

ECONOMIC FREEDOM AUDIT OF UKRAINE

2017



CASE Ukraine

BENDUKIDZE
FREE MARKET
CENTER



According to the Economic Freedom of the World report (www.freetheworld.com), an annual publication by the Fraser Institute, Ukraine is the least economically free country in Europe. In this report, the CASE-Ukraine Center for Economic and Social Research and the Bendukidze Free Market Center undertook discussions with leading Ukrainian business professionals to identify the causes behind this situation and develop recommendations for the necessary transformation.

Report prepared by: Dmytro Boyarchuk, Volodymyr Dubrovskiy, Volodymyr Fedorin, Volodymyr Landa, Natalia Melnyk, and Yevgen Shulga.

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INTRODUCTION

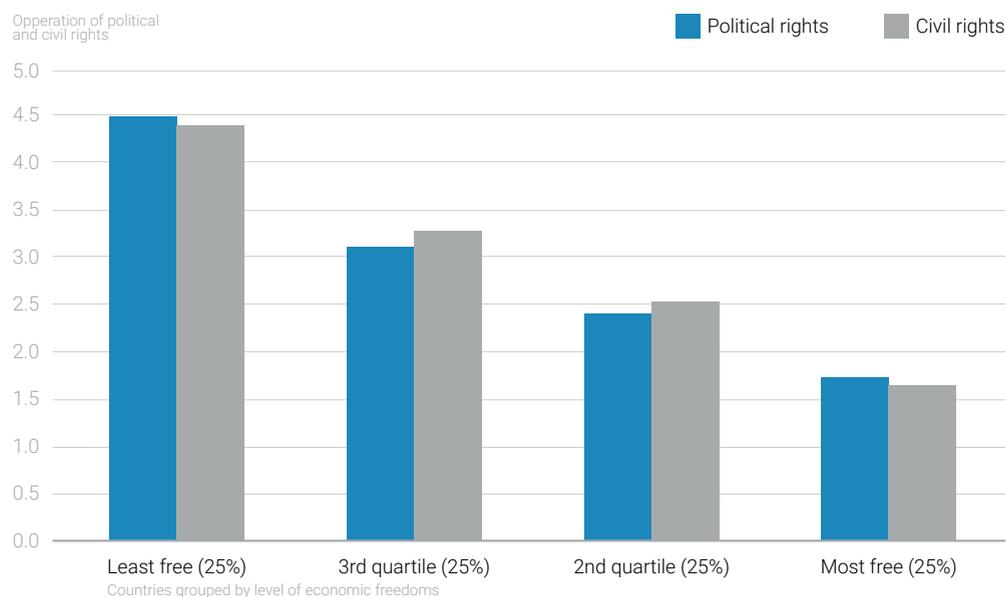
Economic freedom means the opportunity to make personal economic decisions without any pressure. When people engage in voluntary transactions, both sides must benefit—otherwise the losing side will simply walk away from such an exchange. When there are myriad such relationships, they ensure the well-being of the contemporary individual and the advantages of a market economy over other ways of organizing the economic activity of a society¹. In short, economic freedom is the most important foundation for wealth and rapid economic growth, and numerous studies have only confirmed this.

The opposite of freedom is coercion, force and deception. This forces people to make decisions that are negative and prevent individuals from entering into mutually beneficial relations that would increase wealth, and so ultimately diminish or even destroy wealth—through actual prohibitions or, for instance, fear of being tricked. Thus, societies where crooks and con artists thrive remain poor. A state monopoly on legitimate coercion can fix this, but only as long as this is being done in order to promote or maintain economic freedom, that is, free access for all citizens to any kind of beneficial economic activity, coupled with real protection for the inalienable right of any person to freely manage their labor and property.

On the other hand, the state has its price: it collects taxes and establishes certain limitations and responsibilities. Its monopoly on legitimate use of coercion can also be used in the private interests of individuals in power and unscrupulous business owners who take advantage of the government's pressure to force people to make decisions that are not economically beneficial for them—but very beneficial to those entrepreneurs. As a result, in a clear majority of countries today, the state is the guiltiest party among all those who violate economic freedom.

This report looks at economic freedom as tightly tied to natural human rights and freedoms (see Fig.1). To a very large extent, indeed, it is foundation of all other freedoms: examples of countries where there is a high level of economic freedom but limited political freedoms are plentiful whereas their opposite, countries that are politically free and democratic

Fig. 1. Economic freedom and oppression of political and civil rights



Source: *Economic Freedom of the World: 2016 Report (Ukrainian edition)*, Bendukidze Free Market Center, Kyiv, 2017, p. 28

¹ For more details, see a special popular analytical report by V. Dubrovskiy Debunking economic illusions. Part 2: Exchange and wealth, CASE Ukraine, 2013.

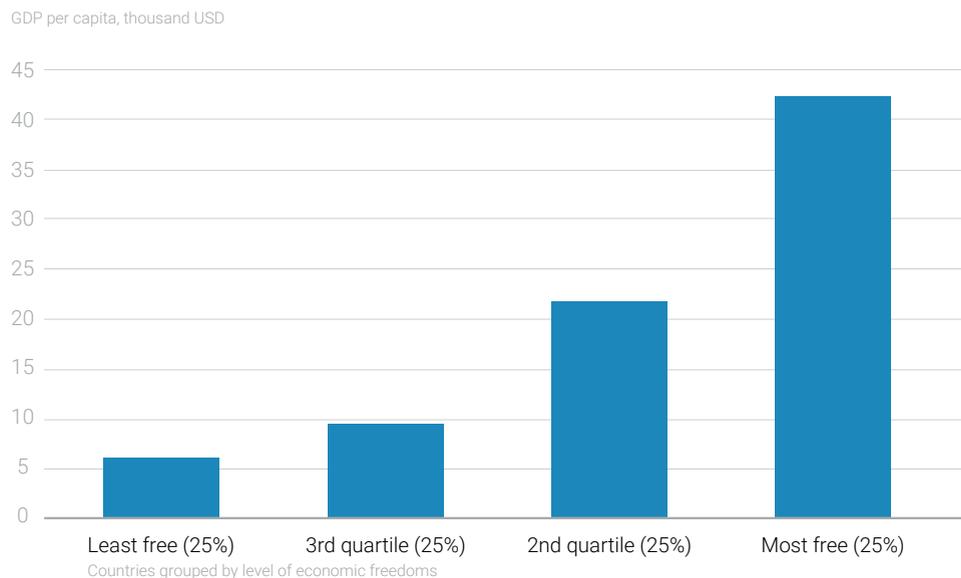
yet lack in economic freedom are few and far between, as it is an unsustainable state. Among the 40 countries with the lowest level of economic freedom according to the Fraser Institute's «Economic Freedom of the World: 2016 Annual Report», based on 2014 data, only 6 countries qualify as «free» in the Freedom House Index—and several of them were run by dictators until not so long ago, so it is unclear how sustainable their political freedoms are. On the other hand, 17 countries are qualified as «unfree», even though Economic Freedom of the World does not cover many countries that are reprehensible in terms of all kinds of freedoms, like North Korea, Cuba, Turkmenistan and Uzbekistan.

Unfortunately, Ukraine is in the bottom quartile of economic freedom: 135th out of 159 in 2016, and 148th in 2017, based on 2015 data. For several years running, Ukraine has also been the lowest-ranked in Europe. So what, other than being in not-so-good company, is so bad about this from a practical point of view? How does this get in the way of ordinary Ukrainians?

First of all lack of freedom means poverty. Ukraine lags behind in Europe not only in terms of economic freedom, but also in indicators that are felt far more by the average person, such as per capita income, where it resembles one of the poorer developing countries. This is not coincidental at all. None of the 40 least economically free countries is prosperous: the tie between freedom and prosperity is very strong. The well-being of a country depends on many factors that are tightly interconnected and are, in turn, dependent on prosperity (see Fig. 2). Experts have not yet managed to untangle this ball of yarn, but one thing remains clear since the days of Adam Smith: markets based on voluntary economic decisions, meaning on economic freedom, are the main source of the wealth of nations.

For Ukraine to at least dig itself out of the poverty which is a reality for a large number of its citizens, its economy needs to grow at a high pace from its current level for a decade or two. However this will be impossible to achieve without a radical improvement in economic freedom because of the well-proved² close link between it and economic growth (see Fig. 2). When it comes to economic freedom, the familiar dilemma, freedom or sausage, is completely wrong because there can be no sausage without economic freedom—even huge petroleum reserves cannot save the day, as Ecuador and Venezuela have starkly proved. And so, if Ukrainians would like to live more like the Poles and Slovaks do, within their lifetime, the country needs to establish the conditions for growth and that means, first of all, expanding economic freedom. Ukraine has enormous problems with this (see Table 1) and ordinary Ukrainians feel it directly.

Fig. 2. Economic freedom and prosperity



Source: *Economic Freedom of the World: 2016 Report (Ukrainian edition)*, Bendukidze Free Market Center, Kyiv, 2017, p. 25

² See, for example: C.S. Akin, C. Aytun, B.G. Aktakas, The Impact of Economic Freedom upon Economic Growth: an Application on Income Groups, *Asian Economic and Financial Review*, 2014, 4(8): 1024-1039.

Economic freedom is primarily necessary for economically active people, especially entrepreneurs, but certainly not only by them, as many mistakenly think. Its lack is felt even by pensioners, as inflation hits them hardest of all, they feel the rising cost of basic items most painfully, and this is the direct result of a low level of monetary freedom, that is, the absence of sound money. For this indicator Ukraine had the worst ranking of all countries in the world: 3.3 out of 10 points in 2017, based on 2015 data³.

Those who work suffer even more from limited economic freedom: the less there is of it, the fewer options they have for choosing jobs that suit them and offer a decent wage for their efforts. The worse off businesses are, the less labor they need because there are fewer people willing to start their own business and compete on the labor market. When an economy is free and business suffers from a lack of qualified personnel, rather than from the absence of a just court system, law enforcement and bureaucrats' extortion, excessive taxes, lack of access to credits, and so on—then working conditions become attractive, wages rise, benefits packages improve, training and professional development are more available, and many more good things.

Ukraine's labor market is heavier regulated than the average in developed or post-communist countries, but this ephemeral protection of workers does little to resolve the issue of low income. The strict requirements of the Labor Code and

Table 1. Ukraine compared to select countries according to components of the Economic Freedom of the World index (2017, based on 2015 data)

	Size of govt	Legal system and property rights	Sound money	Freedom to trade Internat.	Credit regulation	Labor regulation	Business regulation
Hong Kong	8.5	8.9	9.8	9.2	10.0	9.6	9.3
Chile	7.9	8.8	9.8	9.2	10.0	9.3	8.9
Georgia	7.8	8.7	9.8	8.8	10.0	8.9	8.6
Singapore	7.8	8.6	9.8	8.7	10.0	8.7	8.5
Switzerland	7.7	8.4	9.8	8.7	10.0	8.5	8.4
Mauritius	7.6	8.3	9.7	8.6	9.9	8.3	8.3
Panama	7.5	8.3	9.7	8.6	9.9	8.3	8.3
Cyprus	7.2	8.2	9.7	8.5	9.8	8.2	8.3
Lithuania	7.2	8.2	9.6	8.5	9.8	7.8	8.2
Armenia	7.1	8.1	9.6	8.4	9.8	7.8	8.1
Top 10 (average)	7.6	8.5	9.7	8.7	9.9	8.5	8.5
Global average	6.4	5.3	8.3	7.0	8.2	6.4	6.4
Average for developed European countries (Austria, Ireland, Germany, Great Britain)	5.6	7.8	9.7	8.3	8.7	7.5	8.1
Average for post-communist countries	6.4	5.7	9.1	8.2	9.6	6.6	6.5
Poland	5.7	5.8	9.6	8.0	8.8	7.6	6.5
Russia	6.6	4.8	8.5	6.6	7.8	5.6	6.0
Ukraine	6.5	4.3	3.3	6.5	7.1	5.4	6.4

Source: *Economic Freedom of the World: 2016 Report (Ukrainian edition)*, Bendukidze Free Market Center, Kyiv, 2017, p. 13-17

³ That year was extremely poor in terms of macroeconomic situation, but Ukraine performed not much better in previous years too, although not as bad as in 2015.

the minimum wage only protect those who are already legally employed, but no law can obligate anyone to provide such a job. The reverse side of this protection is a lack of jobs. After all, if it's hard to fire an employee, employers have to consider carefully before they hire someone. Fortunately, Ukrainian SMEs largely ignore the Labor Code and so Ukraine is not suffering from high unemployment the way some more law-abiding, socially-oriented EU countries are. Unfortunately, western investors do not understand how you can just ignore the law, and so these rules deter them from coming to Ukraine.

The lack of economic freedom is evident everywhere. Buyers of goods and services often have fewer choices and pay higher prices than in many developed—and a lot wealthier—countries. Why is that? First of all, there is not enough competition in the domestic market: Ukraine was given 6.5 points for «freedom of trade internationally», and Anti-Monopoly Committee figures suggest that less than half of the markets are mostly competitive⁴. But even more importantly, nearly all those who provide goods and services are forced to pay kickbacks to the law enforcement and tax authorities. Indeed, in many cases, the bureaucrats and even the law enforcement are busy quashing competition and seeking justice in a court is in vain. This is confirmed by the very low rating for Ukraine's court system and protection of property rights—4.3.

Finally, those who would like to start their own business, to produce something people need and create new jobs, to expand their existing business, or to simply to get a loan to buy something can look at people in developed countries with envy, because interest rates are usurious in Ukraine. This is also a consequence of limited economic freedom: in this case, inflation combined with high risks for lenders, who also cannot recover their losses through the courts. However, the regulation of the credit market in Ukraine was rated a decent 7.1 points, but even that is far lower than that of more economically successful countries.

More details about Ukraine's position and that of its neighbors worldwide, the methodology behind the Economic Freedom of the World index and other interesting facts can be found in the annual report, which is freely accessible, in English at <https://www.fraserinstitute.org/economic-freedom> and Ukrainian, on the Bendukidze Free Market Center website (<http://bendukidze.org>)⁵.

This Audit of Economic Freedom is a joint project of the CASE Ukraine and the Bendukidze Free Market Center, undertaken with the financial support of the Atlas Network. The purpose of this research was to identify the bottlenecks preventing Ukraine from moving forward, despite having a highly educated, entrepreneurial and freedom-loving population that has managed to organize two revolutions within a decade, and causing it to fall behind the rest of the world where economic freedom is slowly increasing.

Our decision was to identify these problem areas empirically, turning directly to those who make use of economic freedom, owners and managers of businesses. Over the spring and summer of 2017, we held six focus groups with more than 20 business owners and top managers. To ensure that the discussion was open, we followed the Chatham House rule: the researchers were allowed to quote the participants but without revealing their names or positions.

During this study, we discovered four kinds of problems that businesses consider critical. Based on the structure of the Economic Freedom of the World index, they belong to the areas «Size of government», «Legal system and property rights», «Sound money», and the component «Labor market regulations». Accordingly, this Audit consists of four chapters. In each one, we offer an analytical overview of the current state of affairs and formulate recommendations for how to improve the situation substantially. We are confident that if the obstacles discussed in this report are overcome, Ukraine will be on the path to quicker and more sustainable economic growth.

⁴ «Markets without substantial structural restrictions on competition tended to have a 43.4% share of all sales [2016], whereas markets with significant structural constraints had 43.0%». – AMC Annual Report for 2016.

⁵ Economic freedom of the world: Annual Report for 2016 (Ukrainian edition), Kyiv, Bendukidze Free Market Center, 2017.

SECTION 1. SIZE OF GOVERNMENT

Volodymyr Dubrovskiy

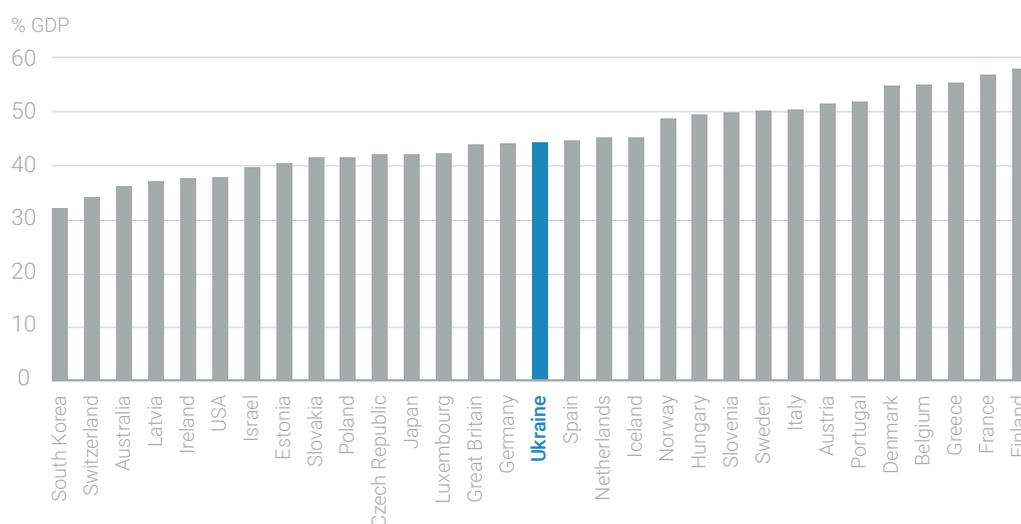
The size of its government determines to what extent a state interferes with economic processes, meaning that the individual choices of households and entrepreneurs are replaced by political decisions. The greater share of resources a government manages and the more it restricts commercial relations with regulations, the less economic freedom there is. In this section, we look only at the economic dimension of government as reflected in the GDP share of state spending. Of course, without at least a certain amount of resources at its disposal, a state cannot really protect property rights, defend the country militarily, or provide benefits to its citizens. Moreover, certain regulations are really needed where market mechanisms fail for one reason or another. Still, governments around the world tend to overly increase their role in the economy and this, as numerous studies⁶ have shown, has a noticeable impact on the pace of economic growth. Wealthy countries where the basic needs of their citizens have already been reliably provided for a long time can allow themselves the luxury of a larger government, although they do not really need it. As one of the participants of our focus groups noted:

“ «Ukraine collects in the form of taxes and spends almost the same amount as Germany (see Fig. 3), although our country is about 20 times poorer. It is really hard for me to imagine that such a tax burden makes sense, given the level of economic development here».

Ukraine's economic freedom ranking

Nominally, Ukraine has 6.5 points for the area «size of government» in the Economic Freedom of the World index, which is close to the world average, 6.4. This coincides with the average for post-communist countries and is even better than the average across the EU, 5.6. Firstly, this assessment is thanks to the relatively small share of investment in state enterprises and the relatively low tax rates on personal income. The most problematic issues at the time of writing were the indicators for the rate of taxes on labor, the so-called «social contributions», 44.0%, and the GDP share of transfers and subsidies, 22.7%. For those two, Ukraine received 4 on a 10-point scale. Whereas the first of these probably came down with a reduction in the tax rate in 2015, the second puts Ukraine far higher than European Union, Russia and most of the rest of the world. The world average for social transfers is 9.0%, in the EU—20.7%, in Russia—20.3%, and in Poland—16.8%. In part, this is connected to the need to temporarily compensate for the cancellation of hidden subsidies that made it look like Ukraine was enjoying cheap natural gas with open subsidies. However, a bigger reason is the huge number of pensioners.

Fig. 3. Ukraine's share of GDP distributed through public spending compared to other countries (one of the dimensions of 'size of government')



Sources: Data on Ukraine from Draft Budget and Pension Fund Budget for 2017; other countries—OECD

⁶ See, for example: Bergh Andreas and Magnus Henrekson. Government Size and Growth: A survey and interpretation of the evidence, IFN Working Paper #858, 2011.

The PIT: reasonable or not?

Modest tax rates do not necessarily mean that Ukraine’s taxes can be called low, otherwise «high taxes» would not be in second place among the obstacles to doing business in Ukraine, based on a business poll carried out by ABCA. First of all, personal income tax (PIT) in most cases is compounded by an employee tax called the single social contribution (SSC) that, even after being reduced for 40%, remains too high.

Secondly, what matters is not only the percentage of the tax rate but also the base: if we take the total taxes from the same size of income in dollar terms, it turns out that Ukrainians are paying more than residents of developed countries, as most of those countries have a minimum taxable income level that is way above what ordinary Ukrainians make. Even if we take into account the difference in scales of income, the Ukrainian PIT is not that light, given that the untaxed minimum called the «social break» is half the size of the subsistence minimum. What is more, as of 2017 the untaxed minimum lost all meaning because it applies not to all incomes, but only to salaries that are less than the government legislated minimum income!

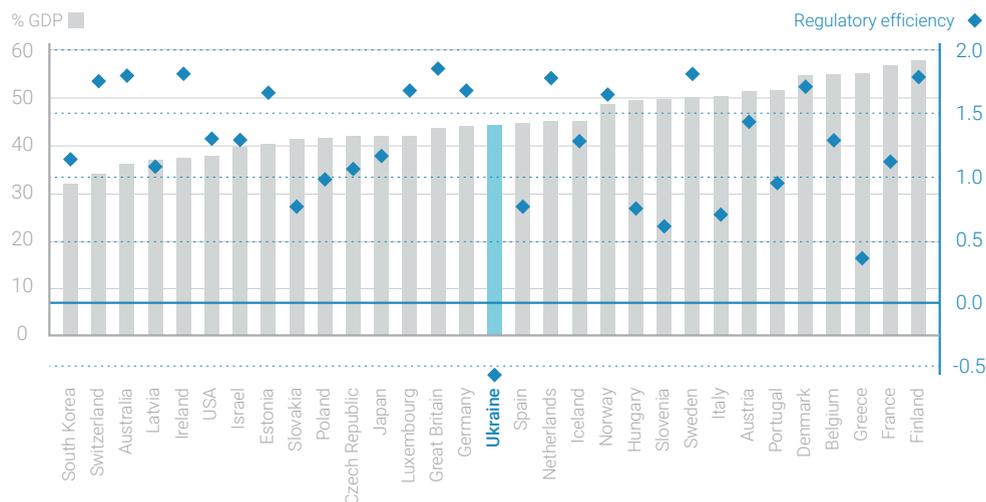
Finally, direct taxes are secondary in Ukraine: the lion’s share of revenues is paid indirectly: the VAT, about twice as high; excise tax, which is two thirds of the PIT; and taxes on resources, which are about half of the PIT. Although they cause somewhat less damage to the economy, they also constitute a heavy burden.

What is more significant is that the tax burden and, together with it, the size of the government are not just weighty in and of themselves but even more so in comparison to the efficiency of the state and in the way taxpayer money is spent on common needs: social welfare and the protection of property rights and market freedom, which is an integral component of economic freedom.

If the state ends up spending money less efficiently in certain areas than the private sector from which that money was taken, this costs the society. It can happen for two main reasons: money is being spent on things people do not need, such as pompous celebrations or luxurious buildings—or it can even be spent on priority needs, but very inefficiently, part of it embezzled, and so on. The third reason is lack of capacity on the part of the state to carry out key functions, such as protecting property rights. In this case, the taxes collected by the state can end up being spent not on the public good but on the so-called «public evil»⁷.

The size of the government needs to reflect its efficiency according to the principle of getting value for money. If we use a business analogy, the size of the government should match its capacity: it should be allowed to grow until it becomes profitable for its owner (i.e. citizens), but not more. If the expansion of the state can be controlled, value will be higher than cost, and then the country stands a chance of becoming an economic «tiger». The problem with Ukraine is that it seems to be exactly the opposite: the Worldwide Governance Indicators (WGI) issued by the World Bank confirm the inefficiency and lack of benevolence, especially when it comes to protecting property rights, quality regulation and so on, yet in size, it is very similar to the other European countries (see Fig. 4).

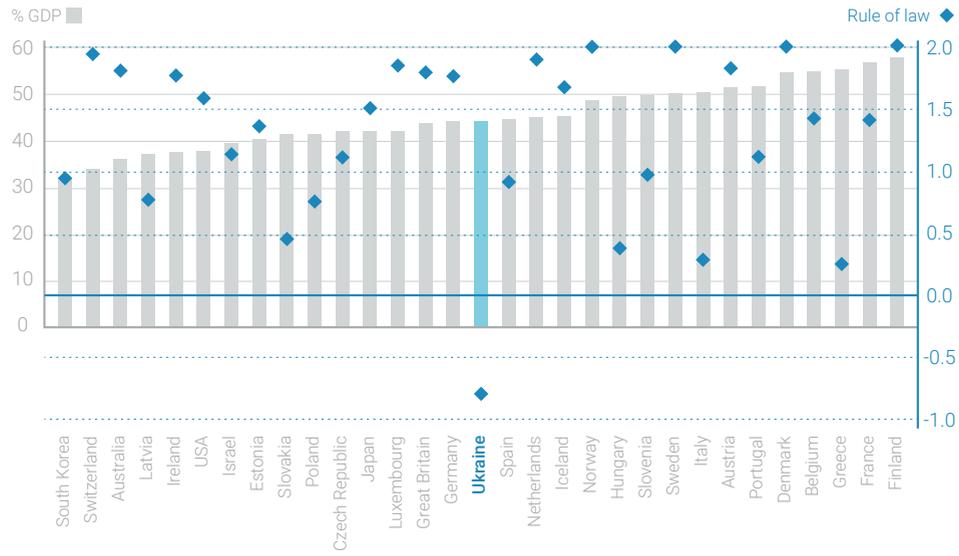
Fig. 4. Regulatory efficiency



Source: World Governance Indicators

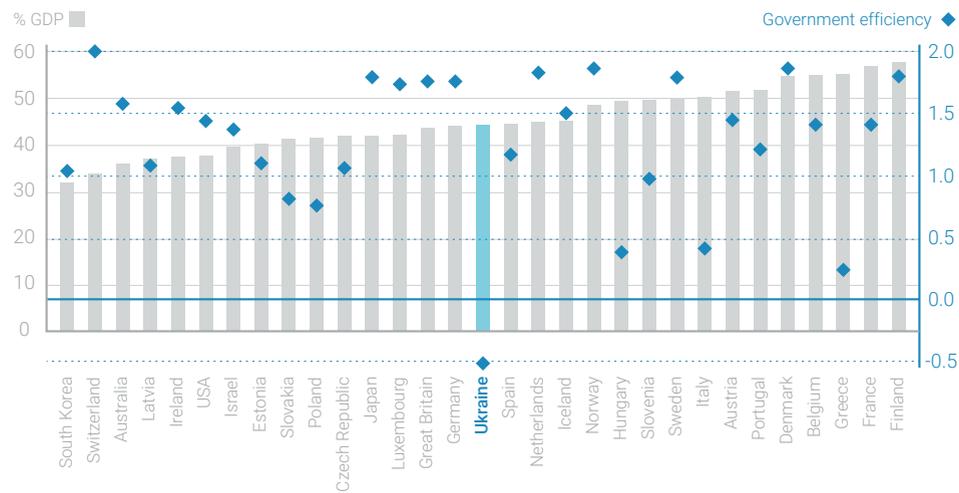
⁷ This is discussed in greater detail in Section 2 on the legal and law enforcement systems.

Fig. 5. Rule of law



Source: World Governance Indicators

Fig. 6. Government efficiency



Source: World Governance Indicators

Why the government is too big in Ukraine

The authors of this study believe that the reason for the overly big size of government in Ukraine is an unfortunate combination of a natural state, as North, Weingast and Wallis call it, that is essentially predatory with huge elements of a welfare state, either inherited directly from the USSR or introduced by populist politicians to satisfy the sentiments of voters who grew up in those times.

In Ukraine, as in most countries around the world, the «natural state» is a collection of extractive institutions, that is, institutions designed for predation, as Acemoglu and Robinson argue. Their main purpose is to satisfy themselves, i.e., those who are in power or who have force-based leverage, and those who faithfully serve those in power. The public goods, including the defense of rights and freedoms, are only provided to the extent that they help increase the rents from organized predation and give those in power sufficient legitimacy in the eyes of their subjects to keep them from rebelling. The governed can hardly be expected to show high efficiency in the spending of taxes collected for the benefit of the citizens, while economic freedom has to be fought for, every step of the way. The Orange Revolution (2004) and especially the Revolution of Dignity (2013) were important steps in the direction of subordinating the state to the people. Every developed country has gone through this process at some point, but Ukraine still has a long way ahead.

One would think that a welfare state is completely incompatible with extractive institutions, as it was set up precisely to redistribute wealth from the rich to the poor. Indeed, it emerged in its modern-day form in developed countries. Still, as it often happens with immature democracies, the government of the natural state buys off its dissatisfied populace by borrowing elements of the welfare state in order to maintain its legitimacy. Emperors of old gave their plebes bread and circuses for free for the same reason.

However, this does not contradict the predatory nature of such a state: those who enrich themselves through the state also continue to use state coercion to steal, and those in power in such a state are indistinguishable from this «business». At the same time, bit by bit but in a very visible manner they «share with the poor», and what is worse, they try to keep the poor quiet at the expense of the middle class and legitimate business that is not connected to the state. This is a typical situation in many countries in Asia, Latin America and Africa.

In Ukraine's case, the situation is complicated by the fact that it is not only a natural state but also a post-communist state.

Firstly, the USSR as a state took absolutely everything and the people were used to being dependent entirely on it. Moreover, it left behind numerous often completely inefficient enterprises that for some reason have not been privatized to this day, often for no logical reasons at all. Almost all education and medicine are also run by the state, as well as the housing stock, the defense industry and many other areas where, as experience has shown in other countries, enterprises can and do operate quite well under the private sector. Direct and hidden subsidies, often ill-conceived and unjustified are provided to many categories of households and even to certain enterprises. Voters are in the habit of placing generous social guarantees at the top of their priority list, without concerning themselves at all about how these will be financed.

Secondly, Ukraine also inherited from the USSR a demographic situation that is typical of many industrialized countries: an aging population and low birth rate. Still, in other countries people continue to be able-bodied for longer, while the subsistence level in Ukraine, unlike those countries, is about half of the per capita average income. This leads to a large share of pension benefits in the economy. What is more, the retirement age in the USSR was established back in the 1930s, when people's active years were far fewer than today. It was less of a problem then because the population was younger and the farmhands or kolhospnyky, constituting more than half the population, had no pensions at all. Moreover, when the situation changed, in the later years of the USSR, the government did not adjust things, worried about damaging the «achievements of socialism». To a large extent, these traditions continued and they are hard to overcome politically. Thus, pension transfers remain nearly 10% of GDP in Ukraine today.

Thirdly, just now, Ukraine has added two items to the budget that together have reached almost 10% of GDP but are impossible to reduce no matter how burdensome they may be: security and defense, and servicing the national debt. The former is tied to the hybrid war with Russia and the second one is detailed in the section «Sound money».

Finally, the Ukrainian state not only «will not» serve the people and protect property rights, but it actually is largely lacking the capacity to reach its goals (see Fig. 6, «Government efficiency»). This is mainly because of its colonial past, where, for nearly 800 years, with the exception of the relatively short Hetmanate, Ukraine was at the periphery of other empires and its people did not experience the traditions of state-building and exercising control over the authorities.

The transition period from a more-or-less consistently organized natural state, that is, the tsarist and soviet Russian empire, to a modern state in the service of its people inevitably weakens the government's capacity as the state bureaucracy is temporarily without a «boss» and begins to take on a life of its own, feeding off the country in an unsystematic manner. And this is exactly what we have witnessed in Ukraine ever since it became independent.

So, for starters, it would make sense to substantially reduce the size of the government, but there is no one to do it, so far. On the contrary, left to its own devices, it tends to expand. The number of civil servants has increased since 1991 nearly sixfold, from about 60,000 to nearly 350,000⁸. Even considering the need to rebuild state institutions, this is far too many, if we take into account that there was a simultaneous transition from a planned economy to a market one that needs less state control. Moreover, innovative technology offered the opportunity to reduce the size of the state bureaucracy. The economic share of the government grew from about 30% of GDP at the beginning of 2000 to 50% and more over 2013-2015. It then fell back to 41% in 2016, but has since begun to expand again. Meanwhile, the efficiency of the state in carrying out its commitments to its citizens, especially to business, remains extremely low.

Public spending: Inefficient and inflated

Public entities typically spend funds far less efficiently than private ones. This is true not only of Ukraine but of any country. A classic example is Space-X, a private company, which was able to build a space ship 10 times less expensive than NASA, a state agency. In Ukraine, such examples happen on a daily basis.

Quotes from the focus groups participants:

- " *«[In the Kyiv City Council] every meeting has a UAH 180-200 million resolution, you simply ask them 'Why?' and they agree to cut the price in half. KyivAvtoDor... procuring salt and I say «Why 200?» And they answer: «Ok, 100». I think that...all those expenditures can easily be divided by three and we would live by them no problem».*
- " *«Social spending. Our government is simply inflated in this area, it is quasi-social... We have... five ministries that have something to do with social policy... The delivery costs contain a 20% transaction fee... we pay UAH 1,200 for the recipient to get UAH 1,000. If you take the analogy of a retail bank, then 3%, well maybe 5%, max... to send money to a recipient. It should be cut fourfold for sure».*
- " *«DerzhStat has 10,450 workers. The central office employs 450, which by world standards could even be understaffed. But at the regional and county levels—10,000 people?! While other countries simply do not deal with statistics at the regional level... Right now, there are American Cropio systems that provide you with data on harvests across the entire country. So why the heck do you need people to send in reports about what their harvest is?»*
- " *«Basically, everything that is connected to UkrOboronProm and the defense industry, the 5% of GDP, I can assure you that 80% of it goes for the wrong purpose... it goes to state companies, where the motivation is to have lots of people who are paid UAH 5,000 each. It is completely inefficient. We can reduce all that [personnel] tenfold and get the exact same results».*
- " *«State companies are simply an unbelievably huge hole through which all that is siphoned and, most likely, the way things are right now, it is not going to stop siphoning. While we are all sitting here and tossing ideas around for a new book, some guys are sitting somewhere, cutting another deal».*
- " *«I was at an event yesterday, a meeting of the aviation cluster... The meeting lasted 2.5 hours. The managers of all the aircraft manufacturers in the country were sitting there, supposedly the elite of the industry. Not a single minute was spent on new models, on entering new markets, or on any kind of reorganization of the sector. All the time was spent on figuring out how to get more cash out of the Treasury or out of defense procurements, and to approve an aviation industry development program worth US \$750 million. So tell me, is this efficient? Is the state needed here? No, it is not. Industrial policy is not needed because, the way things are today... it means little more than access to public resources that will be spent at a rate of 10 to 1 of what is really needed».*

Obviously, when officials or MPs handle money that is not theirs, but public, the question of what something might cost is secondary for them compared to other issues: their personal status as the manager of a major project, the opportunity to bribe voters with the benefits of public procurement, especially in FPTP districts, or to strengthen their own position thanks to the personnel of a useless entity and, last but not least, their own corrupt interests. The ProZorro system has been fighting successfully against kickbacks during public procurement, but as our participants demonstrated with various examples, it does not always work. An auction might select the cheapest executor but, firstly, this can be fixed by establishing qualifications and requirements that block more efficient suppliers. Secondly, resolving the issue by the cheapest means possible, say, through outsourcing, can only be done by a decision-maker, provided they have the necessary desire and qualifications.

One of the reasons for the inefficient use of funds is corruption. It is not just a matter of a sizeable kickback fee for the deciding official included in the price of goods and services. Even the priorities of public spending are distorted under the

⁸ <http://www.expres.ua/main/2016/02/06/172275-roky-nezalezhnosti-chynovnykiv-stalo-6-raziv-bilshe>

influence of corrupt interests: projects are planned because they are easier to steal from, not because they are needed by the public. Similarly, when projects are being implemented, decisions are included that have nothing to do with efficient use of funds but are favorable for kickbacks and «gifts» for the «right people».

“ «For instance, the Kyiv City Council adopts a budget of... UAH 800 million [for computerization]... which is more than what was invested in OLX, Rozetka, ModnaKasta or Prom... in short, in all the online platforms in Ukraine put together, by at least two times... What strikes you most of all is that they built their own data center because they did not want to set up a cloud. Why not? Because they were told that municipal data in the cloud will not be secure, that just about anybody would be able to get in there. Amazon cloud is insecure! And so, they built their own data center, and what is most interesting, they are now installing their own fiber optic lines... For the city to have its own fiber optics is simply outrageous. Fiber optics is a very competitive business, right? And that is what the people who subsequently won the tender explained to the Council. Not a single decent company was invited. And that is how they spent the UAH 800 million».

Among other problems, embezzlement and spending taxpayer money inefficiently and out of line with real priorities is often used as justification by those who themselves avoid paying taxes. Such facts and their consequences—neglected and underfinanced public services that are really needed by ordinary Ukrainians in stark contrast to services that are not needed, plus the luxurious lifestyles of corrupt officials—discourage people from paying taxes.

In the world today, the owners of financial and human capital can choose from a wide circle of jurisdictions and do their business where it is convenient for them. This includes not only direct costs, such as the value of services, labor or state taxes, but also indirect ones: the cost of upholding regulations, ease of doing business, security, property rights, and so on. For this very reason, most direct investors have tended to circulate among developed countries. At the same time in countries where the government and its representatives tend to «milk» business, as is the case in Ukraine, unfortunately, capital and brains flee to more comfortable places, regardless of the relatively inexpensive real estate, low salaries for support staff, and even tax breaks in some cases. This is how one participant of our discussions put it:

“ «I calculated my gross costs of doing business—in Kyiv, in Moscow, in Santa Clara, California, in Tel Aviv, in Amsterdam... Moscow and Kyiv were about the same, Santa Clara was cheaper. There every square meter costs a lot more, but when you add it all up... In Kyiv, there are bribes, kickbacks, all the taxes, the shakedowns and so on. And so when we started adding it all up, it was easier for me to do business in Santa Clara... in California I do not even know what the tax authorities look like».

In Ukraine, the state is very accommodating to businesses that are connected to those in power, tolerates those who are able to «come to terms», and acts like an enemy towards the rest. The last group constitutes about 30% of all business in Ukraine, according to a ABCA business survey, which is twice as many as those who consider the state their partner.

“ «There is no parity between the state and business. An entrepreneur does not have the right to violate the law without facing mandatory fines, while the state, in the person of its bureaucrats and officials, has that right. If we take EU as an example, say, Germany where tax legislation is also not among the easiest to understand, but they do give businesses the right to make a mistake, give or take 10%. We [in Ukraine] have something alike traffic rules: you can go 20 km over the speed limit, so why cannot we allow the same mistake with numbers. When the state does this itself every step of the way. Why does not the government have any limits, adopting certain rules, but we, for instance, have researched certain aspects of corruption and have information regarding education—right now, the government can spend any amount of budget funds, like almost UAH 81,000 per child in rural schools, although the standard is UAH 9,600 a year. The government can do this, officials can do this».

In most cases a «partner» from the government is a government official with whom the business owner has to be on «friendly» terms.

“ «To do business one has to have 'friends'. I do not know a single person who had to deal with Customs and did not have a 'friend' there. Any other approach fails utterly. With the appearance of our new valiant Customs Code one article contains 12 points enlisting the documents needed to get confirmation of the DCV of a product. Moreover, it is very clearly outlined what kind and where from. So you present them all, and then there is the final point that says 'at their discretion, importers may provide any other documents they choose.' When I did not have a 'friend,' the answer from Customs was that the DCV was not approved, and the reason would be 'rejected under Point X, because the importer did not provide documents at their own discretion...' We contacted the prosecutor's office but that did not change anything because it all comes down to money».

Conclusions and recommendations

The more spheres the state attempts to regulate, the worse this problem gets. «The areas that the state decides to regulate are always a loss for the entrepreneur... The property market is so heavily regulated that if we stick to our guns, then we will not open sooner than in two years». This is why deregulation, which means institutionally reducing the state, is so important in Ukraine.

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This is why deregulation, which means institutionally reducing the state, is so important in Ukraine.

“ *«I think the state needs to get out of all these relations as much as possible, because it is hopelessly sick with corruption. Leave it at an absolute minimum, where its influence over business relations is as small as possible... I think that it is better to set up institutions of a non-governmental nature to regulate commercial relations independently rather than trying to fix this corpse that is almost unfixable».*

“ *«In terms of the size of the government, I say as small as possible! Everything that we can handle without the government, let's do it without the government. We will not be able to handle outside aggression without a government, same with intelligence work... We not only have to reduce the size of the government, but we have to change its very quality, the nature of government agencies. That is why we talk about e-government. The state has to stop being a repressive, paternalistic entity and become a service agency. The number of government employees needs to be cut dramatically and pointless agencies and institutions need to be shut down altogether. Get rid of the county and oblast state administrations».*

At the same time, the Ukrainian government executes its main function in relation to business very poorly: protecting property rights, primarily through a fair and effective court system.

“ *«If we say that we have an inviolable right to ownership, it is simply not true. In terms of judiciary reform, rulings on the same case can vary in various parts of the country... You come to court and they tell you: Everything is fine, but you are suing the Pension Fund and the Pension Fund needs contributions».*

“ *Once there is a properly working independent court system, Ukrainians, with their character and style of doing business, will fight to the bitter end for the truth. We are just like that. Give the opportunity to sue, to the point even of turning over the case to the Supreme Court in London for outsourcing. Our people are stubborn.... I think that this would be a major push to wipe out corruption. Because if anyone tried to demand a bribe, you would send him off and go to court».*

One thing that has to be acknowledged is that the problem with poor protection of property rights reflects a much larger, more dangerous problem: lack of respect for these rights among ordinary Ukrainians.

“ *«When property changed hands illegally for centuries, sometimes many times, the continuity of this law was ruined. And right now it is not very popular».*

Thus there is not much demand for the state to protect the rights of businesses and the general public does not defend them from «state-run racket». Looks as though this factor will continue to play a role for many more years, so the Ukrainian government is unlikely to be able to establish protections for business at the level of developed countries. This, in turn, means that Ukraine is likely to remain a much smaller economy relative to its size than these other countries for many years to come.

To tame the «natural state» in Ukraine, we consider the following steps necessary:

1. Similarly to the Georgian Act of Economic Freedom⁹, legislate limits on expenditures in the Consolidated Budget, as well as its deficit and public debt, and provide working mechanisms for upholding such limits, especially the requirement to pass deficit-free budgets until the national debt is reduced to a reasonable level, similar to the New Zealand law on fiscal responsibility. The move to a new level of state spending can be accomplished through medium-term budget planning, including:

- a. Properly and thoroughly verifying and auditing all social benefits and pensions. This will help clean out all the «dead souls» and stop other abuses of this system. Practice in other countries has shown that this kind of measure can cut expenditures by up to 30%.

⁹ Georgia limits state expenditures to 30%

SECTION 2. LEGAL SYSTEM AND PROPERTY RIGHTS

Volodymyr Landa

Reliable protection for property rights is one of the main conditions underlying economic freedom. Ukraine's legal system today, which should be responsible for such protection, especially the law enforcement agencies, is in a terrible state. In the 2016 Economic Freedom of the World index, Ukraine was ranked with Chad in the 10th place from the bottom with 2.75 points for «Reliability of law enforcement agencies», barely ahead of countries like Nigeria (2.7), Peru (2.69), Bangladesh (2.62), and Dominican Republic (2.6). In the 2017 Index, Ukraine's ranking for this component has improved significantly (to 4.21, still below the world average of 5.48) – due to the popular National Police reform that was introduced in 2015. However the information contained in this section, as well as the grounds to believe that the aforementioned reform has not turned out to be sustainable, allows us to predict that once again we should expect a decline in this indicator in subsequent reports.

The hermetically sealed system of law enforcement that the country inherited from the USSR works not for the public good but to maximize its influence and the personal enrichment of its personnel. The logic of this kind of activity was perfectly described by one of our participants:

“ *«What is the point of these raids? In most cases, it is to make money, sometimes efforts to make money on the side also serve the goals of those who ordered the harassment. For instance, some police departments tried to organize this against certain companies in order to change the way they work with distributors».*

What changes have taken place in this area in the last three years? Talking to large and medium businesses suggests that the reform of the police and prosecutorial system has somewhat reduced their pressure on business, but in the meantime, the illegal influence of the Security Bureau of Ukraine (SBU) on business has grown. Our participants say that the SBU's illegal interference is on a larger scale than the National Police, the fire and health departments put together. Of course, even in those departments, there are still regular cases of abuse of office.

“ *«If I look at the dynamic of raids, the Prosecutor's Office is definitely not the main culprit. The tax police used to be the worst, but now the worst 'economists' are the security guys».*

“ *«There is an impression that business has become a dairy cow for the SBU and the SBU is milking it everywhere it possibly can».*

As a consequence, business owners say that the cost of doing business is very high in Ukraine. According to them, it is higher than in other major business centers in the world, even though some aspects cost relatively little.

The situation has become worse because the current Ukrainian government has neither the political nor the economic will to deal with this state of affairs. What is worse, sometimes officials from the central government look at unscrupulous behavior in the security and police forces as a kind of insurance that the status quo will be maintained in the country's political system. For instance, the president recently awarded a state order to one of the deputy directors of the SBU, an individual who has been associated with many cases of pressure on business.

Despite the wide variety of ways that the SBU interferes with the activities of commercial entities, there are several areas in which such interference is clearly systematic.

Financing terrorism

Legislative initiatives to establish responsibility for financing terrorism are not doing their primary function so much as untying the SBU's hands to excessively interfere with the activities of commercial entities. Practice has shown that the special service regularly uses its broad powers for purposes that are against the public good.

For instance, on May 11, 2017, the SBU searched the offices of TRT Oil Retail, a company that sells coupons and smart cards for the purchase of fuel at gas stations. The company was accused of being a conversion center and transferring UAH 2 million a day in cash, part of which was supposedly going to support terrorists. Not long afterwards, Oil Retail Director Inna Koval received notice from the WOG gas station chain that the coupons seized from her company were being redeemed in its chain. According to CCTV videos, these were being redeemed by the same SBU officer who had

carried out the search. Shortly after that, unknown individuals began to call Koval with promises to get back the seized assets for US \$5,000. When requested by a journalist from a major Ukrainian media outlet to comment on this incident, the SBU refused.

“ *«When law enforcement agencies named specific sums that would help ‘resolve’ the issue, I intuitively felt that it was just another attempt at raider take-over. The amount of money is not important. But if you pay once, you have already lost control of the situation».*

Another case: In October 2016, Lakmar, a Ukrainian maker of chemical products, was placed on a sanctions list at the request of the SBU, because of supposed terrorist activity. Six months after the company filed a suit in court, the court still hadn't started hearing the case because the SBU claims that the imposition of sanctions is a state secret so they cannot testify as to the reasons for this imposition.

Sanctions against those involved in foreign trade

The reality is that, against its direct objectives, the SBU has actively been intensifying its anti-business activities which has been confirmed not just by our participants, but also by official statistics. According to figures from the Ministry of Economic Development and Trade, the number of requests from the SBU to sanction companies involved in foreign trade grew from 93 in 2015 to 580 in 2016, which is more than sixfold.

One widely reported case was when the SBU did not limit itself to interfering with individual companies but effectively took control of the entire LNG market. In November 2016, the Energy Customs office, at the demand of the SBU, stopped an entire raft of cisterns with LNG from Russia and Belarus, under the pretext that they needed to be checked for the presence of potent and toxic substances. By March 2017, the SBU prohibited 24 companies from importing LNG, including 8 non-residents. Most market participants say that this «sweep» of the market was in the interests of companies controlled by Viktor Medvedchuk, the infamous pro-Russian politician who has powerful political ties both in Russia and in Ukraine. Even after the personal intervention of the prime minister, the injustice was only partially reversed: two companies connected to Medvedchuk kept the exclusive right to buy LNG from Russia's Rosneft, which allowed them to increase their market share from 1% to 38% as a supply shortage led to a significant rise in the market price¹⁰.

“ *«I have been involved in imports and exports for 15 years at this point and Customs is my main counterparty. I do not know a single person who works with Customs and does not have a ‘friend’ there. No other set-up works».*

The SBU's interest can also be seen in the control of imports of cognac alcohols, which was stopped due to the alleged presence of toxic substances — despite the positive conclusions of the specialized laboratory of the State Fiscal Service. Suspicion fell, among others, on renowned imported spirits. Market participants see this kind of SBU activity as directly corrupt.

The SBU prohibited Matimex Ukraine from importing additives to sausages that are made by its parent Austrian company because of the presence of narcotic substances that were there in microscopic quantities, typically present in walnuts and smoked prunes. The case was dropped only after the PM, Prosecutor General and Austrian ambassador to Ukraine became involved.

Special technology for gaining information covertly

The SBU has a separate source of illegal leverage over business because of the lack of proper regulation of circulation of special technical devices for covert access to information (STD). The only institution that performs expert evaluation of this kind of equipment is subordinated to the SBU and cannot be considered independent. A few years ago, large-scale accusations were based on online orders of pens, keychains and laptop components. Since the decision to declare an item a STD is exclusively the competence of the SBU, «violators» often find out about their «violations» post factum.

The organizational structure for pressuring business

LNG traders and others who have suffered from the unlawful actions of the SBU believe that First Deputy Director Pavlo Demchyna is the person responsible for making the key decisions regarding pressuring commercial entities. According

¹⁰ At the time of writing, the AMC had opened a case involving abuse of monopoly position and price-fixing on the autogas market (LNG for cars). Meanwhile, the monopoly situation led to a shakedown of the market by security forces.

to the Anti-Corruption Action Center, he is operating on behalf of MPs from circles closest to the president. The NABU is collecting evidence of the crimes committed under the aegis of Demchyna in relation to his illegal wealth.

Still, the problem with the SBU is not limited to specific individuals. In contradiction with the functions established by law, the SBU has entire sub-units the main function of which is to seek out promising objects in different sectors of the economy.

" *«Behind the Hilton Hotel there is a nine-story building... that is the SBU's commercial department. I was taken to some general there... we walked up one story, then second, third, and fourth, so I ask the guy who is leading me, 'What do you have here?' and he answers, 'Well, this floor is the sugar industry... that one is communications... And this is the floor for the grain growers. And there is the nuclear industry. Every floor has a slew of so-called analysts who sit and track their objects».*

Conclusions and recommendations

The unlawful influence of the SBU on business has grown to such a scale that it cannot be unnoticed at the highest level of the state. And yet, the Government continues to this day to avoid systemic decisions to put an end to this criminal practice.

Some of the victims of these SBU actions have accused senior officials of organizing these large-scale corrupt activities.

" *«I would sum up the current situation in three main points:*

- *Abuse is embedded in laws and other rules that are open to interpretation by officials.*
- *Personal enrichment is not always the main motive. Often people are simply following orders that they cannot avoid because there is no system of checks and balances.*
- *The caste system in the enforcement agencies makes them immune to the justice system».*

The main impulse to deracinate unlawful pressure on business from enforcement agencies must be political will and the elimination of the kleptocratic interest of senior officials in preserving the corrupt set-ups and unclear rules that provide room for corruption.

The number of laws and other rules that regulate legal relations between enforcement agencies and business needs to be reduced substantially. Regulatory documents need to be written as clearly and unambiguously as possible to reduce the opportunities for officials to interfere with business processes without any real justification. Those who work in law enforcement agencies should have very clear work guidelines.

Given that one of the mechanisms for extortion used by enforcement agencies is launching a case against a business and then demanding a bribe to drop it, the law should limit «frozen» cases where there is no actual investigative activity and the only purpose is to take payouts from business.

" *«The Georgian ex-Prosecutor General, Zurab Advishvili, proposed doing what they did in Georgia: prohibit enforcement agencies from going into business for any reason whatsoever, as long as it is not connected to a particularly grave crime against a person... only if there is a dead body. What we need is simply a deliberate decision. There is the SBU—great. You have what is going on in the East, counterintelligence, operations in Crimea—that is your area of competence».*

In addition to reducing the number of regulations, punishment for crime should also be inexorable. This means that mechanisms that allow officials at enforcement agencies to cut unlawful backroom deals to avoid responsibility for their unlawful actions must be eliminated.

Given the growing influence of the SBU on business, radical reform of the Service is called for and would be a major step to improve the investment climate in Ukraine. It needs to include at least these six components:

1. Demilitarizing the Security Bureau of Ukraine. SBU personnel should lose their status as servicemen and women and all military positions in the SBU need to be dropped, in line with PACE recommendations.
2. Eliminating the SBU Department of Counterintelligence Protection of State Interests in Economic Security Domain.

3. Transferring the functions of the Main Administration to Combat Corruption and Organized Crime from the SBU to the National Anti-Corruption Bureau (NABU) and the National Police.
4. Abandoning the territorial principle of structuring the SBU.
5. Restricting SBU investigations to counterintelligence, countering terrorism, and protecting the constitutional order.
6. Once all the functions that do not suit the SBU are removed, reducing its size to 5-6,000 from the current more than 30,000 employees.

Reforming other law enforcement agencies should include:

1. Cleaning up and streamlining the work of the Prosecutor's Office: reducing staff, reappointing the top-ranked officials with the help of a commission that includes international experts; selecting middle and lower ranked personnel after the appointment of new leadership.
2. Increasing the powers of the National Anti-Corruption Bureau and expanding its technical capabilities by granting the right to independently gather information through communication channels.
3. Setting up the anti-corruption court.
4. Instituting the mechanism of agreement on recognition of guilt.
5. Expanding the list of preventive measures in corruption cases, including raising bail requirements closer to the value of the damage caused.

SECTION 3. MONETARY FREEDOM

Volodymyr Dubrovskiy

Monetary freedom is at a very low level in Ukraine today. Ukraine ranks 153rd among 159 countries with 3.25 points for «Sound money» in the Economic Freedom of the World index. By comparison, Russia has 8.5 points, which is close to the 8.3 global average and slightly below the average for post-communist countries, 9.0, while Poland has 9.6, which is close to the most developed countries. In reality, this low indicator is a reflection primarily of the huge inflation the country suffered in 2014 and a prohibition on Ukrainian citizens to open accounts in foreign banks without special permission that was only recently cancelled. But even adjusting for the tragic circumstances of 2014, the problem with an unreliable currency and financial system remains very urgent.

Inflation and the devaluation that is inexorably part of it continually reduce the buying power of the hryvnia, devalue honestly-earned wages and business profits, as well as savings in the national currency. What is more, inflation fluctuates wildly and unpredictably from year to year, while devaluation occurs¹¹ in leaps and bounds that are catastrophic for commercial entities. The unreliable banking system is unable to guarantee its depositors' money while access to loans for businesses without political connections is very limited. Polls show that this issue is one of the biggest obstacles to business development—second only to corruption, according to the 2016 Global Competitiveness Report. Access to sound money for Ukrainian citizens and businesses alike is restricted by law.

Ukraine has a long history of price and currency instability. Even after the catastrophic hyperinflation of 1993-1995, the Government failed to learn the necessary lessons. Of the last 20 years, only in 8 years was inflation in the single digits—but even then, it was typically close to 10%. At the same time, it is also very unpredictable: in the last few years, it has been as low as 0.6% and as high as 48.7%.

After the introduction of the hryvnia in 1996, the currency experienced a disastrous crisis three times: in 1998, 2008 and 2014-15. The last one led to a threefold devaluation. In the nearly 20 years since the hryvnia was introduced, it has fallen 15-fold in relation to the US dollar. This has led to nearly permanent expectations of a devaluation, all the more so since the macroeconomic factors underlying it have not been eliminated. It is unsurprising, then, that Ukrainians see devaluation as the most obvious manifestation of lack of monetary freedom.

On the one hand, inflation makes devaluation inevitable, because it undermines the competitiveness of Ukrainian goods and services. This means that imports rise while exports decline as demand for foreign currency outstrips supplies and its price rises in order for a balance to automatically be restored. The gap can be covered by incoming credit or foreign investment, as happened during the boom years of 2005-2008 and which naturally ended in a crisis. Still, however ruinous that crisis, it has to be acknowledged that the crisis itself, which was generated largely by weaknesses in the market, was far less felt than those resulting from state policies.

Over 1992-1993, efforts to support «domestic manufacturers» with credits and subsidies based on printing money, no matter what, led to hyperinflation, which resulted in people losing all their savings and the standard of living declining three times.

In 1996-1998 and 2011-2013, the Government tried, for political reasons, to keep the hryvnia stable at whatever cost by burning up NBU (National Bank of Ukraine) reserves and by taking out massive loans. The state was basically building a financial pyramid: investors who bought state bonds at sky-high yields wanted to sell them off the minute they saw the first signs of devaluation. The resulting panic over devaluation went far deeper than would have been necessary to stabilize the balance of trade—a bit less than triple in 1998-1999 and more than triple in 2014-2015.

One of the main reasons for this kind of instability is the constant budget deficit, which forces the government to issue or borrow money. The first option leads directly to inflation, while the second means that at X point in time, this debt will have to be repaid. If the government borrows on the domestic market, it bleeds the non-financial sector, which cannot possibly compete with «risk-free» government bonds. And when Ukraine borrows from foreign creditors in hard currency to cover a hryvnia-based budget deficit, inflows of hard currency artificially raise the exchange rate. But when time comes to pay off these bonds, the exchange rate collapses.

Ukraine's economy is very dependent on exports of raw materials and their world prices tend to fluctuate frequently, sharply and dramatically. Best practice in this case is to set up stabilization funds that accumulate part of the revenues when prices are peaking such as over 2002-2008. When properly used, such funds make it possible to relatively painlessly survive the inevitable dips in the global situation. Yet Ukraine has still not shown the political capacity to avoid the temptation of consuming the money coming in the boom years, by, among others, raising social benefits relative to the growth in revenues.

¹¹ Hopefully, after the NBU switched to inflation targeting and floating exchange rate policy, it will be not the case any more.

This is because Ukraine, like so many other poor producers of raw materials with immature democracies chronically—other than boom years, of course—consumes more than it produces and the public sector chronically—except, again, boom years—spends more than it can collect in taxes, even when those taxes are already choking the economy. This, in turn, leads to instability, and that scares off investors. As one participant of our discussions of economic freedom in Ukraine put it:

" *«As long as the trade balance stays like it is, foreign investors and lenders will be afraid to come here, because the country will always be struggling with a shortage of the currency for which they come here in the first place. As long as there is no inflow of currency or it is accumulated by handful of people, it is guaranteed that there will not be enough to go around.»*

The financial system

When a country's currency is unreliable, borrowing becomes unaffordable. After all, banks can only issue loans out of what they have received as deposits from their clients, while depositors have a choice: to keep their money in hryvnia deposits, to exchange it for hard currency and deposit it, albeit at a much lower interest rate, to keep it under their mattresses, or to lock it in a safety deposit box. If the hryvnia loses value, let alone unexpectedly, it becomes hard for banks to persuade customers to keep it on deposit except at a very high interest rate that will cover anticipated inflation and the possible risk of losing all their money.

Of course, interest on loans has to be even higher, if it is a real bank and not just a pyramid scheme. Hard currency deposits and loans are free of this risk, but the risk ends up falling on the borrower, who could actually go bankrupt if there is a financial crisis. This happened to many Ukrainians in 2008, and even more so in 2014. Even collateral will not save the lender in this kind of situation because it, too, will lose its value. During crises, depositors who, until a few years ago, had the legal right to demand their money at any moment caused a run on their banks as they withdrew their money and exchanged it for hard currency to stanch their losses. As a result, currency crisis inevitably led to a banking crisis. Efforts were made to stop it by refinancing, but this, directly or indirectly with the payout of deposits that moved to the currency market and led to even deeper devaluation. And so the NBU prohibited the issuing of hard currency loans to those who do not have verified sources of foreign exchange earnings. More recently, the right to withdraw a deposit ahead of term was also restricted by law.

Meanwhile, collateral not only loses value due to objective factors, a risk than can at least be foreseen and taken into account. No less, if not greater a problem for Ukraine is weak property rights, especially lenders' interests. Often they cannot recover, let alone make use of collateral, especially if it is backed by a swindler with serious «protection». And so there is no way to pay off the promised interest on deposits. However, borrowers themselves also suffer from this because the interest rates on loans have to include a costly risk factor: the borrower has to offer a 100% guarantee of return, or else suffer through bureaucratic hell.

" *«You see an awful lot of cases where creditors cannot seize the collateral and take it from borrowers like our MPs. Did you hear about the fitness center on Sofiyivska Ploshcha? That case involved Swedbank: this facility was withdrawn as collateral with the bank and now raiders are trying to take it over... It is a common situation...putting up assets as collateral, say, a shopping mall. But in Ukraine, this is not considered a collateral. We were able to refinance our loan [at 11% p a in euros] only when we produced a stand-by letter of credit... We are a company with an international name and a long history, but in Ukraine, it is impossible to borrow money from someone using your real estate assets as collateral.»*

Still, banks have to put their money somewhere, right? Of course, but this is where we once again see a lack of economic freedom. The only people who easily borrow in Ukraine are state representatives and business people with political connections.

State borrowing amounts to more than 30% of all commercial bank assets. On the one hand, this is a resource that businesses were unable to make use of. On the other, interest on them is paid from the budget, that is, money that is taken from taxpayers. In the end, most of it went to depositors, that is, back to the private sector. However, it is often taken from those who are actively creating added value, while it is paid out as passive income. This kind of system kills motivation to invest in business activities that might increase prosperity. If those same depositors were to invest in business instead of depositing their money with a bank, they would not only have greater risks but they would also be paying higher taxes.

A separate case of government interference in the financial system is the state-owned banks, which own more than half of the assets of the entire banking system. Like other state enterprises, banks are a source of enrichment for those close to the sources of power, that is, the oligarchs.

" *«Actually, there is access to credit in Ukraine. But this access to resources is the same as access to power. A lot of companies that belong to our richest people feel no lack of financial resources. Possibly not quite the way it used to be, but still. That is because they use mechanisms that are connected to state banks.»*

" «All state banks have been a black hole in the last few years...The state uses one mechanism, refinancing and recapitalization, to pour money into these banks, and the other one, financing companies linked to people in power, to take that money out... Every state bank has its own president, who has a direct relationship to a certain political party, or is the president's nephew, or is a friend of [former PM] Arseniy Yatseniuk, and so on. In addition to this, however, the Board of Directors and management consist of other individuals who represent interests of other parties and promote interests of other business groups».

" «Today, Oschadbank alone is the biggest network bank, with 6,000 branches and it is comparable to many European banks. The resources at its disposal are enormous in financial terms. ... And all these resources, instead of going to SMEs, instead of bringing some positive effect to the Ukrainian economy, go nowhere because all these factories that are being financed are outdated, running in the red and only bringing short-term profits to their owners».

Regulation

Last but not least, government regulation is a major barrier for accessing sound money in Ukraine.

The first aspect of this problem is numerous and severe restrictions. Citizens of Ukraine until just recently ago were able to open a bank account abroad only with an individual permission from the NBU. Microbusiness and freelancers who wanted to sell their goods or services abroad through global money transfer systems like PayPal were unable to do so legally and were forced to find workarounds, such as registering as an «e-resident» of Estonia.

Registration is mandatory for any borrowings from non-residents, even minor personal loans. Hard currency payments had to be repatriated by the owner within a strict and very tight timeframe for some types of business, or risk heavy penalties if these terms were violated. Moreover, at times over 50% of these earnings had to be sold by law. Within the country, payments can officially only be made in the hryvnia. There are also countless restrictions on withdrawing money, hard currency transfers abroad, the purchase of hard currency—only under specific contracts, through exchanges and so on. There is almost no futures market, so it is impossible to hedge currency risks.

" «So you get money in the form of a loan and here you have to immediately sell 50% of it on the interbank currency exchange. A loan is not income from sales. And maybe you simply wanted to keep the money in an account and in a month or two make use of the loan. Because of devaluatory expectations that typically rise in the fall, non-residents lose money on this kind of seemingly minor detail».

Officially, this is justified as a need to force commercial entities to work in the hryvnia, which increases state revenues through seigniorage, and the need to reduce risks related to currency speculation and positive feedback, which lead to a shaky currency market. The two arguments actually reveal the fundamental weakness of the hryvnia. What is more, in and of themselves, regulatory restrictions of monetary freedom actually feed on each other and increase, rather than reduce, risks.

For instance, if exporters are forced to sell their foreign exchange earnings and have no option to hedge their risks, when, in anticipation of devaluation, they will naturally put off taking in hard currency payments for as long as possible and will accept them only when and in amounts that they will need to make hryvnia payments. As expectations of devaluation grow, the supply of hard currency tends to shrink and those expectations engender what they fear most. To prevent this, the government establishes mandatory requirements for getting payments for goods or services rendered within certain time limits. However, all these and other restrictions are regularly worked around or these violations are «forgiven» to those who have ties to the government or are on good terms with it.

The second element is temporary administrative restrictions that sometimes are in place for years. To rescue the national currency during monetary crises, property rights are sacrificed through restrictions on the repatriation of dividends, higher mandatory sale amounts of foreign exchange earnings, and even restrictions on the use of current accounts. This then undermines trust in Ukraine's banking system and in the country as a whole.

" «The third problem is all these legal restrictions. Yes, the process of liberalization is slowly going forward, but still, as a legal entity, you cannot pay off a loan ahead of term, buy hard currency in advance, or convert your hryvnia earnings into hard currency. Why is that? Because you can only exchange hryvnia for hard currency to pay off hard currency obligations, such as if you have a hard currency loan. Our company lost enormous sums in 2014 because of this, because we were unable to take our money out. And you know that foreign investors, including our beneficiaries, look at Ukraine with caution. They have no desire to make any investments because they have already experienced serious financial losses on all these details».

Conclusions and recommendations

Our participants summarized the implications of everything discussed here.

" «Access to financing is limited because we live in Ukraine...»

... said one businessman. Another participant added:

" «The problem lies in the fact that, although we talk about money, the primary reason for all these problems, I think, is the fact that we have problems with recognizing ownership. And the legislation that regulates all this is historically rooted in soviet principles. Businessmen and people who even earned their own money cannot freely dispose of it or invest it... The government is trying to stave off the outflow of money from the country, but by its very actions it limits the opportunities for its citizens to dispose of their property and assets».

Money comes down to trust: the stronger the trust in a country and all its institutions, including fiscal and monetary ones, the stronger its currency.

Thus, the fundamental factors that objectively lead to low monetary freedom in Ukraine include:

1. lack of respect for property rights,— in which certain interests are involved, and thus weak protection by the state;
2. predominance of commodities in exports, which permanently threatens instability in the currency;
3. deeply-rooted distrust of the national currency leading to constant devaluatory expectations;
4. paternalism and immature democratic institutions, which lead to fiscal irresponsibility.

Similar problems affect many of the world's less successful countries, but even so, Ukraine manages to fall behind among the stragglers. No matter how deeply these factors are rooted, they can and must be overcome. Yet, time and again, we see how the Government sacrifices long-term goals, such as increasing confidence in monetary policy, in favor of short-term ones. The key to resolving such deeply-rooted problems is to depoliticize the economic policy process.

To promote trust in its monetary policy, the country needs to undergo deep structural reforms

1. Enshrine at the highest level a ban on restricting any use of money in current accounts, including transfers abroad and exchange into other currencies, or the opening of accounts in foreign banks abroad, other than when related to criminal charges.
2. Prohibit the National Bank of Ukraine from financing the state budget, including operations involving the restructuring of the state debt.
3. Privatize all state banks as soon as possible and prohibit the government from holding shares in financial institutions.
4. Switch to guaranteeing bank deposits on a voluntary basis.

SECTION 4. LABOR REGULATION

Volodymyr Fedoryn

Freedom to hire and fire is one of the basic components of economic freedom. It protects the interests not only of the employer but also of hired labor, if business owners know that it will be hard to fire people because they are not doing a good job or because of changing circumstances at the company, they will think hard before launching a project that involves new jobs. An over-regulated, inflexible labor market limits choices and opportunities for all its participants.

Ukraine is a perfect illustration of this. Ukraine ranks 119th out of 159 countries for «Labor regulation» in the 2017 Economic Freedom of the World index, with 5.4 points. It is true that there are countries with much freer economies than Ukraine, where the labor market is regulated far more than here: Norway, with 5.3 points against the overall rating of 7.64, Chile with 4.8 against 7.64 overall, or South Korea, with 4.6 points against 7.52 overall. However, in combination with other «unfree» aspects, labor market freedom that is below the global average indicator causes a lot of negative effects— atypical of countries with a similar level of labor regulation, such as an overly large share of informal or shadow labor relations in the overall economy.

The soviet heritage and the shadow economy

Ukraine's labor market is regulated by the Labor Code, which was adopted 46 years ago, when Ukraine was still part of the USSR. Since independence, 235 of the 265 articles in this Code have been amended, but this has not altered the essence of the document, which is fundamentally impossible to adapt to market economy conditions.

" «Unlike modern legislation, [the Labor Code] has absolutely no terminology. To understand what a labor contract is, what hiring and firing mean, we have to rely...on court practice, with interpretations from the Supreme Court... When it comes to an outsourcing employment contract, we turn to the Tax Code».

" «There's no balance in our Code. This is the Code of the Hegemon of the Revolution».

Right now, the Rada has a new version of the Labor Code that, from a strictly legal point of view is more contemporary than the existing one. However, there is reason to believe that the document needs a complete rewrite if Ukraine's purpose is to profoundly liberalize the existing rules and legalize those labor relations that de facto exist. If the proposed changes are looked at through the prism of the Doing Business methodology¹², it turns out that many of them are purely cosmetic and address only 2 of the 21 indicators that are used to assess the flexibility and adaptability of country's labor regulations.

Meanwhile, instead of streamlining rules that contain many absurdities, the Government increased the powers of officials that oversee whether companies are in compliance with labor legislation in 2016. This step was primarily motivated by fiscal reasons, but it ended up restricting freedoms that existed de jure even more.

" «There is this wonderful State Labor Service that, according to the changes, can come at the request...of an employee if that person's rights have been violated. And believe me, we will all be welcoming them with a red carpet. Because they have enormous power».

The USSR was a country of modernization carried out by «shock» industrialization. The relations typical of the Industrial Age are evident in the current rules. In a post-industrial economy, the outdated norms force both employers and employees to lie, looking for ways to fulfill what cannot be fulfilled.

" «The Code is overly regulated and outdated in terms of the form of work at every stage of the worker's lifecycle in an organization. There is no such thing as distance work—you cannot hire someone without designating a workplace. You cannot fire someone who worked from home because there was no three-hour absence...»

" «You are supposed to put together some kind of a standard document, you have to give the employee a job title from the classification list. You are supposed to write up some ancient job description... The modern world works according to function charts, description of processes, not people's positions, but you are supposed to live within this old framework. Everything that regulates the transfer of a person from one job to another, increase or decrease of their workload and responsibilities—is almost impossible».

¹² Maryna Tonkoshkur, Comparing Labour Codes Based on Doing Business Methodology, BFMC Policy Brief Series, № 1, November 2017.

" *«Right now, we have a 40-hour work week. But Art. 6 of the Civil Code mentions the two sides being free in setting up a contract. Say I want to work 48 hours a week and I agree this with an employer ... right now we cannot do that!»*

The Labor Code does not take into account at all that the world has changed, and this has enormous negative consequences. Although the Code is supposed to protect the rights of the worker, participants of our discussions were unanimous that it, in fact, makes official employment so unattractive to business owners that they will do everything they can to avoid officially hiring. As a result, workers are becoming less and less protected and the Labor Code is turning into a purely declarative document.

" *«This Labor Code is supposed to protect the hired worker, but the way things are now, it creates a situation where people are being pushed outside the framework of labor relations. Companies will do everything they possibly can, not to enter into legislated labor relations with a person because it is just too complicated. And although the Code is supposed to protect people, it actually exposed people to a complete lack of security. Because just about the last thing any business owner will do is hire someone on staff.»*

The International Labor Organization (ILO) estimates that the level of unofficial employment in Ukraine was 26.2% of the labor force in 2015, 29.5% among men and 22.5% among women. By comparison, Russia's indicator is at 19.4%. Moreover, there are reasons to believe that the ILO has underestimated these figures, because it is not counting hundreds of thousands of workers who were forced by their employers to register as private entrepreneurs.

Typically, such a high percentage of unofficial employment is tied primarily to a payroll tax burden that is burdensome for a poor country, adding up to over 40%. Historically, it has been much higher. This has led to a situation where many domestic companies, especially SMEs, pay the lion's share of their wages and salaries under the table, while a huge number of workers are not hired officially or they work based on civil contracts. Still, there is another reason as well.

" *«It seems to me that the problem with the labor market is not so much fiscal, at least no more than 50-50. So 50% is a financial issue but the rest is the absence of a balance of interests between employers and employees.»*

Because, even if a person is hired officially but gets paid partly under the table, any issues with firing come down to simply stopping the unofficial payments, without which the employees themselves will see no purpose in hanging onto their jobs. For their part, workers are also not interested in disputes with their employers, especially complaints about violations of labor laws. This kind of situation de facto ensures flexibility in the labor market and more partner-like relations between employers and employees, but unfortunately it is at the cost of massive violations of the law. The strict requirements of the Labor Code work only for law-abiding employers, such as foreign investors.

" *«SMEs generally have agreements between employees and employers that when the person is hired, they are officially paid the minimum wage and the rest is under the table.»*

" *«Small and medium businesses simply ignore the Labor Code.»*

Easy to fire?

In the last 26 years, Ukraine has undergone a huge structural transformation: heavy industry and farming have lost millions of jobs, while millions of new jobs were created in the service industry.

Although the pace of transformation has slowed down, it is still going on. However, labor legislation designed to preserve existing jobs is not helping this process. One of the biggest obstacles is the way that dismissal is regulated: it requires union approval and can lead to lawsuits that drag on for years.

" *To let someone go is the last straw. Better to die... I will do everything possible to not hire people on.»*

" *«It is very hard for a business to break labor relations. The simplest way is Art. 38, «resigned of their own will». A somewhat harder one is Art. 40, «resigned at the request of the company», but there are endless restrictions. You have to get the approval of the company's union, if it has one, and most big companies do. If the union refuses to approve, then the case has to go to a court where the union's reasons for refusal are reviewed. In practice, «substantive changes to working conditions», which is Art. 32 of the Labor Code, also causes a lot of problems.»*

" *«If an employee refuses to resign, we dismiss them under Art. 36, Para. 6 «rejected substantial changes in working conditions». Every time, we the employer have to prove in court that changes in how we organize work and production processes forced us to lay off workers. The court reviews our case under a microscope. This review contradicts Art. 64 of the Commercial Code of Ukraine, which enshrines the right of an employer to determine the staffing and organizational structure independently, to establish the number of employees and their functions. In short, the «old» Labor Code and the more progressive Commercial Code are on a collision course».*

According to what business specialists say, «in 95% of cases, the courts side with the employee».

" *«We end up performing procedural wonders in court. Our lawsuits fill several volumes just to justify our case. And even then... if we win a case in court [that is not the end of it]: for instance, the appeals court rules and we reinstate the person, but there is also a ruling by the cassation court, according to which we stop the proceedings. The employee goes to court again and has the order to cancel the order cancelled. In short, it is a never-ending story that drags on for several years».*

This kind of situation generates enormous demand for the services of HR specialists and lawyers who, as one respondent put it, «are prepared...to bypass the legislation whatever way possible».

Attempts to find other ways to evaluate and motivate employees, for instance, by establishing Key Performance Indicators (KPI), have a limited effect in Ukraine because it is impossible to rely on this kind of system to prove your case in court.

" *«For the Ukrainian market, we have managed to get the KPI system into major corporations over the last eight years and about 30% of them are actually working, more-or-less, with it. By the time you set up the IT platform, by the time you set up all the other stuff... The culture is changing, but so far this is not an instrument that lawyers and attorneys can walk into a court with. Based on the current Labor Code, people are fired under Art. 38».*

" *«With the current Labor Code, it is impossible. Big companies and mid-sized ones use KPI systems, but to prove in court that employees do not meet the requirements of their position is impossible, because only public employees can go through attestation».*

The overregulated procedure for dismissing an employee makes it impossible for employers in the official sector to incentivize productivity in an effective and transparent manner.

" *«Employers are effectively prohibited from paying workers based on their individual performance. It is far more difficult than it needs to be. Payroll costs keep rising but the performance of personnel is decreasing».*

" *«We... cannot influence employees who do not want to work».*

" *«The lower the qualifications, that is, the less skilled the job, the less people are protected and the harder they hold onto their jobs. But not in a normal way, by trying to work diligently, honestly and effectively, but in the worst possible way».*

The lack of instruments that would allow people to work on a daily basis to bring in new technologies and labor processes undermines the competitiveness of Ukrainian companies and the incentive to invest long-term. So it is no surprise that in the last three decades, Ukraine has shown the slowest economic growth of all post-communist countries.

An unholy union: Employers and trade unions

Ukraine's labor market is segmented, and so is its regulation: large companies, especially those with state or foreign capital, try to get around the requirements of the soviet Labor Code, while small and medium enterprises pay little attention to its existence and operate in a grey zone.

" *«We have two classes of enterprises: those that avoid formal labor relations at all costs, and those that are simply forced to do their duty because of external commitments, the ethical standards of their foreign partners, or the nature of their work. If we are talking about a pharmaceutical company, it cannot ignore the Labor Code: staff has to be officially hired, to adhere to legislation, to follow production safety codes. They have to obey the law. Of course, there are fewer of them, fewer than those who can allow themselves to ignore the law».*

" *«Big companies have been clean as a whistle for a long time. We have been adhering to the Labor Code for ages... we do not have a choice».*

" «Huge, systemic companies cannot allow themselves to have unofficial relations with workers. Regulators are on our backs all the time».

Paradoxically, in sectors dominated by large companies, mainly heavy industry, the laws Ukraine inherited from the Soviet Union protect not only the worker but the owner of the business as well, as they act as a restrictive factor for new, typically foreign, companies wanting to enter the market. The participants of our focus groups emphasized the fact that the regulation of the labor market is one of the major barriers in the way of foreign investment coming to Ukraine.

" «When foreign companies look into opening manufacturing facilities in countries that are further east than their headquarters, Ukraine is typically included into their short list because of its fairly high-quality labor force. And then it is written off the list because the labor laws employers have to follow reduce their competitive advantage too much».

" «Ukraine has a fairly qualified and inexpensive workforce, but the laws governing the labor market scare off most of those companies interested in opening a business in Ukraine».

The inefficient balance in the Ukraine's labor market is due, among others, to the fact that at its core is a tight coalition of employers who are not interested in opening up the economy and unions that independent Ukraine inherited from soviet times. Soviet unions never stood in the defense of their workers but were the «reins of the ruling party»¹³.

From the USSR, Ukraine also inherited legislation that provides unions with enormous powers and privileges. The law obliges employers to sign collective agreements if a union has been formed at the company. A collective agreement can be signed, in any sector and at the oblast level, its provisions are binding for the company in this sector or region. This mechanism is little more than a way to restrict competition and raise the costs of entry for newcomers.

Employers are supposed to contribute 0.3% of their payroll budget for all employees at the company to the unions, whether they are union members or not. As one participant stated, «The unions get millions of hryvnia but do not report on the way this money is used and are not under any obligation to offer information about their activities».

Ukrainian workers who are not happy with the choice of jobs in a «limited access system» vote with their feet: the number of Ukrainians working abroad is estimated at a few million. In the last few years, countries like Poland, Hungary and the Czech Republic have simplified their rules for allowing Ukrainians to work, for a very good reason. According to a September 2017 survey of the Sociological Group Rating¹⁴, 44% of Ukrainians want to work abroad and 68% among younger people. Of course, Ukrainian employers are thus forced to offer better working conditions but this is happening at the high cost of losing some of the most productive workers.

Conclusions and Recommendations

The best way to protect the rights of hired workers is to establish conditions for rapid and sustainable economic growth by unleashing Ukraine's entrepreneurial potential to force employers to seriously compete for labor. Among others, this requires moving away from purely declarative or openly harmful regulations that segment the labor market and stimulate the growth of the informal sector.

Legislatively, it means taking the following steps:

1. Develop a new Labor Code that guarantees a minimal but reliably overseen level of rights for hired workers. The new Code needs to focus on guaranteeing: (a) no exploitation, that is, the right to rest, maximum hours of uninterrupted work, and so on; (b) no discrimination; (c) safe working conditions. The other issues need to be agreed in individual labor contracts.
2. Cancel co-funding of unions by employers and enshrined in law rights of unions, including the obligation to carry out sectoral and regional collective agreements.
3. Limit the right of unions to veto a dismissal or to change the working conditions of their members.
4. Establish mediation to resolve labor disputes. Professional mediators can make the search for balanced resolutions significantly simpler and cheaper, and more acceptable to both employees and employers.
5. Look through and eliminate or restrict out-of-use «social benefits» for certain groups of the population, which harm their options on the labor market.

¹³ Josef Stalin, «Organizational Report of the Central Committee of the Communist Party (b), 12th Congress of the Communist Party (b), M. 1923: «The primary and main drive belt..., with which the party communicates with the working class is the unions».

¹⁴ Trends in attitudes towards migration among Ukrainians, 03.10.2017. Accessed at: http://ratinggroup.ua/research/ukraine/dinamika_migracionnyh_nastroeniy_ukraincev.html.