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ANALYSIS of CURRENT EVENTS

Ukraine's Painful Economic Transition

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DESPITE MANY PRONOUNCEMENTS OF RADICAL economic and institutional reforms since 1991, Ukraine has remained an Eastern European laggard in the actual implementation of such reforms. The result has been a continuing decline of economic activity, combined with a growing proportion of economic activity undertaken in the "black" or "shadow" economy.

Ukraine's laggard status in the implementation of reform has recently been underscored by various observers. The World Bank's 1996 *World Development Report* on the transition economies placed Ukraine in the category of slowest reforms. The 1996 *Transition Report* of the European Bank for Reconstruction and Development proposed a set of reform indicators which put Ukraine around 20th out of the 25 countries analyzed. The 1997 *Global Competitiveness Re-*

port of the World Economic Forum ranked Ukraine at 52nd out of 53 countries in terms of overall competitiveness, where the competitiveness ranking is designed to measure the capacity of the national economy for long-term growth.

No doubt, much has been accomplished in Ukraine's reforms. After all, the country has survived the transition to independence, adopted a democratic constitution, successfully managed free and fair elections, introduced a new and relatively stable currency, and adopted the rudiments of a market economy. Through the lens of history, these will be judged to be profound achievements. They are not, however, sufficient to put Ukraine on a path of economic recovery. Economic performance has been, and continues to be, painfully deficient, far below

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what the country's human talents, geography, and physical resources might have produced by this point.

When Ukraine gained independence in August 1991, some Western observers and many Ukrainian national leaders predicted that the country would have a better chance than any other former Soviet republic to complete the transition to a market economy, become competitive in international markets, and begin a process of market-based economic growth. Unfortunately, this optimistic prognosis did not account for the profound inherited difficulties of the new state, nor could it anticipate the failures of the new country to implement vitally needed reforms. For the first two years of independence, Ukraine found itself in a situation approaching utter economic collapse and plummeting living standards.

In major part, the initial economic decline resulted from extremely poor (but often poorly diagnosed) initial conditions: a legacy of industrial policy inherited from the former Soviet Union, which was strongly biased towards the production of military equipment and basic industrial goods. By the mid-1970s, Ukraine produced more steel than France and Britain combined. With only 20 percent of the USSR population, Ukraine produced much of its iron

ore and more than 40 percent of its pig iron and steel. At the same time, its production of consumer goods, textiles, and services remained seriously underdeveloped. Moreover, the entire economy—from the urban central heating systems to the enormous heavy industry—was, and still remains, highly energy intensive.

When faced with sharply higher prices for Russian oil and gas after the breakup of the Soviet Union, Ukraine's energy-intensive industry experienced a supply shock of gargantuan proportions. The deterioration in its terms of trade amounted to several percent of the gross national product. Many energy-intensive industries immediately found themselves to be uncompetitive on global markets. Moreover, the previous "market" for Ukraine's goods in Soviet Union disappeared with the collapse of the Soviet mili-

tary-industrial complex. Thus, what was often assumed before 1991 to be one of Ukraine's great strengths—its vast "arsenal" of heavy industry—posed one of its great difficulties in the transition to the market economy.

A number of serious policy mistakes by the government of Ukraine during the first years of independence also contributed to the rapid pace of economic decline. In a situation where the government was reluctant to liberalize prices, cut subsidies, or implement vital market reforms, the budget deficit soared to an estimated 35 percent of the gross domestic product (GDP) in 1993, much of which was heavily "monetized" by the National Bank or financed through arrears in promised budgetary outlays. (Be aware that all budgetary data and GDP estimates contain a very large measure of error and uncertainty.)

The government proposed to halt the sharp decline in industrial production through extensive subsidization of industrial production, but this strategy merely stoked inflation with-

out solving the deeper problems of lost Soviet markets, energy-intensive production, and poor industrial structure. Official statistical data indicate that industrial production at the end of 1996 barely reached 42 percent of the 1990 level. Faced with growing production costs (occasioned, for example, by rising energy prices), hardening budget constraints, and weak domestic and foreign demand, an overwhelming number of state-owned enterprises (SOEs) significantly cut

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back on production. With economic liberalization and privatization moving at a glacial pace, these SOEs lacked incentives to undertake restructuring, and also lacked the ability to attract new private investment partners. Even today, the government continues to provide a complex (and unintelligible) mix of direct and indirect subsidies aimed at boosting industrial production. But, in fact, these only serve to undermine the incentives for restructuring at the enterprise level and to widen the fiscal deficit, without halting the pervasive industrial decline.

The pace of economic and institutional reforms accelerated somewhat after the 1994 presidential elections. Shortly after the elections, the administration of Leonid Kuchma announced an ambitious program of economic liberalization, macroeconomic stabilization, and private sector development. Rela-

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tive financial stability was reached a few months later through very tough monetary discipline, but only after millions of Ukrainians had seen their monetary savings wiped out by hyperinflation. Cash transactions in the economy were heavily "dollarized" during the hyperinflation, and remained dollarized thereafter, limiting the return of monetary saving to the banking system and sharply restricting the field of action of the monetary authorities. As of June 1997, the tight monetary policy of the National Bank of Ukraine had succeeded in bringing down the year-over-year rate of inflation to a post-independence low of 18 percent.

Following 1995, the government undertook various measures to reverse (or at least moderate) a highly protectionist policy of export licensing and import restrictions inherited from the Soviet Union and maintained in the first years of independence. The liberalization of trade has led to a significant boost of officially registered trade (part of which is a shift from black-market to legal transactions). Significantly, the share of Western industrial nations in Ukraine's export trade also increased substantially. In 1995, the European Union ranked as Ukraine's second largest trading partner, after Russia. The change in composition of Ukraine's exports, on the other hand, has been much less impressive. As before 1995, Ukraine's exports are dominated by primary commodities and basic industrial goods such as steel, chemicals, and sugar, without much evidence yet of structural change to new industries or improved technologies.

For example, a draft law providing tax and other incentives for a joint venture of Ukraine's AvtoZAZ and South Korea's Daewoo was recently submitted to the parliament. Unfortunately, it appears that the government has not undertaken careful analyses of such incentive packages. Overall foreign direct investment has been meager, in absolute terms and in comparison with other transition economies in the region. A number of leading companies, such as ABB, Coca Cola, Pepsico, Kraft Jacobs Suchard, and others, have established production activities, but often with very low outlays of capital investment. Cumulative flows of foreign investment since 1991 are generally estimated at under \$2 billion, or less than \$40 dollars per capita.

The reform of the fiscal sector and public administration has proven to be very slow. Public expenditures still constitute an unsustainably high share of Ukraine's national income (44 percent of GDP according to the 1997 budget). This proportion is probably unsustainable in two senses: Ukraine has been unable to generate commensurate budget revenues under market conditions, and the

government is attempting to impose rates of taxation that are likely to stifle economic growth and legal economic activity. As a result, the heavy fiscal burden contributes to a policy regime of extremely high tax rates, heavy government borrowing, and the accumulation of massive budgetary arrears (as the government falls short of needed revenues). As just one example of the current fiscal morass, payroll taxation constitutes around 50 percent of the total wage bill, one of the highest proportions in the world.

Ukraine continues to have one of the most over-regulated of the transition economies. While an estimated 87 kinds of economic activity still require special licenses, cumbersome business registration procedures encourage corruption by bribe-seeking government officials. The combination of high marginal tax rates, over-regulation, and corruption has pushed an extraordinary proportion of the economy into the black market.

Ukraine's banking sector continues in a nascent state. Most savings of the population appear to remain in dollars, or in other foreign or domestic assets outside of the formal banking system. Total accumulated savings in the banking sector are estimated to be around 10 percent of GDP. In August 1995, a law went into effect that prohibited retail operations in hard currency and that made Ukrainian currency the only legal tender. Nonetheless, despite the legislation and the relative stability of the hryvna-dollar exchange rate, the economy remains highly dollarized. Some recent estimates suggest that dollars and Deutschmarks constitute around one-third of all currency in circulation. It is an uphill struggle, given the meager resources available for banking supervision, lack of experience in market-based supervision, and the inherent uncertainties of the economy. Ukraine will be fortunate to avoid the kind of banking crisis that has plagued many other transition economies in recent years, such as Bulgaria, the Czech Republic, and Lithuania.

Ukraine's privatization experience to date has been similarly disappointing. Originally conceived as a rapid process that would lead to deep economic restructuring, Ukraine's privatization has been shallow, slow, and largely ineffective in establishing real privately based corporate governance. Enterprise management and workers protected by legislation on collective lease agreements have colluded to create a joint force to delay and water down the terms of privatization. As a result of these delays in privatization and in the introduction of true corporate governance, the SOEs have been adrift without infusions of new private capital. Bankruptcy procedures are not used to resolve massive inter-enterprise debts. The administrative payments system of the former Soviet Union is still used by banks to manage the accounts of enterprises in arrears. The combination of massive budgetary arrears and massive inter-enterprise ar-

rears deeply undermines market transactions and the capacity for market-based restructuring.

The social problems faced by Ukraine are immense. While unemployment is artificially masked by unpaid leave and other mechanisms of SOEs, many observers estimate the rate of hidden unemployment at 20 percent or more of the labor force. A significant proportion of government expenditure is spent for social programs and for dealing with the health consequences of the Chernobyl disaster. Unfortunately, many of the social programs are very poorly targeted. The pension system in particular requires a fundamental overhaul. Under the current pay-as-you-go system of pension benefits, the combination of an aging population, massive evasion of payroll taxation, and an extensive yet haphazard system of early retirement has resulted in an astounding situation where every contributor to the pension system must support around 0.7 pensioners (that is, a contributor to recipient ratio of approximately 1 to 1.4). Ukraine has ended up with the worst of two worlds: astoundingly high payroll taxation combined with extremely low real pension benefits. Many recent proposals call for a transition to a fully funded, individualized pension saving system, combined with tightened rules for current workers to qualify for pension benefits. Not surprisingly, there is a strong political lobby against such changes.

In the fall of 1996, the presidential team and the government of Ukraine drafted a package of legislation and budgetary measures aimed at making a breakthrough to deeper economic reforms. The economic philosophy was based on three major pillars: (1) rapid and comprehensive deregulation and liberalization; (2) comprehensive tax reform, involving a cut in tax rates together with a broadening of the tax base; and (3) a deep overhaul of the government's budgetary system, including reform of the pension system and other social policies. Unfortunately, the package was stalled in parliament during the first half of 1997, and the window of opportunity for strong legislative actions has probably passed, in view of the parliamentary elections expected in the spring of 1998.

One must be careful not to be overly pessimistic about Ukraine's prospects. The trade liberalization and monetary stabilization already achieved will surely create conditions for growth in some new sectors of the economy. The new Ukrainian Constitution has contributed to political consolidation, and the performance of economic institutions is likely to continue to improve in the future. Ukraine's political independence, too, appears more and more secure. Against this backdrop, there is a good chance that Kyiv will find its way to more consequential economic reforms. However, the path may continue to be slow and tortuous, at significant and unnecessary costs to the people of Ukraine. *ME*