

Economic Reforms: Aren't we missing the point?

A thick red line that starts as a horizontal line on the left, then curves slightly upwards and to the right, ending in a sharp upward-pointing angle on the right side.

Priorities for economic reforms in Ukraine

Research Note

March, 2014

AYA Capital, a Ukrainian investment banking advisory firm, has developed this Research Note.

We will provide this Research Note to the Government of Ukraine, leading political parties, prospective candidates for the President of Ukraine, media and public for further discussion and use.

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Compliance of Our Recommendations with the EU Association Agreement, the IMF Requirements and the Program of the new Cabinet of Ministers of Ukraine

The recommendations proposed in this report correspond to the economic reforms of the Association Agreement between Ukraine and the EU, the requirements of the IMF and the Program of the new Cabinet of Minister of Ukraine.

Not to waste the reader's time, we have decided not to propose those reforms that contradict the abovementioned documents. Moreover, we do not have any significant objections against these documents and consider them as entirely adequate and consistent to deal with current challenges of new Ukrainian government.

After careful examination of these documents we have agreed that [implementation of described reforms is not sufficient to achieve the objective of ensuring justice and prosperity for the Ukrainians](#). In our opinion, the main disadvantage of these programs is [the lack of emphasis on the importance of building an effective capital market](#).

Neither the Association Agreement, nor the requirements of the IMF, or the government's program are paying enough attention to the development of the capital market. This gap raises concern, as the world economic history suggests that the capital market itself is fundamental for sustainable economic growth (as we describe in this report).

Without development of capital market, the Ukrainian companies will never be able to compete against the EU companies. Almost all modern businesses are very capital intensive and the Ukrainian companies will be less competitive considering the prohibitively high cost of funding due to underdeveloped Ukrainian capital market.

In addition, development of capital markets allows attracting enough capital to invest in the infrastructure projects or energy efficiency measures, which is also one of the key problems of the Ukrainian economy. Moreover, the developed capital markets are key to correcting macroeconomic imbalances.

It is important to note that an [efficient capital market is the key to overcoming economic inequalities in the society and getting rid of paternalism](#). That is why capital market development is a prime example showing that the implementation of the Association Agreement and the IMF requirements should be accompanied by a number of critical reforms.

Introduction

On November 7, 2013, we released our first research on the EU Association Agreement titled “Ukraine in the EU Association: no pain – no gain”, in which we examined the possible effects of signing and implementation of the Agreement.

Then the government cheated on us all over again and did not sign the Agreement. Although, when hundreds of thousands took to the Maidan to express their desire to remove unfair and unjust government, we realized that the Agreement was still to be signed and the “old” government would not resist against a popular uprising, while the “new” government would not have the moral right not to sign the EU Association Agreement.

On December 2, 2013, we announced a release of a research note to help the “new” government develop economic reforms vital for the effective implementation of the Association Agreement.

Given the scope and structure of this Agreement, we believed that it would be logical for the “new” government to develop the economic reforms under the framework set by the Agreement. The Cooperation Program with the IMF (the only real source of foreign funding) would serve as an additional element of this framework.

This framework really inspired us – we hoped that our government would finally be forced to conduct comprehensive reforms, rather than imitate them to cover up for pursuing of their own corrupt interests.

On the other hand, even a preliminary analysis of the Agreement showed that its implementation would not be easy and the “new” government would require assistance in designing and implementing reforms.

Unfortunately, the turbulent and tragic course of people’s struggle for their natural rights forced us to put the research on hold and engage in less intelligent but more “relevant” tasks of the time.

Once we achieved at least an interim victory, we resumed this work and we are happy now to present our first research on critical economic reforms.

You will not find a “wish list” in this report, which is usually a feature of the vast majority of concepts, strategies and reform programs in Ukraine. It has no “road maps” or “schedules”, which application for solving large-scale problems is really a reflection of outdated practices. It is not intended to be all-inclusive; we have tried to ensure compliance with the Association Agreement and the IMF cooperation program, but we did not want to duplicate these documents.

This research note analyzes a conceptual choice that should be made with regard to priorities and approaches to economic reforms in order for achieve the main objective of the reforms – a fair and prosperous life for the Ukrainians!

Choosing the economic model

Plutocratic and oligarchic model of Ukraine's economy, which took shape during the years of independence, has completely exhausted itself. This model does not satisfy the people of Ukraine, who openly rebelled against the system.

“Reincarnation” or “rebooting” of this system, even if it includes some “new faces” in the government, decline in “obvious” corruption and another rotation in the Forbes ranking, yet again will certainly lead to dissatisfaction of the people and criticism from the West resulting in a peaceful (or not) change of power.

Unfortunately, the “new government” clearly lack this understanding and that is why we would elaborate on this statement.

In order to fulfill the social contract where the people would accept the oligarchic and plutocratic model, the government should provide the opportunity to a relatively large number of people to become “plutocrats”, while providing constantly increasing level of social security to the rest.

Obviously, lack of the resource rent or foreign loans (with no strings attached with regard to unpopular reforms) makes it unfeasible for Ukrainian state budget to satisfy the appetites of the “army of plutocrats” and the demand for paternalism from the rest.

Is there a problem with Ukrainian society?

The government must realize that every person, regardless of its mentality, social status, education or even age has a natural sense of unfairness at the level of inborn instinct. In other words, we all feel unfairness towards ourselves. However, a question «why?» arises later at the level of consciousness. If we get an explanation which we can trust (and we feel trust at a physiological level, accompanied by the release of the oxytocin hormone), we agree with this unfairness. However, if we do not trust the explanation, we also begin to behave in an unfair way towards the others. For example, if we feel that the officials receive unfair proceeds, while failing to admit it and demonstrate hypocrisy, then we start doing the same, or if we do not have such opportunity, we just begin to demand «cheaper bread», «lower tariffs», «better social benefits» and so on. Thus, the problem is not that the Ukrainians are prone to paternalism, or they do not want to learn about candidates' political programs, or that our low morale allows us to steal - the problem is that we feel unfairness and do not trust the explanations by the oligarchs and plutocrats.

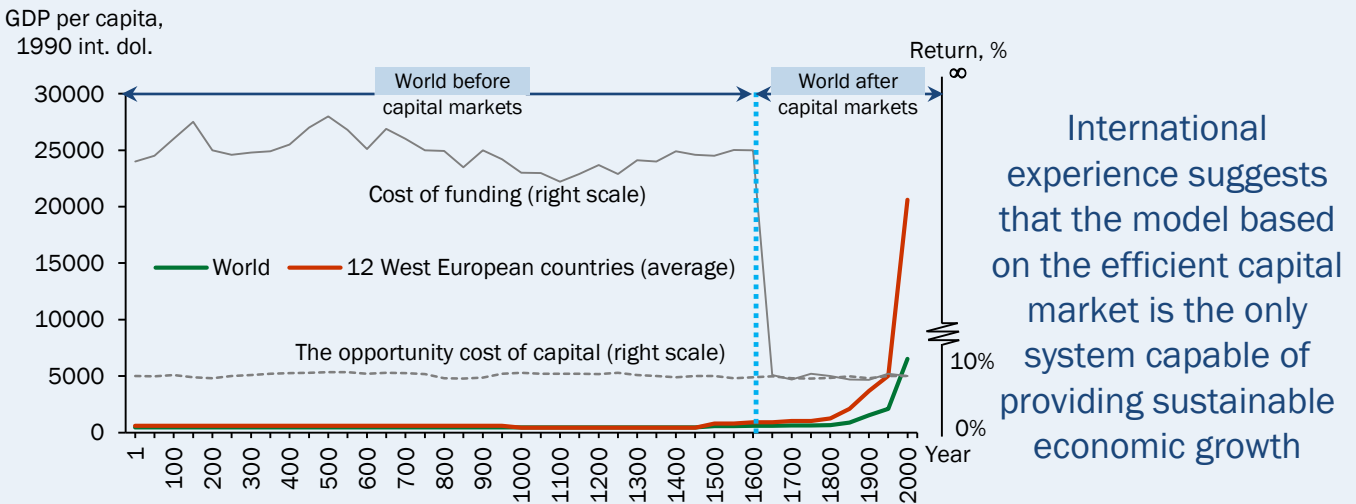
If “rebooting” cannot save the plutocratic and oligarchic model, what should we choose as the “new model”?

Our analysis of the world experience, as well as economic and political demands of the Ukrainian society affirms that **efficient capital market** is the key to the answer to this question

What does the economic history teach us?

For millennia, people's living standards (measured as GDP per capita) were more or less at a similar level (see Graph 1). People planted crops then harvested it from one year to another. They had good and bad rulers, priests and messiahs, scientists and artists, but the standard of living was virtually unchanged.

Graph 1



International experience suggests that the model based on the efficient capital market is the only system capable of providing sustainable economic growth

Source: Angus Maddison, 2007. *Contours of the World Economy, 1–2030 AD*; Kevin Kaiser, 2013. *What is Value?*

In the early 17th century there was an event that changed the course of economic history – the first joint-stock company was established in the Netherlands. For the first time, a sufficient number of ordinary citizens brought together their modest capital to invest it in something they considered beneficial. Their example was so successful that joint stock companies started popping up all over Europe. These companies have begun to invest in trade, manufacture of machinery and equipment. It's them who have made the industrial revolution possible, for which even the «wisest rulers» had not had enough money for thousands of years (because they spent most of the nation's capital on war or building palaces).

The spread of shareholding companies in Europe was accompanied by the emergence of stock exchanges, which can be considered the beginning of a «new era» in the world economic history – the «Era of Capital Markets».

Unlike the previous era, the «Era of Capital Markets» is characterized by sustainable economic growth, as shown in the graph above. Thus, the less «wise rulers» we have in the world (monarchs and dictators, since they all consider themselves very «wise»), the higher the growth rates of the living standards.

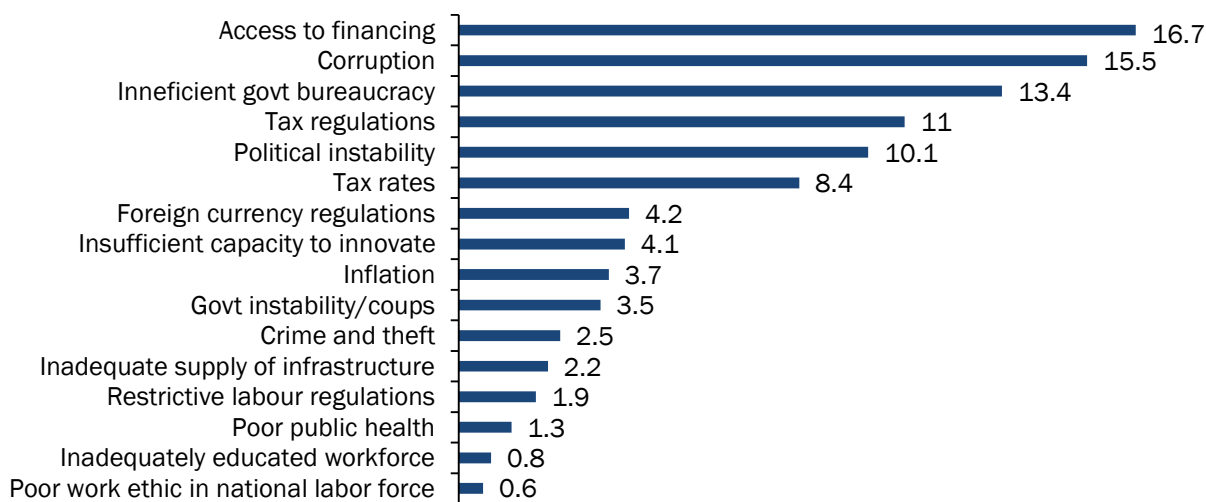
This is no paradox. Capital markets are based on the law of nature - the «survival of the fittest». The driving force of evolution and economic growth has the same nature!

By the way, the red curve on the cover of our report is the GDP growth curve from the graph above. We used it as a symbol for perhaps the most important «message» of this report.

Please note, that the **problem of access to finance is a consequence of the lack of an efficient capital market**. If it's lacking, then the cost of funding (the cost of the financial resources available for the “regular” market participants) will be much higher than the “opportunity cost of capital” (at which “ordinary” investors would be willing to invest in the efficient market conditions). In fact, as proven by the thousands of years of experience (see the right scale on Graph 1), the cost of financial resources for the “real” entrepreneur is critically high without an effective capital market. The entrepreneurs cannot raise capital; therefore, they cannot develop their business, making the economy suffer and especially the consumers. The residents cannot unite and effectively invest their small capital (savings) to the detriment of motivation to save. And since they also suffer as consumers, they have little incentive to work. While the capital “concentrated” by the government of the oligarchs and kleptocrats will always be spent unproductively, as proven by the economic history...

In return, **the problem with access to financing is the most important problem for Ukrainian business**, as reputable surveys show (see Figure 1).

Figure 1. Results of the survey on the most critical issues for doing business in Ukraine



Source: World Economic Forum Global Competitiveness Report, 2013-2014 (% of respondents).

Thus, we may see that as far as efficient capital market is lacking in Ukraine, such obstacles create the biggest problem for the development of Ukrainian companies and economy as a whole.

Changing Principles

It may seem that we have paid too much attention to justify rather obvious theses that the oligarchic and plutocratic system run its course, while the modern capitalism and market economy are based on efficient capital markets (which should still be developed in Ukraine).

However, we believe that since the [current elite took shape in the time of the plutocratic and oligarchic system](#), it does not understand or accept these basic principles.

The elite could even assume that it understands these principles. The elite could declare the readiness to change the system. However, does the elite understand that the change of system requires the change in basic principle of interaction between economic agents? Is it ready to change it?

Efficient capital market, as well as any other effective market, assumes free competition – both for capital and assets. It also assumes trust among the market participants and the government aiming to ensure that the market participants pool their money together and are not afraid of investing it.

Thus, [free competition](#) and [trust](#) are the two principles, lacking which will make it impossible to build any efficient capital market or productive economy in Ukraine.

But at the same time, free competition and trust are the very first things to be “wiped out” by the oligarchic and plutocratic model! That is why the principles of effective capital market is the opposite of the principles of plutocratic and oligarchic model.

That is why, unfortunately, we do not believe that the elite, which took shape in the time of the plutocratic and oligarchic system, could somehow be convinced to quickly change their principles.

The Association Agreement and the implementation of the IMF requirements will still make them do it, otherwise resulting in a fundamental change of elites, what is more likely. Under this scenario, implementing the reforms will turn into a long and iterative process being extremely painful for the people.

Yanukovich did not want to change the principles, besides he was afraid that the people would not endure any additional pain. Therefore, he chose the “Russian option”. This option is not realistic (because of Maidan) for the new government.

Thus, there is still a hope that a critical part of the new government will “miraculously” agree to change their principles even before the implementation of the Association Agreement and the IMF Cooperation Program. If it happens, [Ukraine will witness an economic boom and the new government will play an important role in Ukraine’s history](#).

Legal Framework

Even with consideration to our great desire to believe in rapid succession, we would not rely solely on the conscience of the current elite, as it comes to changing life principles, paradigms and mentality. However, even if the elite would want them to change, we still need a certain “framework”, i.e. conditions to structure and guide these changes.

[“Political” part of the Association Agreement is a necessary but insufficient condition.](#)

Thus, before moving on to a more “practical” part of our report, we would like to steal some of the reader’s attention and discuss the conditions that are critical for shifting the paradigm of Ukraine’s authorities.

We need to accomplish something that we have not been allowed to before by Tsar Alexander I, Nicholas I, then Stalin and now Putin. Something that the civilized world has already recognized in the Declaration of Independence of the United States and in the motto of the French Revolution more than 200 years ago.

We need to finally get rid of the feudal law. First of all we need to recognize the priority of natural law over positivism and anthropocentrism over etatism (expert analysis of required fundamental changes in the legal environment is not the purpose of this report; the priority of natural law and anthropocentrism can be found, for example, in the works of Oleksandr Zadorozhnyi).

In terms of the necessary economic reforms, it is quite important that the Constitution of Ukraine should expressly say that [fairness is more important than norms, human rights are more important than the state, and government’s legitimacy is more important than its legality](#). This should force the government to stop making a “fetish” out of the legal norms, hiding behind it manipulate the law. Certainly, it's complicated, since there is neither a precise and universal definition of fairness nor the exhaustive list of natural rights. Nevertheless, the essence of this change lies in the fact that the authorities should primarily care about whether they understand the natural rights of the people and their understanding of fairness.

Then the today’s situation, when most of the politicians and the media (the fourth branch of power), even the ex-head of the Constitutional Court do not understand the meaning of the term “legitimacy” (confusing it with “legality”), will not be possible.

Should it happen, should the authorities realize that legitimacy is a voluntary recognition of the government’s rights, being a category of confidence, rather than a norm or procedure, should the government constantly strive for voluntarily recognition and [people’s trust in the government and public institutions](#) – only then we can say with certainty that the government changed its principles, and now we can build an efficient capital market in Ukraine, where trust is one of the underlying principles.

Priority of legitimacy over legality is a paradigm based on Max Weber's theory of types of legitimate political authority.

The difference between the two characteristics of power is reflected in the fact that the legal authorities at some point may become illegitimate in the eyes of the population.

Legitimacy of Power	Legality of Power
a) Public recognition of the authorities; b) Accepting government as legitimate and fair; c) Government has authority in the eyes of the population.	a) The government has a legal origin; b) The power is exercised by law (rather than by arbitrariness, violence, etc.); c) The authorities are governed by the same laws.
Ethical and qualitative evaluation of power (existing power is good or bad, fair or unfair, honest or dishonest).	Legal and therefore morally neutral nature of power.

The supremacy of law above the legislation

The supremacy of law above the legislation provides for the necessity and possibility of going beyond the formal law. One manifestation of the rule of law is that the law is not limited to legislation being one of its forms, instead, it includes other social regulators, including moral norms, traditions, customs, etc., which have been legitimized by the society and shaped by the historical level of the society's cultural development. The rule of law is called upon to become a certain standard, not only in legislative activity, but also in terms of adjudication confirming impartiality of justice and judges' efforts to restore justice through adjudication.

The advantage of the natural rights over positivism

The advantage of the natural rights over positivism is expressed in rejecting the identification of law with legislation, which can sometimes be unfair and restrict freedom and equality of individuals.

Natural law	Positive law
Given by birth and does not depend on someone's will	Acts officially recognized within the boundaries of the state and enforceable by law.

Judiciary where justice is more important than a reference to the legislation

The phenomena of justice and legality are separate concepts by nature. Justice prevails in public morality domain and is the only criterion for the legitimacy of the social order that is secured by various means including court decisions. This principle requires that the decisions made by the judiciary are founded on fairness as the basic principle of law. It is justice, rather than procedural rules that is a crucial principle in the definition of law as the regulator and a measure of social relations.

The Role of the State in Economy

Currently, the “reformers” demonstrate “perseverance which could be focused on a more appropriate purpose” and work on developing the “vision of Ukraine’s future”, development strategies and look for the “leaders” and “proven men” for further implementation of these Napoleonic plans. They believe that their supernatural mental abilities will allow them to decide better than anyone else what the people of Ukraine should do and how, such as where to invest, which industries to develop or what products to make. Seriously? Has the entire experience of the economic history failed to teach them anything? Have they failed to realize that the capital market will do this job much better?

If they do not understand it, we can repeat: the government should allow the market decide on the best way to use available resources.

Instead of “good intentions” to make public investment into “strategically important” projects in order to stimulate some “innovative” projects or “prevent negative economic consequences”, [the state should only have one single role in the economy – ensuring “market” efficiency.](#)

As noted above, the “most important” market that should be developed in Ukraine is the capital market. Moreover, this market has to be developed virtually from scratch. As the experts, we can say that the existing stock market in Ukraine is a hoax.

However, it should be noted that effective functioning of capital markets is beneficial not only to the market participants. In contrast, efficient capital market is beneficial primarily to the consumers. In other words, the idea of capital markets suggests that availability of competition in such a market leads to the elimination of “supernormal profits”. Thus, the return on the invested capital will be equal to the opportunity cost of capital, resulting in an effective re-distribution of resources in the market and leading to the development of the most efficient sectors of the economy, which in turn brings economic benefits to the consumers (and not just the owners of capital).

It is important to emphasize that the functioning of the capital market does not mean minimizing the role of government. In contrast, [efficient market cannot be spontaneous, and so the role of the state here is very important and challenging.](#)

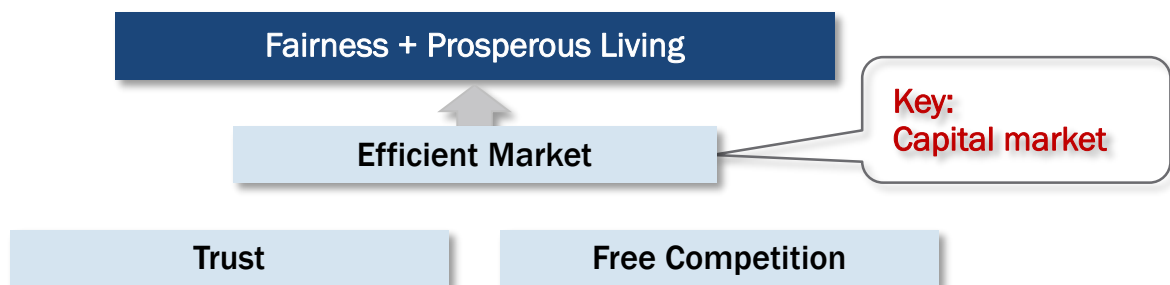
Having this role for the Ukrainian state is more than enough. Any efforts to expand the role of government in the economy will only be a demonstration of “fatal conceit”, as precisely mentioned by the Nobel Prize laureate – Friedrich von Hayek, and unlikely successful due to limited resources, including personnel.

In practice, the role of the state to ensure market efficiency, both in capital and commodity markets, is narrowed down to the three main tasks:

Ensuring market transparency. Market participants should assume that they have the same (symmetric) information about the “asset” (purpose of the transaction). Otherwise, there emerges a market for lemons – a market model where functioning has been violated because of information asymmetry between the “buyer” and the “seller”. [George Akerlof, 1970]

Ensuring market integrity. Modern markets are complex interrelated “ecosystems” in terms of infrastructure, technology and standards. Capital markets are stock exchanges, automatic quotation, clearing, depository, etc. Energy market also includes gas pipelines and storage facilities, generation, distribution systems and so on. Capital markets are interconnected with foreign exchange and commodity markets. Therefore, the state should establish the process of regulation to ensure smooth operation of all the components of this complex system and minimize the possibility of limiting free competition in these markets (due to monopolization, market cornering, fraud, etc.)

Protect property rights. Market participants must have confidence that no one will “rob” them in this market – either by raiding or demanding bribes or by unexpected and excessive taxation, etc.



Transparency	Market integrity	Protection of Property Rights
<p>Information should be:</p> <ul style="list-style-type: none"> ▪ Complete (within the materiality), timely and reliable/proven ▪ Presented in a user-friendly format with advantage given to substance over form ▪ Symmetrical for both parties to the market agreement 	<ul style="list-style-type: none"> ▪ Liquidity ▪ Infrastructure ▪ Integration between foreign exchange, stock and commodity markets ▪ Preventing manipulations 	<ul style="list-style-type: none"> ▪ From expropriation or “surprise” taxes ▪ From raiding, extortion and fraud ▪ From banditism or war

Who and how can implement the necessary reforms

As we noted above, ensuring market efficiency is a very important and complex role for the state. In its turn, a prerequisite for the successful implementation of this role, especially in Ukrainian reality, is [an adequate staffing](#).

We believe that the majority of the readers will agree that the staffing is one of the key problems in conducting economic reforms in Ukraine.

The origins of this problem are the following:

- “Older” generation of managers was formed during the old “Soviet” system. The specialists, who knew how to run this system, were based in Moscow. “On the ground” were mostly “executors” who never quite knew the answer to the question “why”.
- Existing “post-soviet” system is an organization engaged in performing and “covering up” big and small thefts. Accordingly, at that time you could gain experience only in that. Everything, what did not help to steal more, was not interesting for people.

Unfortunately, even the business sphere was not an exception to this rule. Under the plutocratic – oligarchic model, there are no incentives for professional development. Therefore, managers from the “industry”, auditors, lawyers, bankers, consultants and other “professionals” have been lagging behind the international level every year more and more.

Even “expats” or “seconded” foreign experts quickly degrade in Ukraine. Not mentioning the fact that usually it is not “the best of the best” who come to work to Ukraine. In addition, the efficiency of the foreigners is very limited because of the language barrier, different accounting standards etc.

Then, how to provide good staffing for conducting reforms?

Firstly, it must be realized that improving the quality of the staff will depend [on improving competition – both in business and in politics](#).

Dependence of the quality of personnel on competition level, using the example of companies owned by Rinat Akhmetov

Among Akhmetov's various assets, FC Shakhtar belongs to the most competitive environment. The club contracted coaches and players and many of them have been successful worldwide. It seems that foreign specialists of such quality are not available anywhere else in Ukraine. But these players know that they are not guaranteed a position on the field. Therefore, they work hard. A good selection and the right incentives bring results – the club even won once Europa League Cup. However, they also may lose 0-4 to an average club of the German Bundesliga. That's why sometimes Rinat Akhmetov looks very upset after the game of his club.

In the relatively less competitive environment are telecommunication and banking assets of Akhmetov. To manage those assets, he finds successful managers at the regional level and “keeps them on their toes” to manage these assets. However, even in this case the assets are not very profitable, because of the “interfering” competition that is probably not making the oligarch very happy.

Mining, metallurgy and energy sector companies operate in even less competitive environment. They are managed by locals with good education and experience in foreign companies, but not professional (in MMC and energy sectors, respectively). These assets are extremely profitable, because competition usually does not “interfere” while the government is offering “help”. When the competition hampers a bit, or if the state fails, Rinat Akhmetov has to strain, what apparently he does not really like.

The Foundation for Effective Governance operates under even less competitive environment. There are many professionals with experience in leading consulting firms. International ones, but in Moscow or Kiev office. In this Foundation they write something, but few people read, and almost no one applies it in practice. Perhaps, the only exception is the administrative reform – it has little effect on the opportunity to steal, therefore it can be implemented just “for a show”. The quality of the recommendations is the most questionable. They are superficial, without understanding the reality or even how it should work. At least it concerns recommendations for the energy sector reform. But the competition is still not there. Critics neither. Usually, there is simply ignorance. But Rinat Akhmetov never said that it frustrates him. Let them work.

The least competitive environment – this is usually the governmental institutions, especially the parliament. In the parliament, for example, he can fill his “quota” with his former drivers and bodyguards. It is not clear what draft laws they can elaborate there, but Rinat Akhmetov never gave a hint that it might embarrass him.

Secondly, improving the quality of the personnel is not possible without focusing on learning in management process. Such focusing means that decisions are based not on beliefs, values, ethics, intuition or assumptions, but on the hypotheses that are confirmed by data (see Figure 2). This focusing requires constant reviewing of the hypotheses and life-long learning. In this approach, the main task is primarily to shape appropriate expectations and only then draw conclusions.

The use of such an approach will lead to the establishment of an effective decision-making mechanism. In particular, ensuring the competition of ideas, objectivity and validity of opinions, proactive approach and teamwork, trust and professional development will help making balanced and informed decisions.

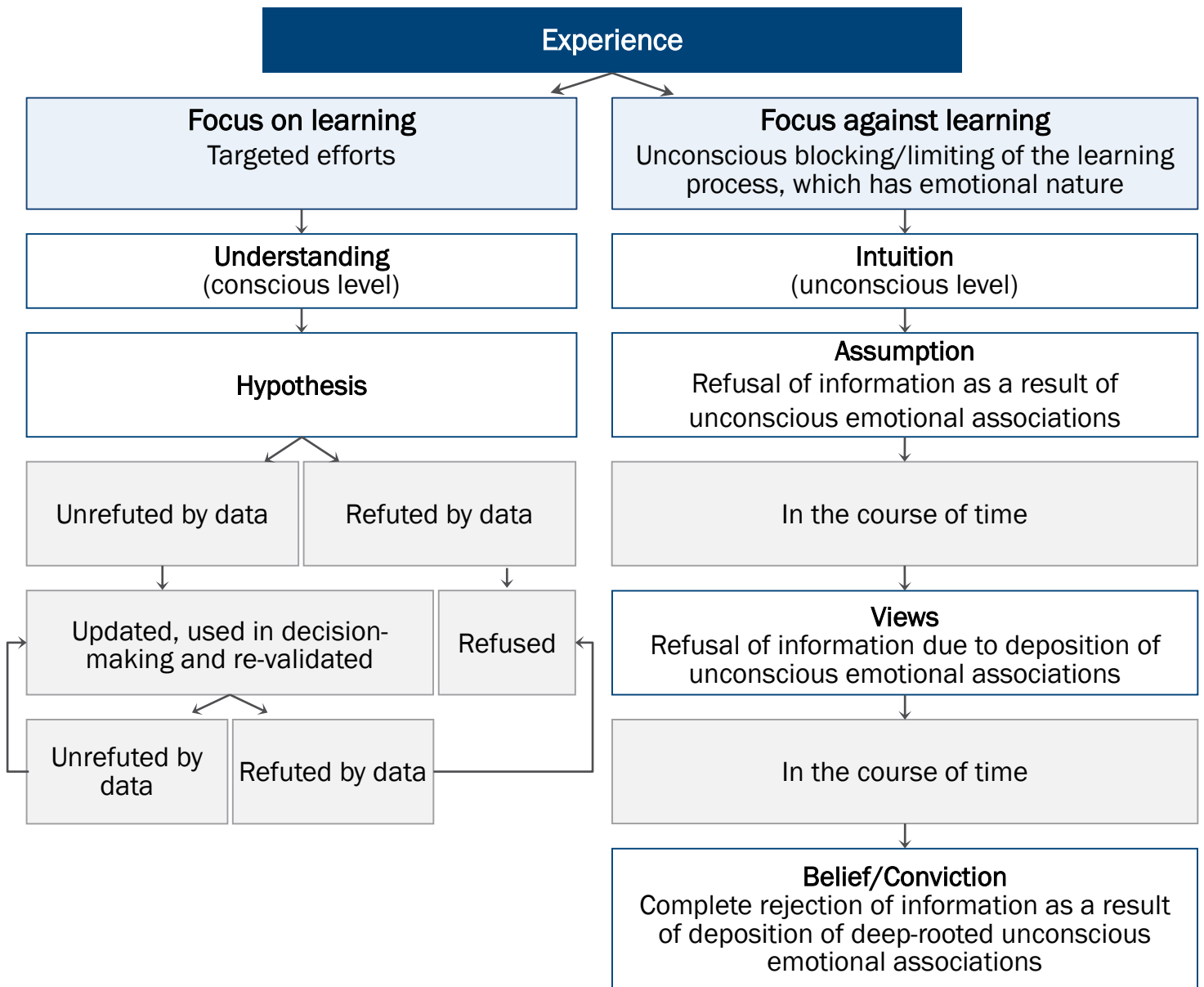
Conversely, if this approach is not applied, then there will always be problems with excessive self-confidence against the background of mental retardation, “star sickness” of bright mediocrity, provincial “messianism” and “the boss is always right” principle not to mention such trivial things as ineffective hierarchy, unproductive disputes, sabotage, etc.

The problem with the choice of focusing on learning is the lack of understanding of the problem by those who actually target “against learning”. Many managers believe that higher education, especially a university degree, diploma or even an MBA from a western business school is a key to focusing on learning. Some even believe that the MS Excel models and presentation charts or use of the words “vision”, “strategy”, “bonds”, “capitalization”, “index”, “audit” and “evaluation” will automatically indicate application of modern scientific approach. However, such beliefs are false, because focusing on learning is not a matter of available knowledge, but rather of the process of “updating” the knowledge.

We pay special attention to the explanation of focusing on learning approach for good reason, since our second important “message” is that the reforms are not just a report consisting of thousands of pages or a road map featuring tables or charts; it's not a team of reformers – graduates of the world's best business schools or foreign experts bringing along a kit of recipes.

The reform is a process that consists of trial and error. And successful reforms differ from unsuccessful ones primarily because they were supported by timely conclusions, what is a focus on learning.

Figure 2. What is the focus on learning



The Areas of Necessary Reforms

Below we present our recommendations on specific areas of necessary reform.

Of course, each of these reforms is a complex process and requires more detailed considerations. From our side we have conducted deep enough analysis of the proposed reforms, but the presentation of this analysis does not match the format of this report.

We note only that our proposed reforms:

- are inter-related;
- meet the concepts stated in previous sections of this report:
 - consistency with the Association Agreement with the EU and IMF requirements;
 - the need to change the economic system and the construction of the capital market as the basis for this system;
 - determine the role of government in the economy as ensuring market efficiency;
 - identifying key tasks to ensure market efficiency as:
 - ensuring transparency;
 - ensuring the integrity of the markets;
 - protecting property rights.

We decided to show in detail the necessary reform of “Naftogaz Ukraine”. In our view, this reform is both the most important and the most revealing in terms of the government’s understanding and willingness to make the necessary economic reforms.

“Public” Enterprises*

* Owned by the government partially or fully, directly or indirectly.

- Sell all state enterprises through IPO/SPO: Ukgazvydobyvannya, Ukrtransgaz, Gas of Ukraine, Chornomornaftogaz and Ukrspetstransgaz etc. (in case of bankruptcy of Naftogaz – new companies that will receive assets currently “given” to Naftogaz by the state. This includes all the assets that were transferred to Naftogaz at the time of its creation); government shares in Ukrnafta, Ukrzaliznytsya, Energoatom, Ukravtodor, Ukrposhta, Savings Bank of Ukraine, Ukgazbank, Bank Kyiv, regional infrastructure companies and more. *These companies should be sold through IPO, not to a strategic buyer - it can “jumpstart” the domestic capital market!*

Privatized Natural Monopolies

- In case of revealing violations during privatization of these companies, the government should have an option to sign a court settlement on termination of prosecution upon the condition of public offering of shares (company share) followed by a surcharge to the national budget to offset the difference between the sale amount and the amount paid for privatization (including net investments)

Resource rent

- Substantially increase rent (royalties) for iron ore, oil, gas and other minerals and bring them to the international levels, taking into account the need to seize “supernormal profits” (reduction of return on invested capital to the normal level)

Pensions and Long-term Insurance

- Implement accumulation system (immediately). *This is a key source of “long” hryvnia!*
- Stimulate life insurance and “bancassurance” by introducing guaranteeing premiums (from the fund) and tax exemptions on capital increase. *Another important source of “long” hryvnia!*
- Revolutionize the sources of financing in the PAYG pension system: the only source to be royalties, licenses for exploration and production of natural resources, privatization proceeds and dividends; it will be fair and substantially increase the level of responsibility in determining the amount of royalties, holding privatization etc.; if it is “fair”, the revenues will be sufficient to fund the pension payments and even increase them

The Tariffs of Natural Monopolies

- Change the method of setting the tariffs in accordance with the European principles: the cost base must include the cost of capital (equity* statutory rate), exclude “income” and “investment component” from the estimate and so on; introduce IFRS-based cost estimation and regulations that would encourage cost optimization. In practice, this will mean a significant increase in tariffs. For example, the real cost of “domestic gas” is over USD 250 per thousand m³, not even near to USD 50, as they say in the media – if it includes the cost of capital rather than just “marginal” costs. Thus, the tariff situation for the energy companies that were privatized “for a song” will become quite “exciting” – as the buyer-invested capital is relatively low while the rate will be “relatively” low.

Reporting and Corporate Governance

- Stop delaying (again) the mandatory introduction of IFRS and audit requirements for all “public” companies (joint stock companies, government-owned companies, natural monopolies and company towns, etc.); encourage other companies to use IFRS due to regulation of the banking sector (reduced provisioning) and market equity investments (collective financing)
- Mandate all “public companies” publish annual and quarterly reports, including segment reporting, management discussion and analysis etc.; publicly disclose ultimate beneficiary owners (this should apply to all media); apply the EU Corporate Governance Standards
- Oblige all companies to disclose ultimate beneficiary owners to public authorities and financial institutions and companies that provide professional services (under the mandatory customer identification procedure)
- Completely abandon national financial reporting standards (in accounting and state statistical reporting); eliminate the relevant departments of the Ministry of Finance

Regulation of the Stock Market and other Capital Markets

- Allow “dual listing”
- Expand the mandate of the Securities and Stock Market Commission fundamentally, particularly with regard to enforcement; liquidate the National Financial Services Commission; reallocate authority between the Securities Commission, the National Bank, the Tax Service, the National Financial Monitoring Commission, the Prosecutor’s Office, the Interior Ministry and others in terms of the regulation of capital markets, financial services, financial behavior, corporate governance and the fight against “financial” crime. *Capital market participants should be protected (i.e., by ensuring transparency and market integrity) by those who have the competence, technical abilities and authority to do so!*
- Develop new regulations concerning equity and debt crowd funding

NBU, Currency Market, Bank Regulation

- Move away from ensuring stability of the exchange rate towards ensuring price stability (inflation targeting) and sustainable economic development (considering the employment level)
- Stop condoning “extend-pretend” practices in the field of “toxic” loans recognition. *To “offset” the situation, it is important to address the corrupt court decisions releasing collaterals and increase the efficiency of bankruptcy procedure!*
- Oblige all the banks to provide accurate and complete information to credit bureaus
- Disseminate standard consumer protection mechanisms to financial services consumers (banking services in particular)
- Oblige NBU publish monetary policy goals/reports
- Reorganize Ukreximbank into an ECA (export credit agency)
- Eliminate restrictions on capital flow and foreign exchange transactions
- Fight manipulations (restriction of free competition, breach of trust, etc.) instead of speculators (their market role is very important – without them there will be no market liquidity)
- Remove all restrictions for IFIs on local currency lending

Law and Judiciary

- Allow partial application of English law in contractual relationships even if “foreign counterparty” is not one of the subjects of such relationships (“foreign counterparty” presence is the obligatory norm for international law application currently, according to the Ukrainian legislation on “International Private Law”). As an example of practical application we could mention use of common (English) law along with codified (Napoleonic) law – a system that has been successful in the province of Quebec (Canada)

Increase the role of “private” institutions in commercial disputes settlements; unilaterally recognize the decisions of English courts by the Ukrainian state bodies in order to enforce them, in particular, via:

- **pre-trial mediation practice** implementation, which allows the parties to submit the dispute to a neutral third party (which was bilaterally agreed) who renders a decision and the possible mechanisms of its’ implementation, which are acceptable for both parties, after hearing arguments and reviewing evidence.

- **Magistrate's court practice** implementation. Considering the discredit of state-appointed judges, the alternative could be in commercial disputes settlement by the Justice of the peace (JP), which would be financed by the disputing parties (similarly to commercial arbitration). JP should be someone of good stature and flawless reputation in the local community who could be elected. Electivity would serve as a basis of objectiveness and incorruptibility as the JP status could be withdrawn after the local community request, in case if JP violates the law/moral principles, etc. Magistrate's court decisions should be enforced in the similar order to state courts' decisions. The implementation of this practice requires passing special law and making changes to the Constitution.
- **strengthen the role of international arbitration courts**, particularly implement constant practice of legal norms application and limiting the cases, when state courts could reject the enforcement of international arbitration decisions in Ukraine, and
- **obligatory recognize the decisions of English courts** in Ukraine. As a common rule, the recognition of the foreign courts decisions in a country is implemented on the reciprocity principle on the basis of applicable international agreement. At the same time, the country could introduce obligatory recognition of another country courts decisions on its territory in unilateral way (e.g., passing internal bill). Dispute settlements by the English law in English courts has disadvantages (high cost and long duration of the process), but their advantages (authoritativeness and constant procedure of disputes settlement) could stimulate the disputing parties to address English courts. Accordingly, existing legal basis of English courts decisions enforcement in Ukraine without the review of the case by the Ukrainian court on the merits would create prerequisites for the use of English courts by the Ukrainian counterparties.

Taxes

- Delegate the following powers to local authorities: a) establishing the VAT rate and income tax rate for “local” businesses (i.e. those where production of goods/services and their consumption is totally local – restaurants, hotels, services etc.), b) replacing these taxes with fixed “license fees” and corresponding revenues will remain in the local budget
- Reduce VAT on essential and “healthy” food, baby clothes, printed materials, educational and health services to the level of 5%-9%
- Raise VAT on goods that are mainly imported (cars, consumer electronics, etc.) to 25%
- Review calculation of VAT and income tax liabilities (including them to deductible expenses/tax credits, benefits in kind, transfer of losses, etc.) in order to facilitate harmonization with the EU; introducing incentives (for example, by including the costs of rehabilitation, health insurance, etc. to deductible expenses) additional tax for “antisocial” consumption, etc.
- Increase excise taxes on alcohol, gasoline, cigarettes, etc., and cut off the possibility of evading excise duties (experimental “petrol” mixes, etc.)
- Significantly increase the fee for new vehicle registration (provide a discount provided that the old one was recycled)
- Introduce a capital gain tax
- Introduce inheritance tax
- Return progressive scale of personal income tax, while foreseeing numerous “civilized” deductions from the tax base: voluntary insurance and additional retirement savings, education expenses, etc.

Business Inspections

- Establish a list of “local” businesses which can only be inspected by a local “Tourism Office”

Codes and Standards: Health, Construction, Architecture, Fire Safety, etc. *

- * Other than those governed by the EU Association Agreement
- Development and approval authority should be delegated to the industry self-regulatory organizations; establish that it can only be appealed in court if contrary to the principles of efficient market, unfair or dangerous
- Responsibility for compliance with these norms and standards should be put on licensed professionals: architects, builders, specialists in sanitary and fire safety etc. Thus, no approvals or permits are required

Labor Market

- Gradually, but substantially, increase the minimum wage (although taking into account the IMF's requirements on social benefits program)

Wage Deductibles

- Reduce the rates of mandatory payroll deductions: social security – 5%-7% (to the State Social Insurance Fund), minimal health insurance – 5%-7% (free choice of the insurer), mandatory pension savings – 9% (free choice of the pension fund), while introducing a ceiling for mandatory deductions
- Allow the State Social Insurance Fund to provide loans for retraining

Public Finance

- Switch to a “rolling” 3-year national budget, with annual approval of the following 3-year period and quarterly reports on expected budget implementation in the current year
- Mandate the Ministry of Finance to publish a schedule for repayment of obligations on public and publicly guaranteed debt
- Implement product/reward-based crowdfunding as a mechanism for improving efficiency of state funding. *This will allow attracting private investors, especially the residents to finance the necessary “projects” leading to a reduced burden of the state budget while being the key to appropriateness of budget spending at the same time!*

Technology in the Public Sector

- Enable online tracking of responses to citizens’ applications, including complaints
- Implement “Big Data” technologies to analyze and improve the quality of public administration
- Disclose analysis results on the implementation of reforms: what has been accomplished in terms of the previously established tasks and how, and what the findings are
- Disclose information on recruitment to civil service, financial and other incentives, performance appraisal, etc. + use the European experience and recruit candidates to civil service only after passing a qualifying test + establish a talent pool and the “pool” of civil servants based on the results of such tests
- Disclose information about all established KPIs and targets for civil servants and structural units: expectations, actual status and conclusions
- Publish minutes of “public discussions” and decisions of the authorities adopted based on the results of such discussions
- Conduct public recruiting of civil servants using modern recruiting and internet technologies

Political Powers

- Mandate political parties, presidential candidates, etc. disclose their sources of funding
- Oblige to publicly disclose information on lobbying activities
- Hold “open list” elections
- Implement the mechanisms of direct sovereignty of the people

Reorganization of Ministries

- The Ministry of Economic Development and Trade should become the Ministry of Trade; all functions related to the preparation of the state budget (“heritage” of the “Gosplan”) should be delegated to the Ministry of Finance; regulation of public procurement should be organized in accordance with the Association Agreement; by doing so, there will only remain the functions linked to the regulation of domestic and foreign trade
- Merge Tax and Customs services

Reforming Naftogaz of Ukraine

The current situation in the Ukrainian gas sector can be summarized as follows:

- Ukraine's gas market is controlled by a public monopoly – Naftogaz of Ukraine (hereinafter – Naftogaz), which manages a so-called “gas balance” for the entire country: i.e. Naftogaz provides sufficient sources of gas and its subsequent distribution.
- Naftogaz controls about 70% of domestic production and 80% of gas imports, making it a major player in the Ukrainian gas market.
- Through its subsidiaries, Naftogaz controls all main gas transportation including transit, as well as all underground gas storage facilities.
- The only segment of the gas market dominated by private capital is the segment of gas distribution supply and transport, where the majority of companies are owned by Dmytro Firtash’s “Group DF” directly or indirectly.

In fact, Naftogaz represents the entire Ukrainian gas market, and all the private companies in this sector heavily depend on it, hence they do not have much negotiating power and are forced to follow administrative decisions made by the management of this state giant.

Removing the formal aspects and looking at the heart of the question “Why the most loss-making company in Ukraine was ever created and is still functioning?”, it is possible to distinguish the following main tasks and evaluate the effectiveness of the company by looking at their performance:

1. Ensuring the adequacy of natural gas sources to meet the needs of all consumers.	Excellent. Even during the longest gas war in 2009 Naftogaz (represented by Ukrtransgaz) was able to “save” the system and prevent mass consumer cut-offs.
2. Manage all major oil and gas industry assets aiming to preserve their integrity and prevent gradual stripping.	Good. For over 15 years of operation, Naftogaz has retained most of the major assets, only losing real control over OJSC “Ukrnafta”, which is de facto controlled by the “Privat Group”, and over all the regional gas companies, which are now controlled by Firtash’s “Group DF”. These are relatively small losses compared with other industries.
3. Providing the population with cheap natural gas.	Poor. Naftogaz delegated this function to Ukraine's state budget, which funds a lion's share of the cash deficit of the above public company and the primary non-government lender – Gazprom.
4. A counterweight to Gazprom – a local monopolist against a regional monopoly.	Poor. The company has lost credibility in dealing with Gazprom while all negotiations on behalf of Ukraine were held by government and / or the President.
5. A money-making tool for the “right” individuals and businesses from the government’s point of view	Satisfactory. The amount of earnings is huge, but “related losses” are too big. Moreover, today’s inadequate decisions (especially in the area of natural gas production) result in losses of greater profits in the future).

Necessary reforms

1. Urgently enter into agreements with the European gas companies to purchase natural gas on the western border of Ukraine, which will be supplied by the existing reverse line or by swapping existing gas supply from Gazprom. Thus, the agreements should provide the opportunity of replacing Naftogaz of Ukraine as a party to the agreement with another company to be determined by the Government of Ukraine.
2. Liquidate Naftogaz of Ukraine as a company through bankruptcy. This will automatically cancel the existing agreements with Gazprom for the purchase and transit of natural gas and begin negotiations from the “scratch”. We certainly won’t get the conditions worse than we have today, since the beginning of the gas war given the recent statements of Gazprom is inevitable.
3. Create a new public holding company, which will receive all public assets, currently managed (but not owned as many believe) by Naftogaz. **NB:** When Naftogaz was created, all major assets that had been “transferred” to this company by the government were not owned but managed by Naftogaz. This makes bankruptcy of Naftogaz relatively painless from the point of view of its owner – the Government of Ukraine.
4. The new holding company will also be responsible for gas imports and for harmonizing the supply sources with consumption, serving as a classic market-maker. In this case, the right to import gas will be available to all companies that want to import.
5. Develop and adopt a new tariff scale for transporting gas through Ukraine, which will be built on the principles of full economic costs (taking into account the real cost of capital). Make an offer to everyone, especially the European companies to sign a contract with the Ukrainian gas transport system operator (Ukrtransgaz) for the transit of natural gas from the eastern border of Ukraine.
6. For the next year or two Ukraine needs to establish a fixed price limit for all the consumers of natural gas at the level of average cost of imports plus necessary expenses. In the future, when the gas market reaches normal level of competition among the suppliers, government regulation limiting the level of natural gas for all consumers should be completely abolished. Protecting low-income consumers will be implemented through the mechanism of targeted subsidies.
7. Develop and adopt a new mechanism for setting the amount of royalties for natural domestic gas, allowing to effectively remove excess profits from Ukraine’s gas production on one hand and stimulate investments of private companies in this business segment on the other. These royalties will be the main funding source of targeted subsidies for the population and public utilities.

8. Establish a modern and transparent mechanism for overseeing and monitoring tender-based procurement of materials and services in all the companies of Naftogaz using modern Internet technologies, which will allow to drastically reduce the level of corruption and the losses resulting from it. Create a single website with public access disclosing information on all major aspects of Naftogaz, except for confidential information and state secrets, and invite everyone to analyze this information in order to find inefficiencies and/or corruption.
9. Immediately start preparations for the IPO, offering at least 75% of shares of all companies that are currently owned by Naftogaz, excluding the gas transport network operator where the government should retain a share of at least 60%.

Important comment: All of the above measures will face violent resistance not only from Gazprom, but also from certain EU countries, as it will radically change the supply scheme of Russian gas to Europe. The experience of 2009 shows that in the case of “gas war”, the European companies will be willing to easily sacrifice Ukraine’s interests for the benefit of Gazprom to restore natural gas supplies from Russia.

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