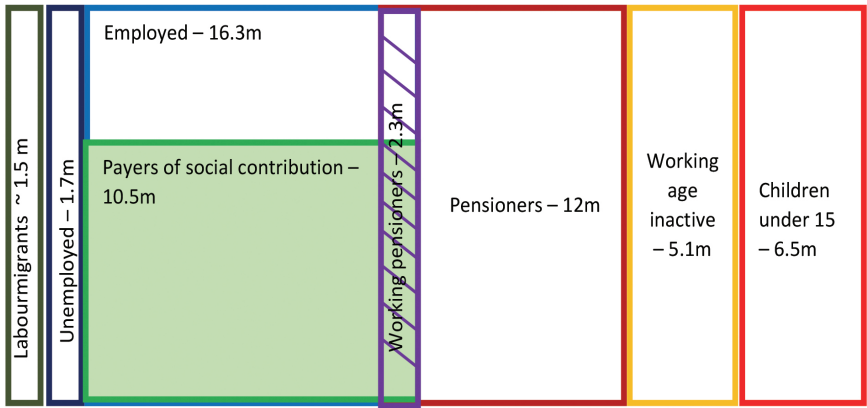


Figure 6 is based on the State Statistics Committee economic activity and population data. Rectangle area reflects the number of people in a category. There are 10.5m of social contribution payers, and the state pays social contributions for additional 1.5m people. Thus, there are 12m Pension Fund contributors and 12m beneficiaries (pensioners), although 2.3m of working pensioners receive only 85% of pension benefit. Generally, less than 18m working population in Ukraine (including labor migrants) support about 23m people who do not work.

Despite relatively high pension expenditures, pensions in Ukraine are very low⁹⁶ – at the end of 2016 average pension was just 26% of average salary, and 8 million of 12 million Ukrainian pensioners receive minimal pension equal to subsistence level (UAH 1312).⁹⁷

payments respectively). However, since a large part of salaries is paid "in envelopes", total effect was a reduction of PFU revenues.

⁹⁵ See PFU annual report for 2016 (in Ukrainian). http://www.pfu.gov.ua/pfu/control/uk/publish/article?art_id=277159&cat_id=122125.

⁹⁶ Average monthly pension was USD 67 as of January 1, 2017

⁹⁷ Source: Pension Fund publication: <http://www.pfu.gov.ua/pfu/doccatalog/document?id=289848>

Suggested changes

The necessity of pension age increase has been discussed in Ukraine for over fifteen years.⁹⁸ Since 2011, pension age for women has been gradually rising⁹⁹ –it will reach 60 by 2021. However, raising pension age for everyone remains a politically sensitive issue, and the Ukrainian government is proud that it convinced the IMF and other international partners to withdraw this requirement. The draft law on pension reform recently adopted in the first reading¹⁰⁰ leaves nominal pension age unchanged, although in reality many people will have to work longer.

The goal of the draft law is to make PYG system sustainable in the long run. The main instrument to achieve this is extension of the minimal tenure¹⁰¹ required for eligibility for the old-age pension¹⁰² (see figure 7). The minimal tenure requirement for people willing to retire at 60 will rise from 15 to 25 years since 2018 and then gradually will reach 35 years by 2028.

⁹⁸ The pension age in Ukraine is one of the lowest in Europe. The main argument against raising the pension age is low life expectancy –66 years for men and 76 for women. However, this low life expectancy is due to high middle-age mortality. Average life expectancy at the age of 60 is 18 years. And if healthy lifestyle was more popular among Ukrainians, many of them could easily live beyond that.

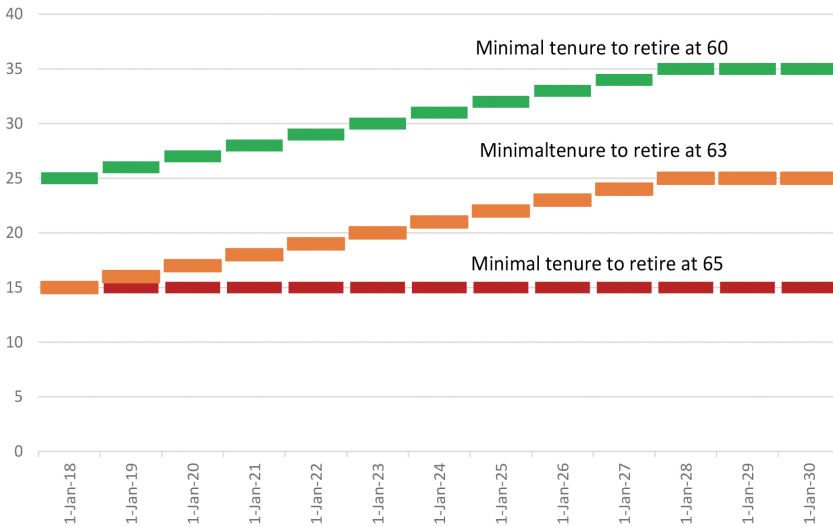
⁹⁹ The law On Measures regarding Legislative Provision of the Pension System Reform #3668-VI of July 8, 2011. <http://zakon5.rada.gov.ua/laws/show/3668-17/>

¹⁰⁰ Draft Law on Amendments to Certain Legislative Acts of Ukraine on Pensions Increase #6614 of June 22, 2017. http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=62088

¹⁰¹ Time during which a person (or his/her employer) makes contributions to the Pension Fund.

¹⁰² Old-age pension is linked to the number of years a person worked and her salary. „Social“ pension is unconditional and provided to people who do not have the right for old-age pension and is usually tied to subsistence level or minimal salary.

Figure 7. Minimal tenure and retirement age, according to the pension reform draft law



Those with lower tenure will retire later – at 63 or 65 depending on the duration of their employment. Instead of working longer, people will be able to “buy” up to 2 years of service by making a lump-sum contribution to the Pension Fund. Therefore, people willing to participate in the pay-as-you-go scheme will have incentives to be officially employed or make contributions to the PFU on their own.

Apart from that, the draft law includes revision of current pensions. Pensions will be recalculated based on the average wage over 2014–2016. Thus, pensions for over 5.6 million pensioners will rise and discrimination¹⁰³ of people who retired earlier will be eliminated. After that, pensions will be adjusted au-

¹⁰³ A formula for calculation of a pension includes person’s tenure, her salary during the last several years of work and average wage in the country. But average wage used for calculation of pensions is not adjusted automatically –for example, now 2007 average wage is used. Thus people who retired earlier, other things being equal, get lower pensions than those who retired recently.

tomatically by either 50% of three-year average wage growth or 50% of the annual CPI.¹⁰⁴

The majority of “special” pensions, including those for public employees, MPs, prosecutors, journalists, scientists etc. will be eliminated, except for special pensions for the military, for people who suffered from the Chernobyl catastrophe, and lifetime support of judges. Previously granted special pensions will remain but they will not be adjusted for inflation anymore.

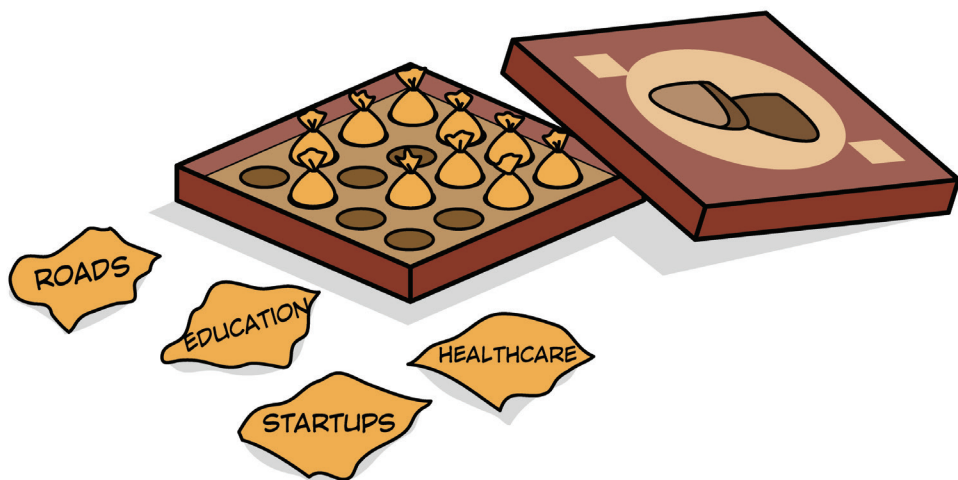
Finally, enterprises with dangerous working conditions (so called list 1 and list 2 professions) will pay higher social contributions - by 15% and 7% respectively. Since 2019 these additional contributions for workers younger than 35 will be accumulated on their personal accounts which will be managed by a special fund created by the PFU. This will be the first small step towards creation of the second level of the pension system.¹⁰⁵

To introduce a full-scale accumulative pillar of the pension system, either mandatory or voluntary, several prerequisites are needed. The first is sound macroeconomic policies to make the future more predictable (inflation targeting is an example). Second is wise regulation of the banking sector and financial markets to minimize the risks of long-term savings. Third, the most important, is establishment of a healthy judiciary and law enforcement system to guarantee property rights protection.

¹⁰⁴ However, the practice shows that in adverse economic conditions the government can suspend adjustment, as was the case, for example, in 2014 (see the law On Preventing a Financial Catastrophe and Creating the Preconditions for Economic Growth in Ukraine #1166-VIII of March 27, 2014. <http://zakon3.rada.gov.ua/laws/show/1166-18/>)

¹⁰⁵ For more extended description of the pension reform see SPFU publication: <http://www.pfu.gov.ua/pfu/doccatalog/document?id=289848>

Chapter 11. Reducing corruption



Popular opinion constantly rates corruption as the largest (or the second largest, after the war in Donbas) problem that Ukraine faces.¹⁰⁶ The Transparency International Corruption Perception Index ranks Ukraine 131 (score 29) in 2017, up from 142 (score 26) in 2014. Corruption is often mentioned as the major problem by Ukraine's international partners.

However, in our view corruption is not a problem in itself but rather a consequence of poorly designed institutions. Diving into the history to explain the roots of this institutional design is beyond the scope of this paper. Enough to say that Soviet people used to view the state as a Leviathan imposed "from above" to oppress a person rather than as a mechanism created by people to serve the society. Many people still have this view and thus very low trust to formal state institutions. This low trust considerably slows down reforms, especially those which critically depend on people's participation (such as decentralization). In their turn, slow reforms cause disappointment and further reduction of trust into government.

This suggests that to reduce corruption from systemic to episodic phenomenon, one needs to set the institutions right. The main features of institutions averse to corruption are transparency and clear procedures for decision-making which minimize the room for discretion of a single one official. Another necessary element of an anti-corruption system is prosecution –there should be someone to dig into all the data that a transparent institution produces to spot and investigate cases of corruption and to punish responsible officials. Results of anti-corruption investigations should be used to adjust the procedures to eliminate opportunities for the same wrongdoings in the future.

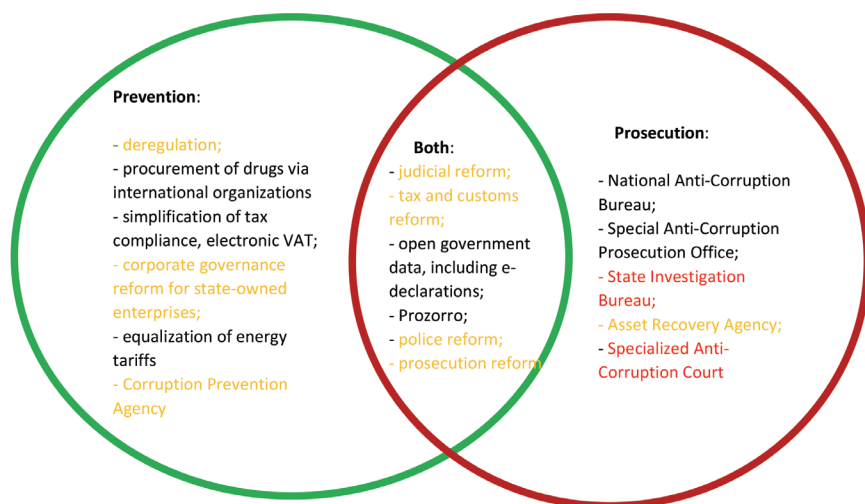
Ukraine has done a lot to limit the room for corruption and introduced almost all institutions responsible for prosecution of corrupt officials (Figure 8), except for the specialized anti-cor-

¹⁰⁶ See, for example, a series of IRI public opinion surveys: <http://www.iri.org/resource/ukraine-poll-continued-dissatisfaction-government-and-economic-situation>

ruption court. These institutions would have been impossible without the effort of Ukrainian civil society organizations and international partners. However, since the political class has not been sufficiently renewed, the newly created anti-corruption bodies as well as anti-corruption CSOs face constant political (and sometimes physical) pressure and attempts to capture them or sabotage their work.

Looking at Figure 8, one can immediately recall a number of scandals related to practically every element of anti-corruption reforms listed there –from sabotaging appointment of new top-managers to state-owned enterprises to the prosecution reform stymied after adoption of Constitutional amendments; from Corruption Prevention Agency formed with a year-long delay and now practically dysfunctional to requirement to submit e-declarations for heads of anti-corruption CSOs.¹⁰⁷

Figure 8. Two sides of the anti-corruption coin



Note: orange text –partial implementation, red text –not implemented

¹⁰⁷ This legislation was the only one that received the grade of -5 from iMoRe experts. In-depth analysis of adopted legislative changes can be found in VoxUkraine publication "Damaged Trust: Politicized Misinterpretations of Ukraine's Newly Amended Anti-Corruption Law" by Ariana Gic.

Nevertheless, the newly created anti-corruption institutions are working –for example NABU is investigating about 400 cases, and almost a hundred of cases have been already passed to courts. These new institutions are still not fully established and experience constant political pressure –therefore, the society should support and protect them rather than demand immediate results and despise for the absence of those.

Many reforms discussed in this paper have an anti-corruption effect. E-procurement and new standards of banking supervision eliminated huge opportunities for misuse of public funds and for money laundering. New rules in the energy sector killed a few corruption schemes. Wise regulation and simplification of administrative procedures should make it cheaper to comply with the laws than to circumvent them. Privatization of state-owned enterprises would eliminate one of the largest remaining sources of corruption. Adoption of healthcare reform and allowing land sale would de-shadow respective markets. Thus anyone who supports these reforms is simultaneously fighting corruption.

Perhaps even more important for reduction of corruption (and certainly more difficult than legislative changes) is transformation of informal institutions –so called 'business as usual' where 'usual' is a euphemism for 'dishonest'. Today, being honest is often costly and time consuming. The good news is that it has a network effect –the more people switch to honest practices, the easier it gets until at some point 'honest' becomes 'usual'. Another piece of good news is that it's much easier for honest people to build strong coalitions based on mutual trust. And, as we have seen during and after the Euromaidan, such coalitions can replace formal institutions and even transform them.