

Research Paper

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# Are Ukraine's Anti-corruption Reforms Working?



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## Summary

- Starting in 2014, Ukraine has undertaken significant reforms to address corruption in public life. So far, there has been greater success in restricting the opportunities for corruption than in bringing corrupt officials to justice.
- Corruption is a symptom of the poor system of governance in the country, not the cause of it. A decisive breakthrough will require opening the political system to more actors, creating greater competition and developing credible institutions to support the rule of law.
- Anti-corruption successes include the cleaning up of Naftogaz and reforms in administrative services, banking, the patrol police, procurement and taxation. Decentralization is also creating new opportunities for citizens to hold local authorities accountable for managing local public resources.
- Progress is lacking in priority areas such as customs, deregulation, privatization, de-monopolization and the reform of public administration. Defence spending is particularly opaque. Corruption schemes remain untouched in some parts of the energy sector. An overhaul of the civil service is also essential.
- Reforms of the law enforcement agencies are proceeding slowly, if at all. It is too early to say whether judicial reform will lead to improvements in the functioning of the courts because of the deep underlying culture of corruption in the judicial system.
- The newly created National Anti-Corruption Bureau has yet to achieve a high-level prosecution because of the influence of vested interests over the judiciary. This situation should change for the better after the formation of the High Anti-Corruption Court, but there is likely to be a risk of selective justice.
- Punitive measures on their own can only have a limited effect on reducing corruption. They must be part of a sustained and comprehensive strategy to reduce the space for corrupt practices and open the political and economic system to greater competition. This requires de-monopolizing politics, and encouraging Ukraine's power groups to accept new rules of the game.
- Citizens condemn high-level corruption but regard petty corruption as a justifiable evil. This perception needs to change, and citizens must accept their responsibilities for limiting the scope of corruption.

# 1. Introduction

Since 2014, Ukraine has taken unprecedented steps to reduce corruption in public life. No country emerging from the former Soviet Union, with the exception of the Baltic states and Georgia, has adopted such significant measures in such a short time to limit the space for corrupt practices while also creating new anti-corruption bodies and starting to reform its judiciary and law enforcement agencies. Results to date have been mixed. The considerable progress on increasing transparency and closing down opportunities for extracting administrative rents has outstripped efforts to bring to justice past and present officials who have abused their public office. As anti-corruption activists quip, these unbalanced outcomes mean that Ukraine is now possibly the most openly corrupt country in the world.

There is nothing surprising about this. Success in overcoming deeply embedded corruption in a country such as Ukraine, with its formal and informal systems of governance, requires much more than new laws and dedicated anti-corruption bodies. Ultimately, it requires consensus among the elites to change the rules of the game. The history of Western Europe shows that this can happen when elites evolve to the point where they see benefit in developing institutions to secure their property rights and access to rents, rather than relying on personal patronage and clientelism. In social science this is known as the transition from a 'limited access order', in which a narrow group of powerful individuals exercise political and socio-economic dominance, to an 'open access order', which admits a wider set of interests based on self-organizing networks and impersonal social relationships.<sup>1</sup>

By some estimates, a transition of this kind typically takes 50 or so years, assuming a degree of linear progress.<sup>2</sup> If Ukraine started on this path in 1991 after independence, it is now around the mid-point. The 2014 'Revolution of Dignity' and its aftermath accelerated progress, but this has not necessarily been linear. In the case of the anti-corruption reforms, a combination of pressures, including the war with Russia, the demand for change from society and the conditionality of support from international partners, forced Ukraine's elites in 2014 to start the process of reducing the scale of wealth diversion and other practices that subtracted value from the country. These abuses had plagued Ukraine since independence and warped its institutional development. They reached unprecedented levels during the presidency of Viktor Yanukovich (2010–14), leaving the country not just bankrupt but defenceless. Previous anti-corruption programmes going back to the late 1990s had only imitated the process of combating the problem.

The exigencies that became evident during the revolution led to the adoption of the Law On Preventing Corruption in October 2014, and of other measures that for the first time sought to limit the losses to society from predatory behaviour by officials acting for their own benefit and on behalf of a narrow group of powerful individuals. However, as the situation has stabilized since 2014, the readiness of elite networks to support change has diminished as they see less need for sacrifice. At the same time, the fightback by some of them against anti-corruption reforms, in particular the

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<sup>1</sup> North, D., Wallis, J. J. and Weingast, B. (2009), *Violence and Social Orders*, Cambridge University Press.

<sup>2</sup> Ibid.

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creation of a High Anti-Corruption Court, is a clear indication that these measures are effective and endanger the vital interests of the groups in power. Yet this does not necessarily mean that reforms are succeeding. In the case of the High Anti-Corruption Court, the independent capacity to investigate, prosecute and convict high-level officials scares power groups not so much because they fear going to jail, but because they see it as an encroachment on their control of the limited access order. In particular, a court that is not controlled by the power groups risks undermining the system of selective justice that derives from their influence over law enforcement agencies and the judiciary.

This paper analyses the effectiveness of the anti-corruption reforms undertaken since 2014 on key sectors of the Ukrainian state in the context of the system that they are seeking to change. Corruption is defined as the misuse of public institutions and office to the detriment of the common good. It does not necessarily involve financial wrongdoing or bribery.

Despite some distinctive cultural features that have shaped its development, Ukraine broadly fits the category of a state with a limited access order in which corrupt practices are the norm and form the root of a system that allows power groups to coexist peacefully on the basis of shared privileges and rents. The system is not just corrupt; it runs on corruption. The paper argues that Ukraine has achieved significant results in reducing depredations by the elites by narrowing the space for corrupt practices, even if overall corruption remains disturbingly high and radical action is still necessary in key areas to consolidate progress.

By contrast, punitive actions against corrupt officials, or the threat thereof, have so far yielded little. For now, such actions are likely to remain a blunt instrument, as the nature of the system has not yet changed sufficiently to allow them to target senior members of the elite. In other words, challenging this system head-on by trying to put corrupt officials behind bars will not change its essence.<sup>3</sup> Instead, some of the interest groups that form this system need encouragement to evolve in response to reduced opportunities for corruption and increased scope for the development of business that derives from genuine creation of value rather than extraction of rents.

### The nature of corruption in Ukraine

In common with many countries with less advanced governance systems, Ukraine has a stubborn form of corruption deeply embedded in its state institutions. Citizens are acutely aware of this, and continue to rank corruption – especially high-level corruption – as one of the biggest problems facing the country, and on a par with Russia's aggression.<sup>4</sup> The most popular perception is that corruption is a type of 'rust' plaguing state institutions and requiring removal with an 'iron brush' in the form of harsh punitive measures. According to this logic, the more senior officials are jailed, the less corruption there will be, and the better state institutions will perform. Yet even if it were

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<sup>3</sup> Rating Group (2018), 'Socio-political moods of the Ukrainians: new challenges', [http://ratinggroup.ua/en/research/ukraine/obschestvenno-politicheskie\\_nastroeniya\\_ukraincev\\_novye\\_vyzovy.html](http://ratinggroup.ua/en/research/ukraine/obschestvenno-politicheskie_nastroeniya_ukraincev_novye_vyzovy.html) (accessed 11 Sept. 2018). Around 40 per cent of respondents say that corruption is a systemic mechanism necessary for society, rather than an illness. Unlike other indicators, this one is surprisingly stable (with almost no change in five years), and tends to increase the higher the level of education and the lower the age of respondents.

<sup>4</sup> *Ibid.* Corruption was mentioned as one of three main problems affecting Ukraine by 40 per cent of respondents, almost as many as those who listed the war in Donbas (41 per cent). Inflation ranked third, listed only by 27 per cent of respondents. This pattern has remained broadly unchanged since 2014.

possible to put in place punitive measures to deter officials at all levels from extracting private benefits, there is no guarantee that these old institutions would start working better. Some might even function worse, if officials deprived of access to privileges lost the incentive to perform their basic duties.

Corruption defies simple description and remedy because of its complexity. At its root are deep systemic problems that create space for various forms of rent-seeking. These deficiencies continue to bedevil Ukraine's state institutions and are the main reason for its poor performance across the board from the economy to diplomacy. As such, corruption is a symptom of underlying systemic problems, not their cause, even if it reinforces some of them.

As Douglas North, John Joseph Wallis and Barry Weingast have noted, 'Natural states [i.e. with limited access orders] are not sick. They have their own logic and are not dysfunctional ... Natural states may appear to be corrupt according to the norms and values of open access orders.'<sup>5</sup> In other words, what Western countries traditionally regard as corruption, such as the fusion of business and power, is an integral feature of a limited access order. Popular anger at corruption reflects frustration with the inbuilt limitations of this system and the aspiration to open it to others. Ukrainians can see successful examples of such a transition in Western Europe; as well as to some extent in Central Europe, where the establishment of an open access order, while not complete, is relatively advanced. Reducing corruption is a by-product of systemic transformation and cannot be treated separately from it.

Resistance to the opening of a limited access order is often considerable because corruption is not only a tool for enrichment of the ruling elites, but also an indispensable instrument of administration. Mid- and low-level officials typically require incentives for executing orders in the form of privileges or side payments that derive from illicit diversion of state resources. At the same time, low-level officials are often required to collect or even extort bribes and channel them to their superiors. In both cases, corruption works as both carrot and stick; senior officials have grounds to report their subordinates' corruption in case of non-compliance with their orders, even if their orders are illegal. It is very hard to estimate the scale of these well-established informal mechanisms, but many of Ukraine's state institutions – especially in law enforcement – would probably experience rapid decay or even paralysis if these reward channels were to close overnight. However, the rapid and successful transformation of the Ministry of Health's system for procuring medicines shows that, at least in one key area, change is possible without undermining the institution.

Paradoxically, some forms of corruption of institutions in limited access orders are conducive to economic and societal development, in that they reduce the effects of limited access and allow for 'greasing of the wheels' from below. This was the case in the Soviet era, when the Communist Party often disregarded the informal barter of goods and services between economic entities in order to alleviate the inefficiencies of the planned economy. Without this expedient, the Soviet economic

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<sup>5</sup> North, Wallis and Weingast (2009), *Violence and Social Orders*, p. 269.

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system could not have functioned.<sup>6</sup> In Ukraine today, corruption remains an important enabling force that keeps the grossly inefficient state bureaucracy and economy functioning. However, despite the mitigating function of this type of corruption, it has malicious spillover effects that contribute to embedding informal practices that are difficult to remove. Just as corruption may help to circumvent trivial but onerous regulations, it can easily do the same, for instance, in the case of rules that protect lives. The number of fatal industrial accidents in Ukraine speaks volumes about this risk.<sup>7</sup> Moreover, tolerance of one form of corruption tends to legitimize other kinds of corruption, and blurs the line for society between acceptable and unacceptable behaviour.

As in much of the former Soviet Union, the limited access order in Ukraine is characterized by overregulation, in tandem with space for the bureaucracy to enforce selectively rules and norms that are intentionally made impracticable so that the authorities have leverage. This combination not only gives the power groups that make the rules significant influence over others in society; it also provides them with the ability to create patron–client networks that ensure the loyalty of the bureaucracy. The bureaucracy gains a stake in the system through selective enforcement of the rules on behalf of its patrons. This derives from a Russian tradition going back centuries whereby norms are deliberately made discretionary, ambiguous and overly restrictive to endow a *nachal'nik* (chief) in the bureaucracy or law enforcement with informal discretionary personal power (*vlast'*) that can be then used either for personal enrichment or sometimes for entirely legitimate purposes.<sup>8</sup> As a result, two of the most widespread forms of corruption in Ukraine are extortion under the threat of enforcement of impracticable rules and regulations, and collusion between officials and business people or citizens to circumvent these norms or abuse them for private benefit.

Constraining the space for this kind of informal influence requires more than drastic streamlining of legislation. In Robert Klitgaard's classic definition, corruption equals monopoly plus discretion minus accountability ( $C = M + D - A$ ).<sup>9</sup> In line with this, cutting corruption in Ukraine means reducing the scope for monopoly decision-making and replacing officials accustomed to personal power with civil servants who are skilled in impersonal and strict implementation of the rules and genuinely committed to the public good. Neither approach can work properly in isolation. Even the best designed norms will be abused, although possibly to a lesser extent by 'old cadres', while even the most impartial officials are at high risk of losing their integrity if faced with the implementation of impracticable norms tailored for maximizing their power.

Aside from the administrative challenges, reforms of this kind are politically difficult to manage. Corrupt 'chiefs' use their money and influence to lobby for even more favourable conditions for corruption. They also have clients and partners from the private sector who are used to benefiting from impracticable norms *vis-à-vis* their competitors through their ties to officials. In addition, senior politicians who may not even be involved directly in corruption schemes may still look on

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<sup>6</sup> Smith, A. and Swain, A. (1998), 'Regulating and Institutionalizing Capitalism: the Microfoundation of Transformation in Eastern and Central Europe', in Pickles, J. and Smith, A. (eds) (1998), *Theorizing Transition: The Political Economy of Post-Communist Transformation*, New York: Routledge.

<sup>7</sup> In 2014, there were 2,034 work accidents with 99 fatal cases in Ukrainian coal mines, and 220 work accidents, with 12 fatal cases in ore and non-metal mines. International Labour Organization (2017), 'New ILO Project aims to reduce work accidents and occupational diseases in Ukrainian mines', 13 July 2017, [http://www.ilo.org/global/about-the-ilo/newsroom/news/WCMS\\_562950/lang-en/index.htm](http://www.ilo.org/global/about-the-ilo/newsroom/news/WCMS_562950/lang-en/index.htm) (accessed 11 Sept. 2018).

<sup>8</sup> Dubrovskiy, V. (2006), *Towards Effective Anti-Corruption Strategies in Ukraine: Removing the Cornerstone without Toppling the Building*, Warsaw: Center for Social and Economic Research, p. 9, [http://www.case-research.eu/files/?id\\_plik=2624](http://www.case-research.eu/files/?id_plik=2624) (accessed 11 Sept. 2018).

<sup>9</sup> Klitgaard, R. (1988), *Controlling Corruption*, Berkeley, CA: University of California Press.

them kindly due to their political interests or because it helps to keep their subordinates under informal control. On a societal level, moreover, it is hard to expect zero tolerance of corruption becoming the norm in the near future because of the general acceptance of petty corruption as a way of life that helps solve problems. Last but far from least, widespread corruption in law enforcement structures and the judiciary, which are supposed to limit the scope of corruption, means that both are accustomed to selective implementation of the law, including anti-corruption norms, and experience very low levels of public trust.<sup>10</sup> Therefore, increasing the severity of the law will not only be mitigated by its customary use; it can also paradoxically result in strengthening the limited access order by further closing the social networks and streamlining the channels that take the proceeds from low-level corruption to the political level.

### Specific features of corruption in Ukraine

The oligarchic system that took shape in Ukraine in the mid-1990s built on the limited access order inherited from the Soviet system and earlier traditions of governance. The wealthy individuals who emerged at that time often did not own assets. They first secured monopoly control of key sectors such as the gas trade with Russia and banking, or they profited from informal control of state-owned enterprises (SOEs). They later increased their wealth through privatizations that sustained patron–client relationships from Soviet days, with ‘red directors’ and their networks assigned prominent roles in these enterprises. The demise of the Communist Party – and its control of the levers of power – gave the new ruling groups vast influence over the machinery of the state in the absence of the old system’s internal checks and balances.

To protect and expand their positions in this emerging order, some of Ukraine’s new rich bought media assets, established quasi-political parties and ensured that their representatives were elected to parliament. They often also found patrons or partners in law enforcement agencies, including parts of the security service, and in the judiciary. Some of these structures had developed ‘commercial’ interests well before the collapse of the Soviet Union. In addition, Ukraine’s judiciary had no tradition of independence. This system coalesced under President Leonid Kuchma (1994–2005) and did not change substantially after the 2004 Orange Revolution. Despite the stirrings of civil society at that time, the power groups did not feel pressured enough to change their behaviour. This explains why anti-corruption efforts at that time proved merely tokenistic; they were often just a tool for settling scores between rivals rather than for improving the public good. President Yanukovich adapted the system by centralizing control to divert rents to his family and its associated networks.

A study of high-level corruption issues prepared by the new government in 2014, with the assistance of the IMF, noted the ‘pyramidal’ nature of influence over the government system with ‘powerful well-known elites at the top, heads of agencies in the middle and agency staff at the

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<sup>10</sup> In a December 2017 poll, law enforcement agencies and the judiciary scored poorly on trust. The least reformed institutions such as the Prosecutor’s Office and the courts scored worst, while the partially reformed police are viewed more positively, and the new patrol police even more so, although it is still more distrusted than trusted. National Anti-Corruption Bureau of Ukraine (NABU) was the best performer. Democratic Initiatives Foundation (2018), *Громадська думка, грудень-2017: виборчі рейтинги і рейтинги довіри* [Public opinion, December 2017: selective ratings and ratings of trust], <https://dif.org.ua/article/rejtingijfojseoj8567547?> (accessed 11 Sept. 2018).



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base'.<sup>11</sup> It described how these groups were able to control appointments in the public sector, to ensure the application of regulations in line with their interests, and to restrict public access to information. The study also noted coordination across different government agencies to intimidate business and extort bribes. The tax administration, the police, the Prosecutor General's Office, the State Enforcement Service and the judiciary were identified as the most corrupt institutions. Typically, positions of power that allowed possibilities for extortion were for sale, this investment would then be repaid through the proceeds of bribes.<sup>12</sup>

There is nothing specifically Ukrainian about these practices, even if they have taken on an extreme form in Ukraine today. They are a regular feature of countries with governance based on a limited access order. The political scientist Henry Hale coined the term 'patronal politics' to describe societies in which individuals can pursue political and economic goals based on personalized exchange of rewards and punishment.<sup>13</sup> The power groups' control of the law enforcement agencies, notably the prosecutorial institutions, and the judiciary is a key feature of these systems. With the ability to make justice selective, some power groups can extract illegal rents with impunity and protect themselves from potential enemies.

The manipulation by certain Ukrainian elites of the electoral system sustains a particularly pernicious form of political corruption. A vicious circle of corruption arises from the fact that members of parliament often pay for their seats either by buying places on party lists or by using illegal campaigning tactics in single mandate constituencies. Regrettably, traditional methods of election observing do not address this problem.<sup>14</sup> Members of parliament elected in this fashion expect to recoup the cost by demanding payments to support parts of the legislative agenda, including voting for formal and informal privileges that benefit certain interest groups, as well as legislation enhancing the *vlast*' and rents of certain categories of 'chiefs' in the executive. In its most primitive form, this is a distribution of rents to the smallest group possible to secure the continued functioning of the limited access order.

A cultural factor causes Ukraine to be especially prone to petty corruption. In contrast to the situation in countries where citizens feel responsible to institutions, Ukrainians feel responsible to a close personal circle of relatives and friends on whom they can rely in case of hardships in the absence of reliable and stable benevolent public institutions. Like citizens in other post-colonial countries, particularly those that have been located on the shifting peripheries of large empires, Ukrainians have inherited a survival ethic that deeply distrusts the state and its institutions, including the law, regarding them as inherently alien and hostile.<sup>15</sup> As a result, many Ukrainians have an ambivalent attitude towards corruption; at one level they strongly oppose it, but at the same time they tend to regard nepotism and other corrupt practices as acceptable means of

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<sup>11</sup> Government of Ukraine (2014), *Diagnostic Study of Governance Issues Pertaining to Corruption, the Business Climate and the Effectiveness of the Judiciary, Government of Ukraine Report*, p. 4, <https://www.imf.org/external/pubs/ft/scr/2014/cr14263-a.pdf> (accessed 9 Oct. 2018).

<sup>12</sup> *Ibid.*

<sup>13</sup> Hale, H. (2014), *Patronal Politics*, Cambridge University Press.

<sup>14</sup> OSCE (2014), *Ukraine, Early Parliamentary Elections, 26 October 2014: Final Report*, Warsaw: OSCE Office for Democratic Institutions and Human Rights, <https://www.osce.org/odihr/elections/ukraine/132556?download=true> (accessed 11 Sept. 2018).

<sup>15</sup> Among Ukrainians, these attitudes date back to the Zaporozhian Cossacks and their success in obtaining privileges and partial autonomy from the tsars, see Applebaum A. (2017), *Red Famine*, London: Allen Lane, p. 4.

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protecting their interests. Many also tend to prefer keeping open the possibility of paying a bribe to settle a low-level matter – to avoid a fine, for instance, or to secure a permit.<sup>16</sup>

In summary, corruption in Ukraine has organizational elements that are commonly found in countries with limited access orders, together with specific features derived from the country's history that make it hard to address without cultural change on the part of its citizens. In particular, this includes how they view the state, and the impact of stealing from it. The challenge for Ukrainian reformers is to align the interests of the progressive elements of the elites and wider society to allow them to accept new rules and behaviours based on strong and reliable institutions. This includes establishing a place for large and small business in this new system.

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<sup>16</sup> Rating Group (2018), 'Socio-political moods of the Ukrainians: new challenges', slide #44, [http://ratinggroup.ua/en/research/ukraine/obschestvenno-politicheskie\\_nastroeniya\\_ukraincev\\_novye\\_vyzovy.html](http://ratinggroup.ua/en/research/ukraine/obschestvenno-politicheskie_nastroeniya_ukraincev_novye_vyzovy.html) (accessed 27 Sept. 2018). Among respondents who admitted to giving a bribe during the previous year, 81 per cent said that there was no justification for this, even if it solves a problem that is personally significant for them.

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## 2. Assessing the Impact of Anti-corruption Measures in Key Sectors

Between 2015 and 2017, Ukraine's reformers and its international partners paid considerable attention to establishing new formal structures and procedures for exposing corruption, investigating it and prosecuting high-level perpetrators. The travails of the National Agency for Prevention of Corruption (NAPC) and the e-declaration system as well as the routine and well-documented struggles involving the National Anti-Corruption Bureau of Ukraine (NABU), the Prosecutor General's Office (PGO) and the Special Anti-Corruption Prosecutor's Office have often distracted attention from the other significant actions taken.

### The energy and natural resources sector

The reforms of the gas market and of Naftogaz that took place in 2015–16 are the most significant achievements of the anti-corruption reforms to date. Up to that point, the highly opaque gas business had been the main source of rents for Ukraine's elites, causing losses of tens of billions of dollars to the state<sup>17</sup> and undermining national security. Arbitrage schemes that exploited the difference between subsidized prices and market prices were central to the siphoning of state funds that left Naftogaz with huge annual losses. In 2014, Naftogaz's deficit was 5.7 per cent of GDP.<sup>18</sup> The government plugged these holes with quasi-fiscal subsidies that in turn hurt public finances. Perversely, for years these schemes incentivized gas purchases from Russia by penalizing national gas production from Ukraine's own relatively abundant resources. They also discouraged energy efficiency measures, creating a vicious cycle of dependence on Russian gas.

The IMF's insistence on equalizing gas household and commercial tariffs as well as on improving transparency at Naftogaz has had marked effects. Although full 'market prices' are not yet in place for the household sector and district heating companies, the dramatic increases in prices for household users have removed the previous arbitrage margins and, along with a clean-up by the new management, eliminated the need for subsidies to Naftogaz. Instead, the company returned to profit in 2016 and has become a significant contributor to the state budget. In the first four months of 2018, it accounted for 19.3 per cent of state revenues.<sup>19</sup> The measures have put greater funds at the disposal of Ukrgezvydobuvannya (UGV), Naftogaz's gas production subsidiary, that have already helped to boost its gas production: UGV's output rose by 4.2 per cent in 2017.<sup>20</sup>

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<sup>17</sup> According to government data, state subsidies to keep gas prices artificially low cost \$53 billion over a decade.

National Commission for State Regulation of Energy and Utilities (2016), 'Чому необхідно було змінити ціну на газ?' [Why was it necessary to change gas prices?], [http://www.nerc.gov.ua/data/filesearch/lystivka\\_gaz.pdf](http://www.nerc.gov.ua/data/filesearch/lystivka_gaz.pdf) (accessed 11 Sept. 2018).

<sup>18</sup> 'Ukraine – Report of the Government, February 2014 – June 2015, p 2 (June 2015),

[https://mfa.gov.ua/mediafiles/sites/edinburgh/files/Government\\_Report\\_June\\_15.pdf](https://mfa.gov.ua/mediafiles/sites/edinburgh/files/Government_Report_June_15.pdf) (accessed 9 Oct. 2018).

<sup>19</sup> Naftogaz (2018), 'Naftogaz group paid UAH 43.0 billion to the state budget in January–April', 4 May 2018,

<http://www.naftogaz.com/www/3/nakweben.nsf/o/010403Bo8E103814C2258283003CF651?OpenDocument&year=2018&month=05&nt=News&> (accessed 11 Sept. 2018).

<sup>20</sup> Naftogaz (2018), '2017 results: Ukraine increased gas production by 450 mcm (+2 per cent)', 6 February 2018,

<http://www.naftogaz.com/www/3/nakweben.nsf/o/3A9F47194FB59AE6C225822C0023051D?OpenDocument&year=2018&month=02&nt=News&> (accessed 11 Sept. 2018).

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The cessation of direct gas purchases from Russia starting in 2016 has removed the schemes previously associated with this business and further increased transparency of the sector. Far-reaching corporate governance reforms at Naftogaz itself, including the appointment of a supervisory board, have contributed to the process.

Revolution and war were the enablers of these major reforms. Ukrainians remembered Russia's coercive 'energy diplomacy' from previous years, and after the annexation of Crimea and subsequent events few could argue against putting an end to dependence on Russian imports. Western countries and civil society also demanded reform of the energy sector. The main beneficiaries of the old schemes had either fled the country or were weakened and could not actively resist. As a result, the balance of interests favoured reform. The political opposition, which could have represented the main losers of this transformation, was in disarray and direct household subsidies softened the impact of price rises, even if only the poorest consumers benefited from this. Predictably, opposition forces moved quickly to make revision of the reforms the centrepiece of their campaigning.

Not surprisingly, the reforms have slowed since 2015–16. The independent directors of the Naftogaz supervisory board resigned in 2017, due to alleged government interference in efforts to modernize the company.<sup>21</sup> The price equalization for commercial and household users initially established in 2016 has proved politically unsustainable as global energy prices have increased prices for commercial consumers (they were 55 per cent higher than for household consumers in January 2018). It is possible that vested interests are comfortable with the current discrepancy between commercial and household prices because this still offers arbitrage opportunities, albeit at a significantly reduced level compared to the situation before 2014.

Wider problems in the sector remain unaddressed. Naftogaz sells gas via regional supply companies (*oblgazes*) that are de facto monopolies owned mainly by Gaztek, which also owns the regional gas networks. The *oblgazes* have been dogged by allegations of corruption related to the sale of subsidized household gas to commercial companies at commercial prices. After 2013, commercial prices were well over 1,000 per cent higher than the lowest prices for household gas. The *oblgazes* claim that they are unable to pay for the gas they receive from Naftogaz, which is obliged to supply them. In January 2018 Naftogaz reported that industrial users owed UAH 34.1 billion (\$1.3 billion). Metering of gas consumption remains inadequate, allowing unsanctioned gas consumption to continue.

Other sources of alleged corruption in the sector include gas production at UGV through joint activity agreements whereby, in return for funding, an investor obtains a share of the gas produced. In the past, some investors stripped out the value of projects by transfer pricing of gas and inflating the cost of equipment.<sup>22</sup> While the scale of the problem has been reduced, industry sources say that

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<sup>21</sup> Naftogaz (2017), 'All independent directors of Naftogaz to quit the Supervisory Board because the government is derailing the reforms', 19 September 2017, <http://www.naftogaz.com/www/3/nakweben.nsf/0/6D7C544D5F376866C22581A0006883A0?OpenDocument&year=2017&month=09&nt=News&> (accessed 11 Sept. 2018).

<sup>22</sup> Stack, G. (2014), 'Naftogaz subsidiary's suspicious tie-up with "Swedish" energy firm to go ahead', BNE Intellinews, 17 July 2014, <http://www.intellinews.com/naftogaz-subsidiary-s-suspicious-tie-up-with-swedish-energy-firm-to-go-ahead-500414360/?archive=bne> (accessed 11 Sept. 2018).

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it has not been eliminated. It appears that the use of the ProZorro e-procurement system at UGV has played a part in reducing these abuses.

High levels of secrecy still surround licences for oil and gas production. These create the impression among investors that politically connected actors are seeking to profit from preventing open licensing rounds.

There are also concerns about progress on establishing an independent energy regulator despite the passing of a law to that effect in 2016 and international support for developing a modern regulatory framework. A fight between leading business groups over electricity tariffs has complicated the appointment of members of the National Energy Regulatory Commission (NERC) and has slowed the development of competitive energy markets. The electricity market remains heavily monopolized and as such a breeding ground for corrupt practices.

In its recent review of the NERC, the Energy Community Secretariat spared no criticism of President Petro Poroshenko for the delay in appointing commissioners, referring to 'political readiness to prevent the effective independence of the regulator'.<sup>23</sup> The NERC's decision in 2016 to set wholesale electricity prices at levels favouring domestic coal producers (known as the 'Rotterdam +' formula) has caused widespread controversy but remains in force.

In this case, the main stakeholders are Rinat Akhmetov's DTEK, a monopoly that controls coal mining as well as power and heating generation, and Ihor Kolomoysky's and Gennady Bogolybiv's Privat Group that owns ferroalloy plants that are very energy-intensive and suffer the most from 'Rotterdam +'. DTEK appears to have stronger backing in parliament as it is a critical generator of power and heating for the country.

Additional problems in the energy and natural resources sector relate to the lack of transparency at the state oil company Ukrnafta<sup>24</sup> and perceived corruption in the State Service of Geology and Mineral Resources.<sup>25</sup> The illegal amber trade has grown since 2014, and the industry currently produces 150–200 tonnes a year and employs an estimated 10,000 people.<sup>26</sup> For this industry to function, collusion between local governments, law enforcement and criminal structures is necessary. The deployment of the police and National Guard in two of the main producing areas to prevent fighting between armed groups involved in the business has produced only limited results. The state has failed to tackle the problem probably because of a combination of the interests of local elites and concerns about cutting off a revenue stream that is vitally important to the local population. The government otherwise lacks the resources to address socio-economic problems in these areas.

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<sup>23</sup> Energy Community (2018), *The National Energy Regulatory Authority of Ukraine: Governance and Independence*, Vienna: Energy Community Secretariat, p.14, [https://www.energy-community.org/dam/jcr.../ECS\\_NEURC\\_reg\\_report\\_032018.pdf](https://www.energy-community.org/dam/jcr.../ECS_NEURC_reg_report_032018.pdf).

<sup>24</sup> NABU reported in August 2017 that it was investigating the embezzlement of oil worth UAH 7 billion (\$274 million) at Ukrnafta through deliveries that recipient companies never paid for. *Kyiv Post* (2017), 'NABU: Largest corruption in energy sector among all economic sectors', 18 August 2017, <https://www.kyivpost.com/ukraine-politics/nabu-largest-corruption-energy-sector-among-economic-sectors.html> (accessed 11 Sept. 2018).

<sup>25</sup> The Ministry of Ecology stated in October 2017 that the agency had illegally blocked the issue of 350 licences, *Chetvertaia Vlast'* (2017), 'У Міністерстві екології скаржаться, що компанія Держгеонадра незаконно зупинила ліцензії 350 підприємств', [In the Ministry of Ecology, they complain that the company Gosgeonedra has illegally stopped licences for 350 companies], 26 October 2017, <https://vlada.io/articles/u-ministerstvi-ekologiyi-skarzhatsya-shho-kompaniya-derzhgeonadra-nezakonno-zupinila-litsenziyi-350-pidpriyemstvam/> (accessed 11 Sept. 2018).

<sup>26</sup> Piechal, T. (2017), 'The Amber Rush in Ukraine', Centre for Eastern Studies, Commentary, 8 May 2017, [https://www.osw.waw.pl/sites/default/files/commentary\\_241\\_0.pdf](https://www.osw.waw.pl/sites/default/files/commentary_241_0.pdf) (accessed 11 Sept. 2018).

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Anti-corruption experts have also expressed concern about the decision in December 2017 to create a national coal company because of the risk that it will come under the control of leading business groups and effectively put state subsidies and funds for the procurement of equipment in private hands.<sup>27</sup>

### The tax system

Reform of the tax system remains one of Ukraine's biggest challenges. While significant progress has been achieved in ending the most egregious schemes that operated during the Yanukovich years, there is considerable scope for further reform.

The main stakeholders of such reform are the highly corrupt tax authorities<sup>28</sup> and connected politicians, officials and businesses on one side, and the rest of business and taxpayers on the other side. The population at large is not active in this struggle and its interests go unrecognized because it does not feel directly affected by the deficiencies of the current system even if it stands to benefit from its improvement. Microbusinesses form the broadest category of stakeholders now using simplified taxation and they are surprisingly well organized as a lobbying force, although they are underrepresented in parliament. At the same time, the IMF plays a critical role as a creditor interested in fiscal sustainability.

### 'Licensed platforms'

After he became president in 2010, Yanukovich set about centralizing the vast tax evasion schemes that had existed in Ukraine since the beginning of the 1990s. To achieve this, the tax authorities introduced a sophisticated and generally effective system for managing value-added tax (VAT) payments that allowed it to control 'missing trader' fraud schemes (also known as 'tax pits').<sup>29</sup> As a result, the VAT compliance gap is believed to have initially contracted to a historical low, reaching about 6 per cent in 2011, comparable to the best European examples. However, in 2012–13 the gap widened back to more than 35 per cent, based on 'licensed platforms' operating under the direct oversight of top tax officials. Using these platforms, a firm could charge VAT on a service it had never provided and receive a VAT credit or cash refund. A commission of 12–13 per cent was payable, with the lion's share apparently going to Yanukovich's 'family' coffers. These platforms had targets for providing revenues to their patrons and sometimes obliged businesses to use them. In 2014, the new authorities investigated these fraudulent schemes and estimated their value at UAH 300 billion (around \$37 billion).<sup>30</sup> This means annual VAT losses to the state budget during

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<sup>27</sup> Makarenko, O. (2018), 'Ukraine's new state coal giant – reform conduit or corruption sinkhole?', EuroMaidan Press, 7 February 2018, <http://euromaidanpress.com/2018/02/07/ukraines-new-state-coal-giant-reform-conduit-or-corruption-sinkhole/> (accessed 9 Oct. 2018).

<sup>28</sup> 54 per cent of respondents named the tax authorities as the most corrupt institution in Ukraine on a 2017 poll conducted by The American Chamber of Commerce in Ukraine, [http://publications.chamber.ua/2018/docs/Other/Chamber\\_CPS\\_2017.pdf](http://publications.chamber.ua/2018/docs/Other/Chamber_CPS_2017.pdf)

<sup>29</sup> The use of 'tax pits' involves entities that are registered to pay VAT but do not do so while operating with counterparties that falsely claim tax credits.

<sup>30</sup> Lyamets, S. (2014), 'Арсеній Яценюк: Всі схеми попередньої влади ліквідуються, Arseny Yatseniuk' [All schemes of the previous regime are being liquidated], *Ekonomicheskaya Pravda*, 14 May 2014, <https://www.epravda.com.ua/publications/2014/05/14/452304/> (accessed 1 Oct. 2018).

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the Yanukovich years averaged UAH 70 billion (around \$9 billion) while the 'family' probably received UAH 15 billion (almost \$2 billion).<sup>31</sup>

### VAT administration

After the Revolution of Dignity, these schemes continued – albeit on a lesser scale, and no longer centralized as before. Anecdotal evidence suggests that commissions from licensed platforms fell to 6–7 per cent due to competition and apparent removal of the Yanukovich 'family' margin. In 2015, the introduction of a new system of electronic VAT administration made it impossible to continue operating the 'missing trader' scheme. Although this new system did not eliminate fraud, the VAT compliance gap almost halved to 18 per cent in 2015 and has probably continued to fall further since then, although no official data are currently available. However, the system imposed an additional burden on businesses since they had to make advance VAT payments to the state. This was particularly problematic for companies with rapidly expanding operations. In 2016 commissions again increased to 12–13 per cent, mostly due to the increased complications in operating the schemes still in existence, while the budget revenue losses from VAT fraud were estimated at about UAH 12 billion (around \$500 million).<sup>32</sup> Additional measures implemented in 2017–18 are expected to reduce losses still further. The Institute for Economic Research and Policy Consulting calculates that the measures to close the 'licensed platforms' and related tax credit schemes have saved the budget around \$3 billion annually.<sup>33</sup>

However, criminal tax specialists continue to exploit other opportunities; for example, by creating short-term fake companies to operate schemes to cash wages and thus avoid a 41 per cent cumulative tax, as well as providing false documents for illegally produced or imported goods.

The introduction of an automatic system for VAT refunds in 2017 has been a major improvement and is successfully tackling evasion and fraud. The new system has enabled the country to clear arrears of UAH 15 billion (about \$700 million) within a year. Based on a transparent VAT register, the automatic system was the result of a fierce battle between the Ministry of Finance, allied with civil society and business, and the State Fiscal Service (SFS). Refunds were previously subject to kickbacks of up to 30 per cent after the introduction of VAT in 1997. This was possible because the tax authorities were endowed with wide discretion over the terms of the refund. Moreover, overdue refunds were used routinely for balancing the budget when problems occurred, and they sometimes amounted to billions of dollars. Usually, exporters received their reimbursement after 'sharing' a part of it with officials or, more often, intermediaries. Given the large volume of exports, the VAT refunds were worth \$6–7 billion annually. Anecdotal evidence suggests that the kickbacks amounted to no less than \$1 billion.

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<sup>31</sup> The figures cited were calculated by Dubrovskiy as part of the project 'Best practices in reducing tax gap in V4 countries – mutual learning and lessons for Ukraine' undertaken by the CASE Foundation, <http://www.case-research.eu/en/best-practices-in-reducing-tax-gaps-in-v4-countries-mutual-learning-and-lessons-for-ukrain> (accessed 10 Oct. 2018).

<sup>32</sup> According to Nina Yuzhanina, the head of the Tax and Customs Policy Committee of the parliament; see <https://www.facebook.com/NinaIuzhanina/posts/410980062595426> (accessed 1 Oct. 2018).

<sup>33</sup> Burakovskiy, I. et al. (2018), *Ukraine's Fight Against Corruption: The Economic Front*, Report, Kyiv: Institute for Economic Research and Policy Consulting, p. 8, [http://www.ier.com.ua/files/publications/Policy\\_papers/IER/2018/Anticorruption\\_Report\\_EN.pdf](http://www.ier.com.ua/files/publications/Policy_papers/IER/2018/Anticorruption_Report_EN.pdf) (accessed 11 Sept. 2018).

This reform was strongly resisted and even sabotaged by the SFS since it had its own interests to protect. It only became possible in 2016 after Minister of Finance Oleksandr Danilyuk reduced the SFS's previously pivotal role in drafting tax legislation and turned instead to specialists from civil society. In the meantime, businesses came together in a broad coalition in support of the reform and lobbied for it with civil society experts involved in its preparation.

Despite the closure of this and other tax fraud schemes used by officials, other sources of corruption in the tax system remain unaddressed. The enterprise profit tax (EPT) is widely abused because of the level of discretion exercised by officials when verifying calculations of profits. The current procedures are inherently cumbersome and open to wide interpretation. The amount payable is often the result of a company's negotiation with officials at the tax office after an inspection. In addition, big business is adept at using transfer-pricing schemes and other instruments related to affiliated foreign parties to minimize EPT payments. After the reform of VAT administration, EPT is now the biggest source of tax avoidance, with estimated annual losses to the state budget of \$2 billion, an amount comparable to the EPT revenues received by the state. A simple capital withdrawal tax is due to replace the EPT in the coming months and should improve the situation since it is designed specifically to shrink the space for corruption. However, there has been considerable resistance to this change from the SFS and vested interests in big business that are set to lose some benefits of the aggressive tax planning that they have used up to now.

Another problem is the excessively high tax on salaries that leads to massive 'shadow' payments and resulting losses to the state budget. The problem is mostly the result of high payroll taxes that neither employers nor employees are interested in paying because of their understandable distrust in the value of future pension benefits. This leads to collusion between the two. The communal utility subsidies have further aggravated this problem by encouraging employees to report low official incomes. The payroll tax was lowered from nearly 40 per cent (differentiated by occupations) to 22 per cent in 2016, and this led to partial 'de-shadowing'. However, the combination of 18 per cent personal income tax, the 1.5 per cent 'war tax' and the overall 41 per cent tax on salaries means that the problem remains acute. Instead of further decreasing this tax, the government has tried to broaden the base for it by raising the minimum wage and introducing draconian fines for non-payment along with a broadening of inspections. This is clearly a recipe for increased corruption in this area.

Radical reform of the SFS should be a priority. This will require ridding it of all the features of its original design from the Kuchma days that enabled it to function as a tool of institutionalized corruption. As in other parts of the system, it is important that reforms reducing discretion and improving transparency should go hand in hand with hiring new staff who are not versed in institutional corruption together with selective punishment. Georgia's anti-corruption reforms were successful because they combined these elements.

### The customs system

With seven neighbouring countries and over 150 border crossing points, Ukraine has a very large customs system to manage. This remains a major source of corruption, despite the closure of the most impudent large-scale schemes of Yanukovych's times.



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Since 2014, the authorities have proved themselves either unwilling or unable to achieve significant improvements beyond the formal establishment of a 'single window' system involving the electronic exchange of data between five inspection agencies. However, this is not fully operational. The system for the valuation of goods crossing the border provides customs officials with ample room for discretion, with inevitable consequences as businesses find themselves forced to bargain. Importers either voluntarily agree or are forced to agree lower customs values for their goods with the difference 'shared' with customs officials. Goods can be held for days or weeks at the border in the absence of adequate regulation. This provides customs officials with further powers of discretion. Crony companies are apparently sometimes able to negotiate special deals with the central customs office. Smuggling and various other forms of illegal imports continue to flourish at huge cost to the state,<sup>34</sup> as well as to businesses that do not engage in these practices. However, the government claims that customs revenues in 2017 were 30 per cent higher than in 2016 and that UAH 70 billion (around \$2.8 billion) was recovered from smuggling schemes.<sup>35</sup> That said, Arsen Avakov, Minister of the Interior, stated in June 2018 that according to conservative estimates, smuggling schemes are costing Ukraine's budget \$3.8 billion a year.<sup>36</sup>

Two sets of interests are in conflict over customs reform. On one side is the public, supported by legal importers and domestic producers suffering from the effects of large-scale smuggling. On the other side are high-level interests in the customs service and their clients who avoid duties (mainly VAT) on an estimated turnover of \$6 billion. These proceeds find their way to the top of the pyramid or are shared with law enforcement officers whose remit includes tackling this form of corruption. The latter are well organized and in a strong position to defend their interests, while legitimate business only started organizing itself recently. So far, business has achieved only one small and probably Pyrrhic victory in closing down a 'scheme', which was based on a consignment of goods being split between numerous people crossing the border.

The fate of Yulia Marushevskaya, the Maidan activist who headed the partly successful effort to reform the Odessa customs service in 2015–16 is revealing. She found herself accused of embezzling or misusing UAH 500 (less than \$20) by the then head of the SFS, Roman Nasirov. She resigned claiming that there was insufficient political will to support the reforms she wanted to implement and described Nasirov as 'a guard dog for a corrupt system'.<sup>37</sup>

For now, the interests committed to preserving the status quo in the customs system appear to have the upper hand over reformers in the government, although there are indications that the Yanukovich system of channelling money upwards as part of a centralized system of extorting business no longer functions. Instead, decentralization of corruption revenues has taken place with

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<sup>34</sup> According to the Ministry of Finance's informal estimate, imports are undervalued for about \$6 billion, which makes customs abuses the second-largest source of conditional budget losses after aggressive tax planning.

<sup>35</sup> Ukrinform (2018), 'Додатково до бюджету 70 мільярдів: Гройсман розповів про досягнення ДФС' [Additional 70bn to the budget, Groyzman spoke about the achievements of the SFS], 21 March 2018, <https://www.ukrinform.ua/rubric-economy/2426166-dodatkovu-do-budzetu-70-milardiv-grojsman-rozpoviv-pro-dosagnenna-dfs.html> (accessed 10 Oct. 2018).

<sup>36</sup> Kyiv Post (2018), 'Süddeutsche Zeitung: Ukraine loses \$4.8 billion a year due to corruption at customs', 6 August 2018, <https://www.kyivpost.com/ukraine-politics/sueddeutsche-zeitung-ukraine-loses-4-8-billion-a-year-due-to-corruption-at-customs.html> (accessed 21 Sept. 2018).

<sup>37</sup> Polityuk, P. and Williams, M. (2016), 'Exclusive: Ukrainian activist faces corruption probe as reforms row festers', Reuters, 29 December 2016, <https://www.reuters.com/article/us-ukraine-crisis-corruption-customs/exclusive-ukrainian-activist-faces-corruption-probe-as-reforms-row-festers-idUSKBN14IoJ6?il=0> (accessed 11 Sept. 2018).

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individual customs areas operating quasi-independently. There is no indication that the introduction of mobile inspection groups to police the customs system has had any real effect.

Integrated border management with advance electronic processing of customs information offers rich opportunities for reducing fraud and the pressure that is felt particularly by small businesses. Despite the government's professed commitment to improvements, there have been signs of internal disagreement and sabotage. Prime Minister Volodymyr Groysman noted in late 2016 that there was not a single x-ray scanner working in the customs service and accused customs officers of breaking the equipment.<sup>38</sup>

This is partly the result of the ongoing struggle between the Ministry of Finance and the cabinet for control of tax policy, with the SFS advancing its own status quo agenda. The latter has much to lose from reforms that increase transparency, reduce the space for discretion by tax inspectors and threaten rule-breakers with punishment. It remains to be seen whether Nasirov will receive a criminal conviction after his indictment by the Specialized Anti-Corruption Prosecutor in November 2017 for abuse of office and forgery of documents related to tax evasion. He denies the charges.

### The banking sector

The problems in the banking system have built up over many years, but they became acute under Yanukovich. Some banks specialized in money laundering, cashing the money generated by tax-fraud schemes. Many others worked as 'vacuum cleaners', attracting deposits with unrealistically high interest rates while in fact either building Ponzi schemes or just providing loans to affiliated firms, or both. This led to a banking crisis in 2014 when depositors tried to convert their cash holdings into foreign currency. In the process of cleaning up the system, 98 out of 182 Ukrainian banks have been liquidated or are in the process of liquidation. They nominally held about a third of the assets and liabilities of the whole banking sector.

PrivatBank, owned by the 'oligarch' duo of Ihor Kolomoysky and Gennadiy Bogolybiv, is a special case since neither was ever affiliated with Yanukovich. However, the bank became insolvent with a €5 billion hole in its balance sheet. The government intervened at the end of 2016 to bring it into public ownership and re-capitalize it. The former owners and management stand accused of embezzling the deficit by providing loans to related parties and then shifting these loans to firms with no assets. Kolomoysky and Bogolybiv deny these allegations and are challenging the nationalization in multiple court cases, while the new management appointed by the government is suing them over allegations of fraud.

Much stricter anti-money-laundering rules have been introduced, along with tighter control over cash. Banks must now disclose their end beneficiaries and are liable for possible losses to their clients and the state incurred by fraud. This reform has left the banking system much healthier,

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<sup>38</sup> Ubranska, T. (2016), 'Володимир Гройсман: Я випустив контроль за ситуацією буквально на дві години – бо саме перебував на операційному столі – вийшовши з наркозу, дізнався, що ОПЗ зупинився' [Volodymyr Groysman: I lost control of the situation for literally two hours - because I was on the operating table – and after coming out of anaesthesia, I learned that the OPZ stopped], UNIAN, 15 October 2016, <https://www.unian.ua/politics/1572622-volodimir-groysman-ya-vipustiv-kontrol-za-situatsieyu-bukvalno-na-dvi-godini-bo-same-perebuvav-na-operatsiynomu-stoli-viyshovshi-z-narkozu-diznavsya-scho-opz-zupinivsia.html> (accessed 11 Sept. 2018).

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although it has shrunk by about one-third and still holds a vast stock of underperforming loans. These were the result of two currency crises (in 2008 and 2014–15), imprudent expansion of lending and fraud. The price of reform has been high: re-financing provided by the National Bank of Ukraine amounted to about 2.5 per cent of GDP while compensation to individual clients of failed banks amounted to 4.4 per cent. Corporate clients lost UAH 86 billion (more than \$3 billion) of liquid assets held in current accounts. Together the non-recoverable losses of the private sector amounted to 16 per cent of GDP.<sup>39</sup>

The banking sector has become more concentrated and more than half of all its assets are now state-owned. Some experts and politicians blame the reformers, primarily the National Bank's head, Valeria Hontareva, for large-scale abuses and deliberate persecution of competitors of the ruling group. Hontareva has denied any wrongdoing. It is clear that the losses to clients were inevitable due to the fragility of 'bad' banks, and that they could have been much larger if these banks had created a domino effect.

## Procurement

Massive embezzlement and kickbacks related to procurement contracts have been a consistent problem since independence. According to some assessments, the kickbacks under Yanukovich reached 30–50 per cent, or sometimes even more, of the procured amounts.<sup>40</sup> In the case of large-scale procurement these kickbacks were paid to offshore companies, while particular decision-makers received a share as 'commission' from their patrons.

The introduction of the electronic procurement platform ProZorro has largely put an end to some of the most blatant schemes related to tendering and made others more difficult to operate. Estimates suggest that it has already saved about UAH 51 billion (almost \$2 billion) of state procurement expenditures since its introduction in February 2016.<sup>41</sup> In some cases, such as at Naftogaz and some of its subsidiaries, the problem may have disappeared altogether although it is hard to say so with certainty. However, the system still requires further development to reduce the remaining corruption opportunities. These include insufficient auditing of the efficiency of government spending, weak anti-trust policies that fail to prevent collusion in procurement tenders, additional agreements that are signed after tenders have taken place, 'tender trolls' that dispute the results of tenders until other bidders withdraw, and special conditions that only preferred companies can satisfy, including specially introduced technical specifications.

At the same time, corrupt officials and their counterparts in the private sector have become increasingly sophisticated in circumventing the transparency procedures imposed by legislation designed to prevent corruption. Encouragingly though, activists and investigative journalists have

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<sup>39</sup> Council of the National Bank of Ukraine (2017), 'Рішення: Про діяльність Правління Національного банку України щодо розвитку банківської системи та окремих нормативних актів з питань банківської діяльності зі змінами, внесеними рішенням Ради Національного банку України від 14 липня 2017 року № 32-рр [Decision on the Activities Of the Board of the National Bank of Ukraine regarding the development of the banking system and separate normative acts on banking activity as amended by the decision of the Council of the National Bank of Ukraine, 14 July 2017 No 32], Kyiv: Council of the National Bank of Ukraine, 14 July 2017, <https://bank.gov.ua/doccatalog/document?id=51452711> (accessed 11 Sept. 2018).

<sup>40</sup> Shavaliuk, L. (2016), 'Анатомія клептократії. Нотатки про економічні злочини режиму Януковича' [Anatomy of a kleptocracy. Notes on the economic crimes of the Yanukovich regime], 19 August, *tyzhden.ua*, <http://tyzhden.ua/Economics/171563>, (accessed 11 Sept. 2018).

<sup>41</sup> ProZorro (2018), 'Key indicators', <http://bi.prozorro.org/sense/app/fba3f2f2-cf55-40a0-a79f-b74f5ce947c2/sheet/HbXjQep/state/analysis> (accessed 11 Sept. 2018).

also become more adept at spotting these attempts. The most audacious attempt to subvert ProZorro is the draft 'Buy Ukrainian goods' bill that requires a tender applicant to collect a few dozen documents confirming the domestic origin of supplied goods and all their components in order to be classified as a domestic producer. Otherwise, the auctioned bid is subject to inflation of up to 43 per cent of its real amount.<sup>42</sup> This not only complicates procurement and deters small business from participating in procurement (which reduces competition), but, most important, it also provides the officials in charge with vast discretion that effectively negates the very idea of transparent auctions. The bill passed its first reading in parliament in December 2017, but it has stalled since then.

Radical change in the procurement system for medicines and medical products has brought immediate tangible benefits. Prior to 2015, the Ministry of Health was responsible for these purchases through a system of intermediaries that did not provide adequate quality control. This led to inadequate patient care and inflated prices. Forty per cent of the budget for medicines and medical products was lost because of overspending or theft.<sup>43</sup> From 2015, the ministry began outsourcing its centralized purchases to international organizations with specialist capabilities in this area. From 2016, three entities (Unicef, UNDP and the UK Crown Agents) took responsibility for most purchases of medicines, buying them directly from manufacturers. The results were impressive: according to an analysis by the Accounting Chamber, savings for the state budget of UAH 373.6 million (\$13.4 million) – around 39 per cent of the audited purchases, which were valued at UAH 939 million (\$33.6 million) – were achieved from 2015 to the end of the first half of 2017.<sup>44</sup> This allowed the ministry to make additional purchases of vital medicines. However, as the Anti-Corruption Action Centre has noted, distributors who lost out because of the change to the procurement system for centralized purchases switched their attention to regional health budgets (previously 60 per cent of the procurement budget) where controls can be lax<sup>45</sup> and ProZorro does not provide sufficient protection.<sup>46</sup> These can lead to mark-ups of 200–300 per cent on medicines. The Accounting Chamber's report also points to the effectiveness of using international organizations to procure medicines since they are beyond the reach of law enforcement agencies that otherwise seek to protect vested interests in the healthcare sector.

Such radical reform was only possible because Yanukovich's close circles that monopolized government procurement disappeared after the Revolution of Dignity, leaving this space largely deserted. In addition, the two post-revolution ministers of economy and trade, Pavlo Sheremeta and Aivaras Abromavičius, were not only personally committed to fighting corruption, but also had a strong mandate to do so, at least in this area. Sheremeta deserves praise for hiring advocates of e-

<sup>42</sup> MediaUA (2017), 'Adopted in First Reading a Bill "Buy Ukrainian, Ukrainians Pay" violates the Association Agreement with the EU – Nefedov', 8 December 2017, <http://en.mediaua.com.ua/1839-adopted-in-first-reading-a-bill-buy-ukrainian,-ukrainians-pay-violates-the-association-agreement-with-the-eu-nefedov> (accessed 11 Sept. 2018).

<sup>43</sup> Information provided by the Ministry of Health, citing SBU data.

<sup>44</sup> Ukrainian Accounts Chamber (2017), 'Про результати аудиту ефективності використання коштів державного бюджету, виділених у 2015–2016 роках та і півріччі 2017 року міністерству охорони здоров'я України для здійснення державних закупівель із залученням спеціалізованих організацій за бюджетною програмою «забезпечення медичних заходів окремих державних програм та комплексних заходів програмного характеру» [On the results of the audit of the effectiveness of the use of state funds allocated in 2015–16 and the first half of 2017 by the Ministry of Health of Ukraine for state procurement with the involvement of specialist organizations under the budget programme "Ensuring Medical Measures of Specific State Programs and Comprehensive Programme Activities"]', Kyiv: Ukrainian Accounting Chamber, p. 42, [http://www.ac-rada.gov.ua/doccatalog/document/16753358/Bul\\_MOZ.pdf?subportal=main](http://www.ac-rada.gov.ua/doccatalog/document/16753358/Bul_MOZ.pdf?subportal=main) (accessed 11 Sept. 2018).

<sup>45</sup> Anti-Corruption Action Centre (2017), 'Transparent/non-Transparent Procurements of Medicines', p 44,

<https://antac.org.ua/en/analytics/transparent-nontransparent-procurements-of-medicine-new-antac-report/> (accessed 11 Sept. 2018).

<sup>46</sup> *Ibid.*, p. 57.

procurement from civil society and giving them the necessary means for the fast-track development and implementation of the ProZorro system. They succeeded before a new 'procurement mafia' managed to replace Yanukovich's cronies in this sector.

## Transparency of the defence budget

The Ministry of Defence has stated that classified procurements will account for 19.6 per cent of the UAH 83 billion (\$3.2 billion) defence budget for 2018. According to an analysis by the Independent Defence Anti-Corruption Committee (NAKO), around 45 per cent of defence procurement is currently classified and beyond parliamentary oversight. By contrast, in the US the figure is 16 per cent (or 10 per cent of overall defence spending).<sup>47</sup> The corruption risks are serious. Investigative media have pointed to the role of politically connected insiders able to position their private companies for contracts processed under the classified part of the defence budget. Ukroboronprom, the state conglomerate comprising 130 defence companies, remains particularly opaque. A much stronger focus on this area is necessary to help Ukraine achieve better value for money from its defence spending.

## Deregulation

Strategic deregulation is a particularly effective approach to reduce corruption risks as it can limit the need for contact between officials and businesses. Although Ukraine's business climate still has an unfavourable reputation, it has improved since 2014. According to the World Bank's Doing Business rankings, the country has increased its score by just under 10 per cent since 2015.<sup>48</sup> However, measurements of this kind can be misleading. During the Yanukovich presidency, the improvement was far more impressive: more than 23 per cent in three years. Given the overall deterioration of the business environment during that time as the government established a 'vertical of corruption', that improved score suggests the deregulation that took place at that time was largely superficial and had negligible consequences for business. However, unlike then, there now appears to be some genuine, albeit modest, improvements.<sup>49</sup>

Deregulation since Yanukovich's time has occurred through several channels. First, the government abolished or re-vitalized several ineffective government agencies that previously had a reputation for high levels of corruption. These include the Price Inspectorate, the Sanitary Inspectorate, the Traffic Police Inspectorate and the Real Estate Registration Agency. Price regulations were scrapped all together (except for natural monopolies), while other regulations were to some extent reassessed and, in some cases, updated.

Second, in 2014–15, the Ministry of Economic Development and Trade and the Ministry of Agriculture initiated large-scale deregulation programmes. They abolished outdated or unnecessary

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<sup>47</sup> Nako (2017), 'Ukraine's Ministry of Defence Intends to Classify Even More of the Defence Budget', 18 October 2017, <https://nako.org.ua/en/news/ukraine-s-ministry-of-defence-intends-to-classify-the-defence-budget-even-more/> (accessed 11 Sept. 2018).

<sup>48</sup> In the 2015 Doing Business index, Ukraine was ranked 96th (up from 112th in 2014) with a DTF (distance to frontier) score of 61.52; in the 2018 index, it had risen to 76th with a DTF score of 65.75. World Bank (2018), Doing Business Reports, 'Doing Business 2018: Reforming to Create Jobs', <http://www.doingbusiness.org/reports/global-reports/doing-business-2018> (accessed 11 Sept. 2018).

<sup>49</sup> Institute for Economic Research and Policy Consulting (2017), Annual Business Climate Assessment, 'Annual Business Climate Assessment 2016: National and Regional Dimensions', [http://www.ier.com.ua/en/sme\\_development/ABCA?pid=5808](http://www.ier.com.ua/en/sme_development/ABCA?pid=5808) (accessed 11 Sept. 2018).

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regulations, including the requirement to obtain a quarantine certificate for internal transportation of agricultural products across regional borders, which was costly to administer and led to widespread corruption. The Ministry of Infrastructure also deregulated civil aviation so that low-cost carriers could enter the market despite fierce resistance from Ukraine International Airlines, the oligarch-controlled national carrier.

For several reasons related to compliance with its Association Agreement with the European Union (EU), Ukraine failed to implement a 'regulatory guillotine' in 2015. Instead, regulations are now undergoing review and adjustment by the Better Regulation Development Office, which provides technical assistance to the Ministry of Economic Development and Trade. Several times a year, the cabinet approves deregulation packages and submits amended laws to the parliament, which usually passes them with remarkable unity. As a result, several hundred outdated or ill-designed regulations have been cancelled since 2016.<sup>50</sup> Deregulation legislative documents adopted in 2017 are expected to save UAH 11.4 billion (\$440 million) of compliance costs for Ukrainian business.<sup>51</sup>

However, previous reform efforts have shown that excessive regulations, especially those with high corruption potential, can sometimes reappear, as happened in the late 1990s when more than 200 licensing requirements were abolished only to re-appear shortly afterwards as 'obligatory certifications'. The State Regulatory Service (SRS) was established in 1997 with a strong mandate to prevent this happening and initially played an effective role. Not surprisingly, it found itself marginalized during the Yanukoych years. All new regulations were supposed to be vetted as part of an open process but this effectively ceased. In 2014–15, the SRS returned to full capacity, primarily focusing on the improvement and enforcement of regulatory policy, as well as the assessment of new draft regulations. It also managed to enforce norms obliging government bodies to perform cost-benefit analyses of proposed regulations with a special emphasis on small businesses. In the absence of other bodies with anti-corruption expertise to assess these types of regulations (the National Agency for Prevention of Corruption was supposed to provide this capability but did not), the SRS has proved to be an effective barrier against attempts of expanding the space for corruption. If a proposed regulation does not contain a proper cost-benefit analysis, or if this analysis shows that regulation is not justified, the SRS rejects it. As a result, the number of proposed regulatory acts dropped twice in 2016 and by another 20 per cent in 2017, with around one-third rejected.

Nevertheless, as noted by the head of the SRS, Kseniya Lyapina, despite the fact that Ukraine has joined the EU's Small Business Act, small businesses remain mostly below the radar and are still disproportionately affected by excessive and burdensome regulations.<sup>52</sup> This is mostly because they lack political representation and lobbying power. Instead, the bulk of successful deregulation mentioned above has benefited medium-sized and, to some extent, large businesses. In the

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<sup>50</sup> State Regulatory Service of Ukraine (2018), 'Кабмін у рамках «дерегуляційного дня» схвалив важливі рішення для спрощення умов ведення бізнесу 'Kabmin u ramkakh "dereguliacijnogo dnia" skhaliv vazhlyvi rishennia dlia sproshchennia umov vedennia bisnesu' [Cabinet of Ministers approved important decisions for simplifying business conditions as part of 'deregulation days'], 10 May 2018, [http://www.drs.gov.ua/press-room/kabmin-u-ramkah-deregulyatsijnogo-dnya-shvalyv-vazhlyvi-rishennya-dlya-sproshchennya-umov-vedennya-biznesu/?print\\_page=true](http://www.drs.gov.ua/press-room/kabmin-u-ramkah-deregulyatsijnogo-dnya-shvalyv-vazhlyvi-rishennya-dlya-sproshchennya-umov-vedennya-biznesu/?print_page=true) (accessed 14 Sept. 2018).

<sup>51</sup> State Regulatory Service of Ukraine (2018), 'У ДРС відбувся публічний звіт Голови Державної регуляторної служби України Ксенії Ляпіної про результати роботи у 2017 році' [A public report by the Chair of the State Regulatory Service of Ukraine Kseniya Lyapina on the results of work in 2017 took place at SRS], 21 February 2018, <http://www.drs.gov.ua/press-room/u-drs-vidbuvsya-publichnyj-zvit-golovy-dержavnoyi-regulyatornoyi-sluzhby-ukrayiny-kseniyi-lyapinoyi-pro-rezultaty-roboty-u-2017-rotsi/> (accessed 14 Sept. 2018).

<sup>52</sup> Interview with the authors, May 2018.

meantime, additional regulations passed in 2017 are to increase the compliance burden for small businesses by UAH 1.2 billion (\$46 million).

The results of reforms are evident in the Annual Business Cost Assessment which acknowledges that the cost of compliance with non-tax regulations for small and medium-sized enterprises decreased by 8 per cent in 2016 in absolute numbers.<sup>53</sup> Although no direct comparison is possible with other previous years, since this survey was conducted only in 2015–17, respondents said that the situation had improved compared to 2013; on average, the index of changes in the regulatory climate compared to three years earlier was 17 per cent in 2015 and increased only slightly to 19 per cent in 2016. Clearly, there is a vast amount of work ahead to improve the quality of regulation in Ukraine.

## De-monopolization

Monopolization is one of the economic evils embedded in the limited access order and frequently a major source of corruption. In such an order, market power is mostly the result of deliberate formal or informal abuse of government functions in favour of certain affiliated entrepreneurs ('oligarchs'). Ukraine has many examples of this; beyond the changes in the gas market and, more recently, air travel, there has been no significant de-monopolization. Indeed, some large and medium-sized companies have been trying to enhance their market power since the 2014 revolution. At the same time, there has been some limited de-concentration of the economy; for example, in the import of goods and in public procurement.

Ukraine's economy was extremely concentrated because of Soviet industrialization policies and it had the highest share of large enterprises in the Soviet Union. The dominance of metallurgy and other heavy industries exacerbated this effect. It is not surprising that these enterprises were a magnet for the vested interests associated with the new form of limited access order that was taking shape after independence.

The establishment of the formal and informal nationwide and local monopolies or cartels gathered momentum and became one of the features of the Yanukovych system of rule. According to official data, the share of competitive markets contracted from 48.3 per cent in 2010 to 42.7 per cent in 2015.<sup>54</sup> Through informal agreements each 'oligarch' was allotted monopoly control of a given sector. For instance, Rinat Akhmetov's domain was power generation and coal mining (DTEK), Dmytro Firtash's was the production of fertilizers (OstChem), and Ihor Kolomoysky had control of air transportation. As a result, only 42.7 per cent of all markets examined by the State Anti-Monopoly Committee in 2015 were found to be competitive, 47.5 per cent with limited competition, and 9.8 per cent qualified as full monopolies. These figures do not tell the full story, though, because many formally separate entities that in fact belong to much larger groups are counted as

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<sup>53</sup> Institute for Economic Research and Policy Consulting (2017), 'Annual Business Climate Assessment 2016: National and Regional Dimensions', [http://www.ier.com.ua/en/sme\\_development/ABCA?pid=5789](http://www.ier.com.ua/en/sme_development/ABCA?pid=5789) (accessed 11 Oct. 2018).

<sup>54</sup> Anti-Monopoly Committee of Ukraine (2010), Annual Reports, '*Richnyi zvit antimonopolnoho komitetu Ukrainy*' [Annual Report of the Antimonopoly Committee of Ukraine], <http://www.amc.gov.ua/amku/control/main/uk/publish/article/89512> (accessed 14 Sept. 2018). Anti-Monopoly Committee of Ukraine (2015), '*Zvit antimonopolnoho komitetu Ukrainy za 2015 rik*' [Report of the antimonopoly committee of Ukraine for the year 2015], Annual Reports, <http://www.amc.gov.ua/amku/doccatalog/document?id=122547&schema=main> (accessed 24 Sept. 2018). Official reports of the State Anti-Monopoly Committee are, unfortunately, available only for a limited number of years.

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independent. In addition, concentration of the market does not take into account protectionism that is an additional source of power; for example, in the car market, domestic producers along with main official importers successfully lobbied for draconian restrictions on the import of used cars, which allows them to maintain high prices and inflates demand for new vehicles.

Since Yanukovich fled the country in 2014, the sharing out of monopolies among leading business groups has continued and there are no plans for their dismantlement. Still, as noted above, the reforms of the gas sector and the breaking of the de facto monopoly of Ukraine International Airlines are significant developments that have introduced new players. In both cases, reformers in government led the process. The Anti-Monopoly Committee was formally involved but did not play an active part. The most prominent case in which it has played a major role was its attempt to end the liquefied petroleum gas market cartel. However, its intervention has so far failed to make this market competitive.

It is still questionable, however, whether stronger anti-monopoly policies are feasible and even desirable in present circumstances since they could encourage further corruption. The problem is that anti-trust regulations are inherently subtle and complex, and they leave extensive discretion for the officials in charge. In many countries, including Ukraine, this discretion is routinely abused for political purposes or personal benefit – ironically, very often for putting competitors out of business. In Georgia, the authorities closed down the anti-trust agency in 2004 for precisely this reason. In Ukraine, the tax authorities and the notorious tax police, in particular, have traditionally acted as the attack dogs of vested interests.

The slow progress on de-monopolization reflects the desire of Ukraine's power groups to retain their control over key parts of the economy. While the 'oligarchs' have lost considerable ground since 2014, they retain significant residual influence in the economy, and in politics since the two are inseparable. The Revolution of Dignity aspired to change the system but has not yet done so. The forces seeking to preserve the status quo have deep defences and are well equipped. However, they are not invulnerable, particularly if electoral reform leads to an opening of the access order and further reduction of their influence.

### Privatization and reform of state-owned enterprises

Ukraine has a very large public sector with close to 3,400 companies owned by the state and more than 11,000 communal enterprises covering sectors from social services to utilities and manufacturing. Their combined revenue is about 20 per cent of GDP, with the majority of assets in the coal and energy sectors.<sup>55</sup> Only half of the SOEs are operational and only a third report profits, according to official data.<sup>56</sup> The quality of transparency, fiscal risk management and overall

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<sup>55</sup> IMF (2016), *Ukraine – Technical Assistance Report: Reforming Management and Oversight of State Assets*, Washington, D.C.: International Monetary Fund, <https://www.imf.org/external/pubs/ft/scr/2016/er1631.pdf> (accessed 14 Sept. 2018).

<sup>56</sup> Ministry of Economic Development and Trade (2016), 'ТОП - 100 Огляд найбільших державних підприємств України' [Top 100 - Review of the largest state enterprises of Ukraine], Kyiv: Ministry of Economic Development and Trade, <https://www.kmu.gov.ua/storage/app/media/reforms/top-100-naybilshikh-derzhpidpriemstv-ukraini.pdf> (accessed 14 Sept. 2018).



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governance in the sector is very low. As Prime Minister Groysman has stated, 'The largest sector of corruption today is SOEs, which have been used for decades to create corrupt schemes.'<sup>57</sup>

To meet IMF conditions for the release of further financial assistance to the country, the parliament passed a law in January 2018 to speed up privatization and make it more transparent. The government says that it can generate up to UAH 21.5 billion (\$747 million) in 2018 as a result. Starting in 2016, it began efforts to improve corporate governance in SOEs, including the establishment of supervisory boards and requirements for strategic planning.

The main problem with the privatization agenda is that the cash flows from many profitable SOEs have already been embezzled by their managers, in some cases under the direction of individuals from the power groups. These de facto owners stay in the shadows and appoint 'supervisors' at the SOE to ensure that they receive their share of revenues. Of course, these quasi-owners and their patrons are strongly opposed to privatization because it would require them to invest in the companies rather than have the state perform this task at no cost to them.

The multiple failed attempts to privatize the Odessa Port Plant provide a clear example of this problem.<sup>58</sup> The only way around it during the Kuchma and Yanukovich presidencies was to earmark a buyer powerful enough to outperform the quasi-owners and offer an asset to that potential buyer at an attractive price. In some cases, the incumbent management was the buyer, but more often than not the lucrative assets were designated for 'oligarchs'.

The current government is in a different position and cannot easily resort to these practices. It has no choice but to make privatization transparent in order to receive IMF financing and retain support from donor countries. However, it is not enthusiastic because of the loss of easy cash flows for parts of the elite and of the risk that the process itself may not prove transparent and become a source of embarrassment.

Nevertheless, it is likely that the privatization of mainly small and medium-sized enterprises will take place later this year through ProZorro Sales, a system of electronic auctions. Large-scale assets are due to be sold with the assistance of international consulting firms and investment banks. The authors of the law believe this should secure transparency and competition, and that it could start to restore the reputation of privatization, which is seen by the public as the most corrupt of all reforms after non-transparent deals saw major companies pass into 'oligarch' hands during the Kuchma presidency.

Some experts argue that improved corporate governance for SOEs can be a better alternative to privatization, especially given that market conditions are unfavourable for divestments. This point of view is very popular in Ukrainian society, mainly because of a tendency to underestimate the role of private owners.

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<sup>57</sup> Zinets, N. (2018), 'Ukraine passes privatisation law needed for IMF aid', Reuters, 18 January 2018, <https://www.reuters.com/article/ukraine-privatisation/update-1-ukraine-passes-privatisation-law-needed-for-imf-aid-idUSL8N1PD3LS> (accessed 14 Sept. 2018).

<sup>58</sup> The Ukrainian authorities detained two members of the company's supervisory board in July 2016 on suspicion of embezzlement. BNE Intellinews (2016), 'Odessa Port Plant officials detained on eve of privatisation tender', 14 July 2016, <http://www.intellinews.com/odessa-port-plant-officials-detained-on-eve-of-privatisation-tender-101984/> (accessed 14 Sept. 2018).

Reform has started but has so far yielded mixed results. The structure of corporate governance has changed: instead of direct government control, international boards of directors were established at some of the largest companies and filled with reputable professionals. Remuneration for top managers of these SOEs was raised to a competitive level, making it possible to hire talented professionals, including foreigners. SOEs are obliged to use ProZorro for their procurement and to report their financial statements publicly.

The reform of Naftogaz, as discussed above, is one of Ukraine's major successes since 2014. Yet even there the top management team complains of government pressure and interference in its work, and the supervisory board resigned in 2017, alleging lack of progress on corporate governance reforms. In some cases, senior managers dismissed from one part of industry were appointed to government positions in other parts. The new team at UkrPoshta, the state-owned mail service, has also started to modernize the company. First results are encouraging, but it is too early to assess their success. UkrZalyznitsya, the state railway giant, is an example of mixed results. Under its Polish CEO, it generated a profit in 2017 for the first time since 2013 (i.e. before transit traffic to Russia collapsed) but then he clashed with the minister of infrastructure and was dismissed. Reform at UkrZalyznitsya has not so far been sufficiently successful in closing the space for corruption for which the company is notorious, although just recently it became the first to disclose its transactions as now required by law.

Corporate-governance reform for SOEs cannot be a substitute for privatization because the government cannot possibly oversee its implementation across such a large number of companies. As experience already shows, such reforms at some of the largest SOEs have proved challenging. Despite the problems of privatizing SOEs, doing so will be simpler and more effective than keeping them in state hands. Not only will it raise cash for the state budget, it will offer important opportunities for further restricting opportunities for corruption. This, in turn, will facilitate the cleaning up of the political system that has been infected by its symbiosis with corruption in SOEs.

### Land reform

Corruption is a contributory factor to the delay in the liberalization of agricultural land, which has the potential to significantly boost Ukraine's overall economic development.

While most urban land can be bought or sold freely, sales of agricultural land remain subject to a moratorium. Initially introduced for a year in 2001 as a response to the absence of a special law for the functioning of the market as well as that of a reliable land register, the moratorium has undergone annual extensions since then. A draft law is not ready since there is no agreement among politicians and experts on basic questions of who should be allowed to own land and in what quantities. However, there has been significant progress with the register. The problem is that the moratorium has created vested interests in its indefinite extension; large agricultural companies benefit from non-market prices at which they can lease the land from the owners of small plots.<sup>59</sup>

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<sup>59</sup> After the privatization of collective farms in 1999, 7 million farmers working at the farms each received around four hectares of land.

At the same time, the interest of landowners in taking full advantage of their property is outweighed by their fear of possible compulsory sales at low prices to 'raiders', along with stubborn prejudices against a free market that the interested parties keep alive. In addition, landowners' interests are dispersed and not easily represented en masse. Furthermore, politicians are in no hurry to vote for land reform since the urban population, which constitutes the majority of the electorate, has no immediate positive interest in the issue but shares many of the prejudices and fears about this reform.

Various forms of corruption characterize the current system for managing agricultural land. Tenants have market power over landowners and ensure that rents are kept well below their real value. Even though increased competition in the agricultural sector in recent years has pushed up prices, most landowners cannot enjoy higher rents because the minimum term for letting land is set by law at seven years, in order to protect the land from predatory use. This restriction is one of the reasons why an estimated 30 per cent of land is being leased unofficially.<sup>60</sup> Another reason is tax evasion. In some cases, land is being sold unofficially on long-term leases. This market lacks transparency and is open to corruption.

On top of this, the state-owned land that constitutes about a quarter of all arable land resources is being unofficially leased on a large scale. Also, according to a law adopted in the early 1990s every citizen has a right to a small piece of land. Some people claim what is due to them but the law fails to specify any details for how to do this, leaving it to the discretion of the authorities. Given the very different valuations of land depending on its location, this is an endless source of rents for those in charge of its allocation. In addition, the regulations for land use, particularly for changing its designation (for example, from agricultural or recreational to urban), encourage corruption because of the degree of bureaucratic discretion involved. The same applies to the sale of urban land.

At the political level, there is interference in the development of new laws. It appears that groups interested in preserving the status quo not only lobby against the lifting of the moratorium, but also seek to obstruct reform preparations. As a result, slow progress on the passage of laws pertaining to agricultural land reform simply justifies the moratorium.

There are also some genuine political problems related to allowing the sale of agricultural land. The experience of the privatization of industrial assets since the 1990s has encouraged the belief in society that big business will once again benefit to the detriment of the average citizen. From the government point of view, it is a reasonable assumption that many small owners will end up selling their plots at a low price before the market starts working properly. This in turn could easily lead to a serious increase in social tension. There is also a risk of criminal businesses using the opportunity to force owners to sell attractive plots at low prices, as has been done in many cases with urban real estate.

Nevertheless, liberalization of the land market is necessary, particularly on economic grounds. The agricultural sector already accounts for 40 per cent of exports and 14 per cent of GDP, and it has the potential to grow significantly by raising its efficiency. Land liberalization will stimulate

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<sup>60</sup> Introducing Reforms (2017), 'Протидіягіньовому ринку оренди землі' [Countering the shadow land lease market], [http://reforms.in.ua/sites/default/files/protydiya\\_tinovomu\\_rynku\\_orendy\\_zemli.pdf](http://reforms.in.ua/sites/default/files/protydiya_tinovomu_rynku_orendy_zemli.pdf) (accessed 14 Sept. 2018).

investments that will in turn raise yields. However, to avoid replacing one source of corruption with another, reform should create strong and enforceable property rights. The sustainability of the process will be more important than its speed, so a gradual approach is likely to be the best. This might start with auctions for state-owned land, followed by a lifting of the moratorium on sales to neighbours and then the opening of the market to increasingly broader circles of buyers, including foreigners. Transactions must be fully transparent with a mandatory, automatic waiting period between striking a deal and the contract taking force, during which the relevant information should be publicly available on an online land exchange.

It is encouraging that the government is thinking along these lines despite its reluctance to grasp the nettle of land liberalization. A further positive sign is that Ukraine is set to introduce blockchain technology to manage the registry of arable land as part of an effort to reduce fraud. This mirrors the success of a similar reform in Georgia.

### Reform of law enforcement agencies

With the exception of the patrol service of the police force, there has been no significant reform of Ukraine's law enforcement agencies since 2014. The lack of progress is not surprising. Reformers in Central European countries seeking to dismantle similar Soviet-style systems designed to uphold the authority of the Communist Party rather than the rule of law found that these institutions were the most impervious to change. With a powerful set of instruments for protecting the limited access order, these bodies were often strongly motivated to resist democratic control and rule of law because they stood to lose their access to revenue streams from schemes that included 'protecting' business and other forms of extortion. Ukraine is no exception.

#### The police

Currently operating in 33 cities, the new patrol police formed in late 2014. It initially developed a positive reputation as a body recruited, trained and managed to a higher standard than the main part of the police force, although public enthusiasm for it appears to have waned. Its creation shows that an alliance of reformers<sup>61</sup> and civil society organizations, with support from international partners, can lead to new organizations that act with higher levels of integrity than those inherited from the old system. However, the patrol police, which has around 13,000 officers, is only part of the front line of the police force, and it is responsible for a small portion of the overall force's duties. Nevertheless, its symbolic value is considerable.

At the same time, the old system has proven resistant to change. An effort to reassess 70,000 police officers to establish their suitability for service in the reformed police faced delay and led to only 5,000 losing their jobs. Furthermore, all were able to appeal successfully against wrongful dismissal and were reinstated because of the way the new National Police Service Law had been drafted.<sup>62</sup>

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<sup>61</sup> Reformers from Georgia played a key role in establishing the patrol police, based on their experience of replacing their own country's police force after the 2004 Rose Revolution.

<sup>62</sup> Goncharuk T. (2018), 'Where is Ukraine's new police force?', OpenDemocracy, 31 January 2018, <https://www.opendemocracy.net/od-russia/tetiana-goncharuk/where-is-ukraines-new-police-force> (accessed 14 Sept. 2018).

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## The Prosecutor General's Office

To date, reform of the PGO has been insubstantial. This is not surprising since it is central to a system that relies on the administration of selective justice to protect itself and its interests. President Poroshenko's extraordinary efforts to install Yuri Lutsenko as prosecutor general after the US insisted on the removal of his predecessor in 2016 underline the importance for the head of state of having a personally loyal individual in this position.<sup>63</sup> The creation of a new State Bureau of Investigation is meant to separate the investigative and prosecutorial functions of the PGO but the first senior officials appointed to the body have long backgrounds in the PGO system, suggesting that the bureau will be a new structure with an old ethos. The establishment of an inspectorate general within the PGO to tackle internal corruption and the effort to recruit new blood have brought few results.<sup>64</sup>

## The Security Service

The Security Service of Ukraine (SBU) is a highly opaque, unreformed institution that has retained law enforcement functions, including the investigation of economic crimes. It is much more than an intelligence agency and proposals to trim its powers have stalled. It is not accountable to parliament and has so far resisted efforts to include it in a list of security and defence agencies to be overseen by a new specialized parliamentary committee. Through its Main Directorate for Organized Crime (Directorate K), parts of the SBU are believed to play a major role in sponsoring and protecting corrupt practices through linkages with criminal networks. This is by no means exceptional in former Soviet countries. Smuggling activities between the rebel-held areas in Donbas and the government-controlled territories as well as across the border with the state of Transnistria point to the involvement by parts of the SBU as well as of the customs service and the armed forces.

## The National Anti-Corruption Bureau of Ukraine and the Specialized Anti-Corruption Prosecutor's Office

NABU and the Specialized Anti-Corruption Prosecutor's Office (SAPO) are unprecedented new institutions, created in 2015 with the participation of civil society and donor countries. The rigorous staff selection procedures for both and the efforts of civil society backed by international partners to ensure their institutional independence have produced agencies made from a different fabric from the rest of the law enforcement system. NABU has faced increasing attacks and has sometimes found itself at war with the PGO and the SBU, and it has generally retained a reputation as a 'clean' organization.<sup>65</sup> By contrast, the reputation of SAPO has been damaged after a NABU investigation revealed that Specialized Anti-Corruption Prosecutor Nazar Kholodnitsky had encouraged a witness

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<sup>63</sup> It was only possible to appoint the current prosecutor general by changing the law requiring the holder of the position to have a legal education and to have served at least 10 years in the PGO. Yuri Lutsenko satisfied neither requirement but, as the head of the Petro Poroshenko Bloc in parliament, he scored high marks for political reliability. Bargaining at speed with several forces in parliament, President Poroshenko was able to submit a draft law allowing his appointment. Within 24 hours, a parliamentary majority had voted to appoint him, and one and a half hours later the president had signed a decree confirming him to the position. Yet by law the appointment could only come into force after the publication of the law in the official newspaper of the parliament. Within two hours, a special edition had appeared.

<sup>64</sup> The PGO reported that in 2015 more than 3,330 external candidates had applied for 155 positions as heads of local courts. Not a single application was successful. Prosecutor General's Office (2016), 'Statistical data on local prosecutors' offices reform', [http://en.gp.gov.ua/ua/statref.html?\\_m=publications&\\_t=rec&id=183269](http://en.gp.gov.ua/ua/statref.html?_m=publications&_t=rec&id=183269) (accessed 14 Sept. 2018).

<sup>65</sup> Some commentators have questioned NABU's methods, including the means used to obtain evidence. See, for example, Karatnycky, A. and Motyl, A. (2018), 'How Western Anticorruption Policy Is Failing Ukraine', *Foreign Affairs*, 29 May 2018, <https://www.foreignaffairs.com/articles/ukraine/2018-05-29/how-western-anticorruption-policy-failing-ukraine> (accessed 14 Sept. 2018).

to give false testimony and tipped off several suspects about impending searches of their properties.<sup>66</sup>

NABU's main problem is the lack of a properly functioning judicial system to try its cases. By June 2018, it had filed charges in 207 cases but secured only 19 convictions, none of which are high-level officials past or present. The first-instance courts have been blocking or delaying progress of these cases, making the establishment of a High Anti-Corruption Court an urgent priority for anti-corruption activists and western governments.

The establishment of NABU and SAPO has shown the ability of progressive Ukrainians to create new institutions, though the limitations of these are clear. They cannot produce results because of the challenge they pose to the limited access order and of the desire of the power groups to retain their monopoly on law enforcement and justice. Saving these new institutions requires creating an independent High Anti-Corruption Court. The old system is insisting on its right to control the appointment of judges to the court. Urgently requiring IMF finance that was made contingent on creation of the court, the government has had little room for manoeuvre and has been forced to agree to many of the terms demanded by civil society and backed by donors. At the time of writing, the target date of February 2019 for the launch of the court seems ambitious. The authorities look set to make the process as long and difficult as possible in order to postpone the inevitable.

### **The National Agency for Prevention of Corruption**

Established in 2015, the NAPC has the key responsibility of developing and implementing the national anti-corruption strategy. However, it has been the source of controversy and scandal since its establishment, amid allegations that its leadership is not politically independent and that it sabotaged the process for verifying the asset declarations of state and local government officials. It has not been possible to check the declarations using automated software and the NAPC has not initiated investigations against any senior officials of note. The IMF and the EU have been pushing hard to rectify the situation but it is clear that the agency has not established credibility. To do so will require changing its leadership and 're-booting' the entire organization. This is essential given its wider responsibilities, including the enforcement of rules on the financing of political parties. It has also failed to vet proposed legislation for corruption risks that is essential for preventing new possibilities for corruption.

Ultimately, willingness to reform the law enforcement agencies and the judiciary, along with other government bodies such as the SFS that are instruments of informal control in the limited access order, is a reliable barometer of progress in terms of broader systemic change. The public only has control over the state to the extent that it has control over the agents of force. So far, there is little progress in these areas. As a result, Ukraine is only at the beginning of the process of establishing rule of law.

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<sup>66</sup> Goncharova, O. and Sukhov, O. (2018), 'NABU recordings implicate chief anti-graft prosecutor in alleged corruption', *Kyiv Post*, 4 April 2018, <https://www.kyivpost.com/ukraine-politics/nabu-releases-recordings-implicating-kholodnytsky-alleged-corruption.html> (accessed 14 Sept. 2018).

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## The judiciary

Judicial reform began in 2016–17 with the formation of a new Supreme Court and the reduction of the four levels of justice to three. More than 2,000 judges voluntarily left their positions between 2014 and 2017, many possibly in response to the need to comply with the new e-declarations policy. However, this has not so far led to a rebuilding of the judiciary, one of the most distrusted institutions. The 2017 Index of Public Integrity ranked Ukraine 101st out of 109 countries for judicial independence. In 2016, opinion polls indicated that as little as 3–5 per cent of the population had any trust in the courts.<sup>67</sup>

The recruitment process for the new Supreme Court was transparent only in part. Of the 113 judges appointed in late 2017, the Public Integrity Council, a civil society body, objected to 25. The High Council of Justice overrode its recommendations. The new composition of the Supreme Court falls far short of what civil society had hoped for: nearly 80 per cent of the appointees have previously served as judges, the majority at cassation level.<sup>68</sup> There is little indication that the new Supreme Court will be culturally different from its predecessor. This means that it is likely to remain politically dependent. Meanwhile, the cleaning up of the lower courts appears only cursory. The Public Integrity Council abandoned its participation in the process of reassessing judges in March 2018, accusing the High Qualification Commission of Judges, the body responsible for the process, of lowering standards and not vetting candidates properly.

The formation of the High Anti-Corruption Court has taken on symbolic importance for Ukraine's reformers and international partners. However, it should not distract attention from the need to rebuild the police, the PGO and the SBU. These are the hardest reforms to carry out and they are essential for further reducing corruption as well as for preventing the reversal of the reforms successfully undertaken so far in this area. While the creation of the court is an important part of the effort to build clean institutions for punishing corruption, the most valuable role it can play is in helping to accelerate the closure of the space for corrupt practices.

In the absence of rule of law, judicial reform is the key underpinning for the majority of the sectoral reforms underway in Ukraine. New regulations, however well written, must be enforced. Developing law enforcement agencies under democratic control relies on them having the ability to investigate and prosecute individuals guilty of corruption. In other words, successful judicial improvements can provide reformers with critically important influence over the policy effort. This explains the efforts of the incumbents to slow down judicial reform in order to prevent progress on the broader reform effort that undercuts their interests. By definition, judges have to exercise discretion. Consequently, they are vulnerable to political interference and corruption if the system allows this, as it does in Ukraine. The most effective tool to counter this tendency is to make judges properly accountable for unlawful decisions. The High Anti-Corruption Court can potentially play a valuable role in developing this culture as existing judicial disciplinary bodies have proved inadequate.

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<sup>67</sup> Stelmashchuk, A. and Maksymov, M. (2016), 'Judicial reform in Ukraine', [http://vku.ua/publications/articles/judicial\\_reform\\_in\\_ukraine/](http://vku.ua/publications/articles/judicial_reform_in_ukraine/) (accessed 11 Oct. 2018).

<sup>68</sup> Zhernakov, M. (2018), 'The Only Way to Improve Ukraine's Courts', *Kyiv Post*, 15 May 2018, <https://www.kyivpost.com/article/opinion/oped/mykhailo-zhernakov-way-improve-ukraines-courts.html> (accessed 14 Sept. 2018).

## Public administration reform

The quality of Ukraine's civil service is an enduring weakness that pre-dates independence. In the Soviet period, aspiring officials headed to Moscow for better careers, leading to a weakened talent pool for administering the country after 1991. This was part of a deliberate Soviet policy to prevent national republics from developing strategic decision-making capabilities. As noted above, the governmental structures inherited from the Soviet Union gave officials wide powers of discretion to apply impracticable rules and regulations. In the absence of the discipline instilled by the Communist Party and the KGB after independence, officials had far greater opportunities to engage in corruption than in the Soviet period. This encouraged greater cronyism and further lowered the standards of administrative competence, while deepening the distrust of business and citizens towards government bodies.

The Law on Civil Service passed in 2016 marked the start of an ambitious initial three-year plan, supported by the EU and Ukraine's other international partners, to build a professional, politically neutral civil service. There has been progress on two levels.

First, in order to separate the role of a politically appointed minister from their ministry's bureaucracy, open recruitment of state secretaries took place in 2017 in 10 out of 18 ministries. Although the competitive process had some shortcomings, it started to establish a different culture of administration. A competitive application process now applies to positions across the entire civil service. The low base salaries for civil servants are slowly being raised and performance bonuses are to be limited to 30 per cent of salary. Previously, 60 per cent of salary was discretionary, giving excessive power to managers and creating insecurity for staff.

Second, administrative services for citizens are now much more easily accessible. As part of the decentralization reform, it is now possible to receive through local offices documents such as birth and marriage certificates, taxpayer cards, driving licences and passports. The application process for these documents has been simplified and, in many cases, it has moved to an electronic system. As a result, it is faster and less prone to corruption risks. For Ukraine's long-suffering population, this is one of the most visible and tangible benefits of the reforms since 2014. The process of electronically integrating government registries to cross-reference data, however, is only in its infancy. Its expansion offers significant opportunities to minimize corruption risks and to ensure that citizens are fairly treated by state institutions.

The modernization of the civil service is a vast project that will take many years to complete and requires extensive streamlining of the current system. It is clear that reform has numerous enemies in the bureaucracy and parliament who stand to lose from introducing transparency to government and, in particular, from recruiting civil servants on competence rather than loyalty or allegiances.

## Decentralization and political reform

Ukraine's political system is currently undergoing major changes that can potentially have a decisive impact on the opportunities for corruption and on overall anti-corruption efforts. The key issue is whether civil society can expand its role in elected bodies from top to bottom to ensure that these become more representative of the population rather than just the power groups. The



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decentralization reforms that started in 2014 are a particularly encouraging step in this direction since the management of budget revenues at the local level provides civil society with a strong incentive to engage with local authorities and hold them accountable. Before the start of the reforms, 70–80 per cent of municipalities were entirely dependent on subsidies, creating a culture of rent-seeking.<sup>69</sup>

It is too early to say whether the decentralization reforms are raising transparency at the local level and encouraging greater accountability. However, it is clear that local government is active in new ways. There is abundant anecdotal evidence of road repairs and other improvements of infrastructure not seen in recent years. At the same time, there are also reports that local elites in some cases have strengthened their grip on local resources, with corruption in land allocation and construction permits still rife. Before the fiscal decentralization began, a lack of financial resources largely disempowered local government. *Rayons* (districts), the administrative level above councils, assumed many of its tasks. Now that budget revenues are remaining at the local level, they are likely to reveal a lack of project-management experience at this level. Local government officials and civil society representatives will receive increased assistance from donor countries to mitigate the risk of corruption.

The Revolution of Dignity restored Ukraine's 'dual' constitution that was first adopted after the Orange Revolution and then rolled back to Kuchma's presidential model under Yanukovich. A constitution of this kind makes the prime minister appointed by parliament nearly as strong as the directly elected president. According to the political scientist Henry Hale, such an arrangement is the most effective in preventing the emergence of 'single pyramid' (or a Russian-style 'vertical of power') because it creates two centres of power comparable in strength.<sup>70</sup> Importantly, however, in its current form the Ukrainian system, based on rule by selective enforcement of impracticable laws, leaves too many informal tools in the president's hands and creates imbalances. The president is not only the commander-in-chief of the armed forces but has sole authority over the SBU and retains sufficient control over the PGO and the court system to prosecute most members of the power groups. A president skilled in using the tools of 'patronal politics' and bold enough to employ them fully can act as a dominant leader, and even manage to change the constitution, as Yanukovich demonstrated. However, Yanukovich's presidency also showed the downside of concentrated power since it ultimately unbalanced the entire system and led to its collapse.

The checks and balances of the dual system are real and, even though President Poroshenko was able to secure the appointment of his long-term ally to head the government in 2016, Prime Minister Groysman has acted with a degree of independence. This reflects the division of political power that has made it harder to sustain old corrupt schemes and create new ones. Under Yanukovich and Kuchma the situation was quite different.

The next challenge of political reform is restoring the electoral system for parliament to a fully proportional one, as stipulated by the constitution, but this time with open party lists as stipulated

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<sup>69</sup> Chatham House (2015), 'Ukraine's New Constitution: Devolution of Powers and the Rule of Law', Event Summary, 4 November 2015, <http://www.chathamhouse.org/sites/default/files/events/2015-11-04-ukraine-new-constitution-event-summary.pdf> (accessed 14 Sept. 2018).  
<sup>70</sup> Hale (2014), *Patronal Politics*, pp. 123–177.

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in the coalition agreement of 2014. The draft law to enact this measure passed in the first reading in December 2017 but it has advanced no further since.

The current mixed electoral system – with half of parliamentarians elected from single-member constituencies and half proportionally from closed party lists – is open to ‘pork barrel’ politics. Some constituency MPs who ran as independent candidates during the 2014 election campaign later joined the pro-presidential faction in order to receive budget funds for the development of their district and other support. Others join minority groups that have little in common with their electoral platforms and seek opportunities to receive payment for their votes. It is widely believed that many members of parliament effectively buy their seats and have debts to pay immediately when they take up their places in parliament. The constituency members are often also guilty of breaching campaigning rules by bribing voters and their use of television advertising.<sup>71</sup> This is a form of corruption that sustains the limited access order and breeds further political corruption through the adoption of legislation that is paid for by vested interests.

The cabinet also has important tools for influencing the parliamentarians elected from constituencies through subsidies for social and economic development, amounting UAH 6.2 billion (\$220 million) in 2017, that are allocated annually via a highly discretionary and non-transparent procedure in which even the names of the commission members are kept confidential. According to recent investigations by two NGOs,<sup>72</sup> their allocation depends mostly on the loyalty of parliamentarians, particularly when it comes to the approval of the budget. At the district level, this subsidy money often finds its way to firms affiliated with the members of parliament or with the local authorities. In the best cases, it is spent not on the development or maintenance of critical infrastructure, in line with the designated purpose of this fund, but on certain highly visible improvements such as playgrounds and outdoor gyms that carry the member’s name as if they are personal gifts. The provisions of funds for these purposes can be used to incentivize voting on specific issues on which the government needs support.

For progress on curbing corruption, it is essential that the new election law opens up the political system for newcomers unrelated to the current elites. It can potentially serve as the catalyst for systemic transformation. The current power groups understand this very well, which explains their foot-dragging on their commitment to electoral reform in the 2014 coalition agreement.

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<sup>71</sup> According to an analysis by the Westminster Foundation for Democracy, in 2012 it cost up to \$5 million to win a constituency seat. The sources of funding for these campaigns are opaque. Some experts calculate that up to 90 per cent of campaign expenditures may constitute illegal spending. Meleshevych, A. (2017), *Cost of Politics in Ukraine*, Background Paper, London: Westminster Foundation for Democracy, p. 3, <https://www.wfd.org/wp-content/uploads/2017/09/Cost-of-Politics-Ukraine.pdf> (accessed 14 Sept. 2018).

<sup>72</sup> Viedrov, O. (2018), ‘Barter Loyalties’ [Exchange of Loyalties], zn.ua, 13 May 2018, [https://dt.ua/internal/barter-loyalnosti-277519\\_.html](https://dt.ua/internal/barter-loyalnosti-277519_.html) (accessed 14 Sept. 2014). Opora (2017), ‘Public subvention: who and how much solicited for the constituency’, 15 November 2017, <https://www.oporaua.org/en/news/45101-public-subvention-who-and-how-much-solicited-for-the-constituency> (accessed 14 Sept. 2018).

### 3. Conclusion

The experience of the past four years has shown that in the Ukrainian system at its current stage of development, it is far easier and more effective to shrink the space for corrupt practices than to deter corruption by punishing corrupt individuals. To this extent, Ukraine's anti-corruption reforms have been working. The overhaul of Naftogaz, the clean-up of the tax system and the establishment of the ProZorro procurement platform are specific examples of progress.

Despite these achievements, anti-corruption activists and the donor community have focused heavily on the establishment of the High Anti-Corruption Court to preserve the credibility of NABU. The agency clearly cannot continue its work without securing criminal convictions. In theory, the court will be the first genuinely new judicial body with the capacity to act independently, although this will depend on how exactly the recruitment process for judges and other civil servants takes place, and to what extent civil society and donor countries are involved.

Even in the best-case scenario, however, the High Anti-Corruption Court will not *per se* be a silver bullet, since it will not be able to address the systemic causes of corruption.<sup>73</sup> Ukraine's elites are likely to make common cause to limit the court's effectiveness, either by direct sabotage or by trying to integrate it into their system of power. However, if the court focuses on bringing to justice those individuals who impede efforts to close the space for corrupt practices, it can play a valuable role in promoting systemic transformation by disrupting the limited access order and forcing the key players to make a choice. They will either have to agree to stop their rent-extraction activities, or face the possibility of criminal investigation with outcomes that go beyond what they have come to expect.

For now, international donors and creditors rank second after the 'oligarchs' in terms of their ability to influence the ruling elites. The influence of international donors and creditors is finite, and must be exercised carefully to achieve maximum possible systemic transformation. They have an important role to play in further closing down the space for corruption across different economic sectors.

It is essential therefore that civil society and international partners do not lose sight of the considerable progress made in restricting the possibilities for long-established corrupt schemes that caused such damage to Ukraine's development over more than 20 years. The reforms of the gas sector, the tax system, the banking sector and the procurement system are substantial, even if they are not complete. Initial progress on deregulation and vastly increased transparency are contributing to a slowly improving business environment. Decentralization has removed some funds from the control of the poorly regarded Ministry of Regional Development,<sup>74</sup> and public

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<sup>73</sup> The example of Guatemala is instructive. Despite the jailing of large numbers of senior officials instigated by a UN-sponsored anti-corruption agency, corruption levels have not fallen.

<sup>74</sup> In June 2018, the former minister of finance, Oleksandr Danylyuk, said that he had come under pressure to support a spending programme for socio-economic development in Ukraine's regions based on 'the distribution of money to the projects of ... lawmakers', Zinet, N. and Williams, M. (2018), 'Ukraine finance minister says was told to back corruption or quit', Reuters, 6 June 2018, <https://www.reuters.com/article/us-ukraine-finmin-dismissal/ukraine-finance-minister-says-was-told-to-back-corruption-or-quit-idUSKCN1J213I> (accessed 14 Sept. 2018).

administration reform is finally under way. The latter has the potential to revolutionize the concept of public service in Ukraine, and to raise administrative competence from its current desperately low level. Five years ago, such achievements were inconceivable.

Yet there are no grounds for complacency. Enormous scope remains for further progress in all these areas, particularly in an energy sector that is still disturbingly opaque in parts, as well as in SOEs. Transparency in the defence budget is a particular area of concern, and must be addressed as a priority if Ukraine is to make further progress in increasing its defence capacity. President Poroshenko's repeated claims that the war with Russia is limiting Ukraine's capacity to reform lack credibility. It is precisely because of the war and the need to increase the resilience of state and society that the government must act quickly to reduce corruption across the board.

Moreover, many of the successes so far in preventing opportunities for corruption are also reversible. Ukraine's bureaucracy is skilled at finding ways around rules, or at delaying their implementation. Recent efforts to restrict the scope of ProZorro or weaken it, and to introduce corruption opportunities in the taxation of small business, as well as the introduction of the Rotterdam+ formula for coal purchases, are examples of the system's capacity to resist reforms. Efforts to undermine the Ministry of Finance's control of the SFS are a particularly discouraging development. At the same time, a combination of vigilance by civil society and Ukraine's increasingly competent investigative media, as well as by international partners and businesses seeking transparent and stable rules, can hold the government to account and make it harder to subvert reform measures.

Predictably, there have been limited efforts to address the problem of corruption in the law enforcement agencies, and none at all in the SBU. These deficiencies, combined with tentative reform of the judiciary, are part of a pattern: in the absence of a viable alternative, the power groups wish to preserve their system of administrative control in order to protect themselves and their assets. This requires a system of governance that serves their interests, not those of the country. This is the essence of a limited access order. The challenge for reformers is to prise this system open further, and to accelerate its transformation by challenging its key economic players to relinquish their monopolies and the practices that sustain them.

The key to this 'de-oligarchization' of the economy is political reform. At Ukraine's stage of institutional development, it is not surprising that its national wealth is concentrated in the hands of a small number of individuals who control the media and exert disproportionate influence in parliament. The history of Western Europe is replete with examples of identical problems that countries eventually overcame in different ways. The imbalances created by this 'oligarchic' influence are evident in laws that meet only the narrow needs of the elites as a whole, or sections of them, in parties that are simply short-term mechanisms for election rather than generators of new ideas, and in institutions that fail to represent the people and gain their trust. These distortions are the direct consequence of political corruption. The result is a fragile order built on pluralism among the elites that is prone to sudden shifts. As demonstrated in 2004 and 2014, these shifts can trigger revolution. This is not a recipe for stable economic growth, and it makes it hard to attract foreign direct investment because of the perception of unstable property rights.

Ukrainian civil society designed largely on its own the far-reaching corruption-prevention measures described above. However, while it understands how to open up the political system and foster

wider representation of society's interests, civil society lacks funding, and its leverage over the authorities is in decline. This is a result of its conspicuous failure after 2014 to establish a counter-systemic force to serve as an effective political opposition to the current power groups.

A full-blooded fight against corruption will require a complete overhaul of law enforcement agencies, the SBU, the tax service, the agencies that inspect business, the judiciary and other corrupt government bodies. A full audit of their tasks and performance will be necessary, followed by the abolition of superfluous or irredeemably corrupt agencies. In addition, there will need to be privatization of most SOEs and very high levels of transparency imposed on the ones that remain in state hands. Radical deregulation must go together with streamlining of all administrative procedures, with the aim of minimizing contacts between officials and citizens as well as reducing all forms of regulatory inspections to a minimum. Finally, wholesale revision of legislation will be necessary, including the completion of the tax reform, to reduce the extent of discretion, ambiguity and excessively restrictive norms that lead to abuse by officials. In short, Ukraine needs to emulate many aspects of the reforms implemented in Georgia after 2003 that were so successful at reducing low-level corruption and changing the habits of society.

For this to happen, Ukraine's elites and the general public alike need to have confidence that they will gain from changing their behaviour, and that they will lose out if they continue to support the status quo. The elites will commit themselves to dismantling the limited access order only if they have sufficient trust that they will not have to pay for their past sins in the form of criminal prosecution or expropriation. At the same time, citizens must be confident that this is a better option than the superficially attractive solution of putting the elites in jail. Ultimately, they must also recognize that it is no longer acceptable to live with the contradiction that senior officials should not engage in lucrative corruption while the public continues to be open to the possibility of paying bribes as an easy way to 'settle issues'. These are two sides of the same coin.

The process of cleaning up institutions must, however, start at the top. Ukraine's vicious circle of corruption begins with the power groups that have created and sustained a system in which citizens have concluded that it is impossible to live without corruption.

### **Policy recommendations**

- Ukraine's reformist forces, together with its international partners, should focus more on preventing corruption than on punishing corrupt officials. There is currently a disproportionate focus on the establishment of the High Anti-Corruption Court. Prevention and punishment should be viewed as instruments of a broader systemic transformation of the social order, with punishment being an important but secondary element that can support prevention.
- De-monopolizing politics and the economy, while progressively reducing opportunities for government officials to exercise discretion and increasing accountability, will drive the systemic change needed to make a decisive breakthrough in reducing corruption. The debate needs to prioritize this in order to generate concepts and programmes to address the roots of the problem.

- Building strong and capable institutions staffed by a new body of officials of great integrity should remain a high priority. After a slow start, reform of public administration is moving in the right direction. This momentum must be maintained. NABU is a powerful example of how it is possible to create a new professional agency with different values. Rigorous selection procedures for appointments, including involving civil society, were essential in the process.
- Root-and-branch judicial reform remains essential as part of the process to limit the space for corrupt practices, and should be a priority. Efforts undertaken so far are insufficient. Far greater attention needs to be paid to the problem of the political dependence of the judiciary, and to ways to change its culture. The High Anti-Corruption Court offers an important chance to create a new part of the system that operates under different rules.
- Anti-corruption investigations should target the staunchest opponents of the reforms in the power groups. More accommodating forces should ultimately receive amnesties in return for not obstructing the implementation of the reforms.

### **International partners should:**

- Devote more effort to understanding the nature of the problem of corruption in Ukraine and recognize that it is not a disease, but rather a manifestation of deep-rooted systemic and cultural phenomena that should not be regarded as permanent. Broader appreciation of the origins of the problem and of the ways to overcome it should lead to support programmes that target not just the symptoms but also the underlying causes. The present reality is that at some levels in international agencies and donor governments, including in their embassies in Kyiv, there is sometimes only fragmentary understanding of the problem.
- Apply strict conditionality for further financial, economic and defence assistance to Ukraine that should be, among other things, tied to the following:
  - Radical overhaul of the SFS.
  - Measurable improvements in the running of the customs service.
  - Curtailment of the SBU's responsibilities for ensuring economic security and fighting corruption. Creation of a single agency to investigate large-scale economic crimes to replace the departments of the SBU, the SFS and the Ministry of Justice that currently have responsibilities in this area. This agency should not be subordinate to any law enforcement body. Nor should it enhance the president's power – or that of any other official.
  - Greater transparency of defence spending.
  - A programme of corporate-governance reform at SOEs.
  - Electoral-reform measures to ensure better representation and to increase political competition.

- Demonstrable efforts to improve the integrity, independence and professionalism of the judiciary.
- Establishment of the State Bureau of Investigation based on a new culture and working principles.
- Increase assistance programmes to local governments to mitigate risks of corruption related to management of local resources arising from decentralization.
- Facilitate training of civil society organizations on holding local officials accountable for mismanagement of local resources.
- Continue contributing to increasing the technical skills of anti-corruption organizations and investigative media, so that they have the legal, financial and accounting expertise to carry out their work.
- Increase support for civil society initiatives aimed at reducing the space for corruption in different areas, while avoiding efforts that can potentially lead to increased corruption opportunities (for example, by introducing impracticable norms) or reduced competition in the economy and politics. This should be one of the leading criteria in the assessment of grant applications.
- Signal to major business owners that, if there is evidence of their engagement in corrupt practices, their assets held abroad may come under scrutiny as part of anti-money laundering policies.
- Review existing election-monitoring methodology to assess more effectively the deficiencies of the current electoral system in Ukraine.
- Take a proper look at their own immigration and financial regulatory systems to consider how they are in some cases contributing to the preservation of corrupt practices in Ukraine by offering safe havens to the perpetrators of corruption, as well as to the assets they have stolen.

### **Ukraine's policymakers should:**

- Develop a detailed roadmap for further reducing the space for corrupt practices in:
  - The energy sector;
  - The land market;
  - The tax system (including a concept for radical reform of the SFS);
  - The customs service;
  - The banking system;
  - The procurement system (in particular, the tendering process);

- The system for regulation and licensing; and
- The judiciary.
- Take urgent measures to raise the transparency of defence procurement and the system for certifying suppliers.
- Develop procedures for vetting relevant draft legislation to include anti-monopoly assessments to prevent damage to competition by discriminatory norms.
- Use the establishment of the High Anti-Corruption Court to create space for putting into practice judicial independence by increasing accountability of the judges for unlawful rulings and corruption.
- Accelerate public administration reform and communicate its objectives to society.
- Accelerate privatization and reform of SOEs.

### **Civil society should:**

- Communicate to citizens the achievements of the anti-corruption reforms so far and build on success stories, in healthcare and administrative services.
- Channel citizens' energies away from justifiable anger at the lack of progress in punishing high-level *korrupsioneriy*, and towards addressing the institutional roots of corruption by creating open and fair competition in politics and business.
- Prepare citizens for land reform, countering the fears of the rural population that are exploited by rent-seekers who deliberately seek to undermine the concept of property rights in order to maintain the status quo.
- Push harder for electoral reform and enlist the active support of donors for parliament's adoption of the Election Code.
- Develop a concept for rebooting the NAPC and empowering it to fulfil its mandate, including in the analysis of asset declarations and vetting of legislation.
- Develop a bold vision for shaping the future development of the law enforcement agencies.
- Ensure that all draft legislation undergoes anti-corruption vetting and is complemented by similar anti-monopoly assessments to prevent damage to competition by discriminatory norms.



## Abbreviations and Acronyms

CEO	chief executive officer
EPT	enterprise profit tax
GDP	gross domestic product
IMF	International Monetary Fund
NABU	National Anti-Corruption Bureau of Ukraine
NAPC	National Agency for Prevention of Corruption
NAKO	Independent Defence Anti-Corruption Committee
NERC	National Energy Regulatory Commission
PGO	Prosecutor General's Office
SAPO	Specialized Anti-Corruption Prosecutor's Office
SBU	Security Service of Ukraine
SFS	State Fiscal Service
SOE(s)	state-owned enterprise(s)
SRS	State Regulatory Service
UAH	Ukrainian hryvnia
UGV	Ukrgezvydobuvannya
UNDP	United Nations Development Programme
Unicef	United Nations Children's Fund
VAT	value-added tax

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Cover image: Anti-corruption activists in Kyiv in October 2016 play on the word *trusi*, which in Ukrainian means both 'underwear' and 'cowards', in a demonstration against senior public officials who refuse to disclose their financial assets.

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