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Ukraine
Special Focus Note:
Reforms for Sustainable Recovery and Shared Prosperity

September 22, 2016

- ***Moving from stabilization to sustained recovery and shared prosperity for the population will require addressing longstanding structural challenges, including macroeconomic instability, weak productivity growth, and ineffective social services.***
- ***Safeguarding macroeconomic stability will require addressing the largest sources of fiscal risk and addressing financial sector vulnerabilities.***
- ***Unlocking productivity will require more effective public investment, creating a level playing field for the private sector, reforming land governance, and facilitating trade.***
- ***Providing more effective services and targeted assistance to the population will require health financing reform, effective decentralization, and improved targeting of social assistance.***
- ***Tackling corruption and improving governance are central priorities on the road toward sustained recovery and shared prosperity.***

Development Challenges

Ukraine today is at a crossroads: the economy has stabilized but longstanding structural challenges stand in the way of sustained recovery and shared prosperity. Strong reforms in 2014-2015 helped to stabilize the economy and reduce large macroeconomic imbalances. However, poverty is up significantly and prospects for economic recovery remain weak. Moving from stabilization to sustained recovery and shared prosperity for the population will require addressing longstanding structural challenges including macroeconomic instability, weak productivity growth, and ineffective social services. These three challenges have contributed to an unsustainable pattern of growth and development in Ukraine over the last fifteen years and ultimately compounded the serious economic crisis of 2014-2015.

Economic growth has stagnated since 2008, with macroeconomic imbalances and weak productivity growth leading to a pattern of unsustainable growth. Real GDP declined by 0.7 percent per year during 2008-13 and contracted sharply in 2014-15, so that real GDP in 2015 was below the level of 2004. Ukraine has been running large fiscal and quasi fiscal deficits for an extended period. The general government deficit, including Naftogaz, increased from 1.8 percent of GDP in 2005 to 9 percent of GDP in 2009 and has remained high ever since, driven by rising pension spending, significant quasi fiscal deficits, and a growing public wage bill. Furthermore, weak financial sector supervision led to a credit fueled consumption boom. Both of these factors contributed to a large current account deficit, which reached 8.1 percent of GDP in 2013, and has been responsible for the cycle of boom and bust in Ukraine. Weak productivity growth has also contributed to the unsustainable growth pattern. An abundance of evidence across countries has shown that productivity growth is the foundation of sustained economic growth. In Ukraine, however, productivity growth averaged only 1.2 percent per year during 2001-2015. Limited progress in diversifying exports and the production base has contributed to weak productivity growth.

Poverty increased sharply in 2015, with reliance of household incomes on pensions and social transfers raising concerns about sustainability, although more effective services can provide an important route out of reliance on social benefits. Moderate poverty increased to 22 percent in 2015, up sharply from 14 percent in 2013 and above the 21 percent level of 2011. Furthermore, a look at household income sources indicates that out of income growth of 4.5 percent per year during 2009-2014 for the bottom 40 percent of the population, pensions and social assistance account for a large portion (2 percent per year), while labor income accounts for only 2 percent per year. This raises concerns about sustainability of earlier gains in reducing poverty, particularly because of the large cost of pensions (15.6 percent of GDP in 2014). Improved education can lead to a higher share of income from labor, suggesting that education and other services can support a more sustainable model of poverty reduction.

Figure 1: Economic Growth in Ukraine has Stagnated on average since 2008

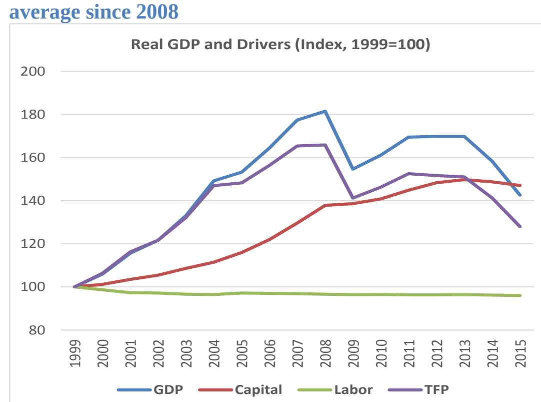


Figure 2: Macroeconomic imbalances and instability have contributed to an unsustainable growth path

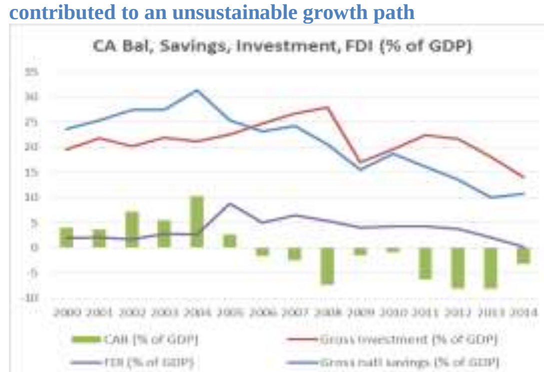
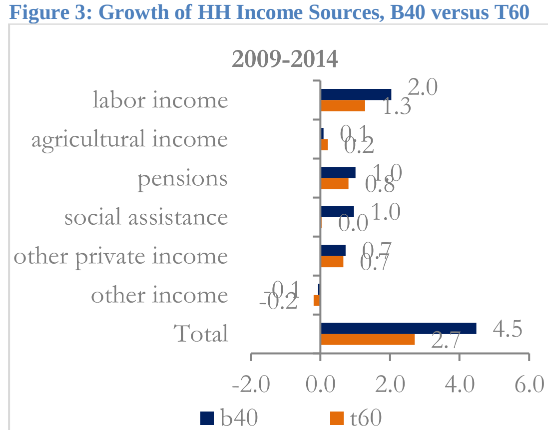


Figure 3: Growth of HH Income Sources, B40 versus T60



Reform priorities

Ukraine will need to simultaneously advance reforms on multiple fronts to achieve sustainable recovery and shared prosperity going forward. The reforms will need to safeguard macroeconomic stability, bolster productivity growth, and deliver more effective services and more targeted assistance to the population. Across the board, making progress on the reforms will require intensifying anti-corruption and governance efforts to reduce the influence of vested interests.

Safeguarding macroeconomic stability will require addressing the largest sources of fiscal risk and addressing financial sector vulnerabilities. Some of the greatest fiscal vulnerabilities come from a narrow tax base and weak tax administration, an ineffective pensions system that accounted for 31 percent of public spending in 2015, and a wide range of quasi fiscal liabilities. Tax administration reforms will require putting in place measures to broaden the tax base, lower costs of compliance, and strengthen tax administration. Pension reform options include gradually increasing the retirement age and minimum service requirement; restructuring the benefit package into a basic and insurance component; and introducing clear and equitable rules for indexation of individual pension benefits. Until recently, the gas sector has had a large quasi fiscal deficit, so monitoring the drivers of the Naftogaz deficit will be important. In the financial sector, deep-rooted related party lending and weaknesses in supervision have combined with the economic downturn to result in large numbers of bank closures and an increase in non-performing loans (NPLs). Strengthening the financial sector will require implementing the framework put in place to resolve and recapitalize banks and strengthen supervision, but also supporting a resumption of credit growth by strengthening corporate governance of state-owned banks and facilitating work out of NPLs.

Unlocking productivity will require more effective public investment, creating a level playing field for the private sector, reforming land governance, and facilitating trade. Public investment in Ukraine is very low (2.4 percent of GDP during 2010-2014) and with weak management. This calls for creating fiscal space for capital expenditures, while strengthening public investment management systems. Ukraine's highly concentrated and anticompetitive production structure, the stagnant structure of industry and exports, along with the absence of a level playing field in the private sector, are serious impediments to productivity and job creation. Creating a more competitive and level playing field in the private sector will require streamlining the regulatory environment, strengthening competition policy, and reforming state owned enterprises. With weak land governance seriously undermining investment and productivity in agriculture and other sectors, a number of initiatives will be important, including increasing efficiency of state land management.

Providing more effective services and targeted assistance to the population will require health financing reform, effective decentralization, and improved targeting of social assistance. Ukraine spends a large share of GDP on social services and assistance, but this does not translate into high quality service delivery. More effective services and targeted assistance will not only reduce expenditure pressures, but also result in tangible improvements in the quality of life for the population, improve labor market outcomes, and ensure that the benefits of economic recovery are broadly shared. This will require reforming health care financing; optimizing the school network and enhancing skills of the workforce; effective decentralization of service delivery; and improved targeting of social assistance. The health financing model requires serious reform from input-based norms toward payment systems where "money follows" the patient. Ukraine spends a considerable amount on social assistance (4 percent of GDP in 2014, among the highest in the region), but does not adequately protect the poor. Providing more effective protection to the poor will require moving from categorical to targeted benefits and improving targeting of the housing utility subsidy (HUS) program.

Finally, tackling corruption and improving governance are central priorities on the road toward sustained recovery and shared prosperity. Ukraine was in the 15th percentile worldwide in the WGI (World Governance Indicators) Control of Corruption indicator in 2014, well below Poland and Romania (71st and 53rd percentile, respectively). Powerful vested interests across a wide range of sectors seriously impede progress in addressing key development challenges. A two-pronged strategy is important in addressing Ukraine's governance and corruption challenges. The first involves building institutions of public financial management (PFM), anticorruption, justice, and public administration. The second prong involves advancing progress on reforms across the three challenges that undermine vested interests. Both will require nurturing citizens' engagement, voice, and accountability to overcome vested interests.

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