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POINT OF VIEW

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VIKTOR YANUKOVYCH'S REFORMS

Sławomir Matuszak, Arkadiusz Sarna

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KEY POINTS

- Ukraine is a country in need of deep political, economic and social reform. After coming to power in 2010, Viktor Yanukovych and his government developed an ambitious and comprehensive programme of reforms across the key areas of social and political life. A return to the presidential system of government just a few months after the election allowed Viktor Yanukovych to consolidate more power than any other Ukrainian president before him. This, for the first time in years, created the ideal conditions for the introduction of deep reforms in the country.

- The constitutional changes, which have given the president complete dominance on the Ukrainian political scene, were initially seen as a step which could ease and improve the governance of the state and as a way to implement the president's reform programme. The manner in which these changes were carried out, however, was borderline illegal and consequently led to a gradual erosion of political competition, resulting in the marginalization of Ukraine's opposition parties and even the Party of Regions' coalition partners.

- Several of the planned reforms have indeed been carried out, or at least initiated. The first and the most important success achieved was the stabilisation of the public finances, following Ukraine's most serious economic crisis ever in 2009. It should be stressed, however, that this was achieved not only thanks to government policy but also thanks to the financial assistance provided by the International Monetary Fund and the overall recovery of global markets (which impact directly on the condition of the Ukrainian economy). The official goal of many of the reforms was to bring Ukrainian legislation in line with EU law, which correlated with the intense negotiations between Kiev and Brussels on an Association Agreement and the creation of a Deep and Comprehensive

Free Trade Area. The conclusion of these negotiations in 2011 was seen as a great success and a sign of the government's administrative efficiency.

- Nonetheless, most of the planned reforms have been implemented only partially or still remain in the planning stages. A new Tax Code has, as promised, simplified Ukraine's tax law, but its numerous inaccuracies have complicated the processes of doing business for small and medium-sized enterprises. The measures undertaken to reform the gas market and diversify Ukraine's energy supplies have been slow and inconsistent. The pension reform has been carried out only partially, and focused mainly on raising the retirement age. The attempts to complete land reform stalled at the stage of developing a new land market law.

- In many other areas, the government's performance has been even poorer. The authorities have failed to introduce many long-awaited and fundamental reforms in the areas of local government, municipal infrastructure and housing (the government has now been working on this legislation for eight years) and no progress has been made on the new Labour Code (which was submitted to Parliament back in 2007). The government's attempts to improve the investment climate in Ukraine, believed to be among the worst in Europe, have been equally unsuccessful. Since the welcome adoption of the Public Procurement Act in 2010, Parliament has passed a number of amendments to the document. These amendments have been aimed at excluding the compulsory use of transparent tendering procedures. Similarly, the highly publicised anti-corruption campaign has turned into a complete failure.

- The reformist zeal of Ukraine's political elite had been progressively diminishing as the parliamentary election approached and the polls showed a decline in support for both the president and the Party of Regions. During his time in

office, Viktor Yanukovych has been unable to make systemic changes, and his new powers have been predominantly used to crush his political opponents. The collapsing economy and the results of the recent parliamentary election (which effectively rule out a stable pro-presidential majority in the Verkhovna Rada) have significantly curtailed any chance of serious reform in Ukraine, at least until after the 2015 presidential election. This will further exacerbate Ukraine's political, social and economic problems, causing the country to be left far behind its Central European neighbours or even Russia.

INTRODUCTION

Ukraine's political and economic transformation after 1991 was much more difficult and happened more slowly than in the neighbouring countries across Central Europe and the Baltic region. This was partly due to the seeming lack of prospects for EU membership, seen as the main stimulus for change in Central Europe in the 1990s, and more recently also in the Balkans. Even more important, however, may have been the different socio-historical experiences of the Ukrainian people and the different mentality of their political elite. In the first few years as an independent state, following the collapse of the Soviet Union, Ukraine faced challenges on a scale unseen elsewhere in Central Europe. It witnessed the collapse of entire industries (including its heavy machinery, high technology, and arms industries), which had previously been closely linked to the economies of other former Soviet republics. With the creation of customs borders between the republics in 1991, however, all such links were suddenly severed. The Ukrainian people, accustomed to the 'big government-small society' model, were now forced to find ways to survive, with no hope of help from the state. The situation was further compounded by hyperinflation, a deep economic crisis, and the weakness of the newly independent country. The political reins in Ukraine were seized by Soviet-era bureaucrats and administrators. Their experience of governance, however, was shaped by the highly centralised model employed by the former Soviet Union, and completely unsuited to the new circumstances. These Soviet-era political circles produced the first generation of Ukrainian leaders, which might explain why the country's top political positions have never been filled by individuals with a clear vision for transformation.

It is possible to delineate periods when the reforms took on greater momentum, for example, at the beginning of President Leonid Kuchma's first term (1994-1999) and during the premiership of Viktor Yushchenko (1999-2001). But even then, the reforms were

limited in scope and were quickly abandoned due to lack of popular support, and resistance from officials and growing business groups uninterested in change. Large domestic businesses (which created the so-called oligarchs) gained unprecedented influence during Leonid Kuchma's presidency, and began to play an increasingly important role in the country's economy. On the one hand, these businesses were instrumental in spearheading the necessary privatization, on the other hand, they prevented attempts at reforming and liberalising the Ukrainian economy in line with the "Central European model" (which was seen as dangerous and overly hasty from the oligarchs point of view).

In late 2004 and early 2005, it was seemed, that the impetus for change would come from the Orange Revolution and the subsequent election of Viktor Yushchenko as president. Initially, Yushchenko enjoyed high levels of public support, and the revolution itself had raised hopes for fundamental changes in Ukraine. The five-year period following the Orange Revolution, however, proved rather disappointing with regard to political and economic transformation. The 'orange team' quickly broke up, forming two mutually opposing camps, one led by President Viktor Yushchenko, and one headed by Prime Minister Yulia Tymoshenko. This limited the government's capacity to bring about change and resulted in continuing political crises, effectively crippling the state.

Viktor Yanukovych, who won the presidential election in February 2010, quickly consolidated all political power under the Party of Regions, completely marginalising the country's opposition forces. After amending the constitution and restoring a presidential system of government in Ukraine, Yanukovych took control of Parliament and consequently became the country's most powerful political figure since independence. Furthermore, both the president and his party enjoyed a relatively high level of public support.

President Yanukovych and the Party of Regions promised not only to stabilise the situation after the chaotic rule of the 'orange

camp', but also to carry out far-reaching reform of the state apparatus. The political coalition that formed around the Party of Regions, rebranded itself as Stability and Reform. The new government had a strong mandate to carry out reforms – a real need for change could be sensed in Ukrainian society. Subsequently, in mid-2010, the president published a reform programme for 2010--2014 entitled "Wealthy society, competitive economy, effective state", which constituted the first concrete plan for comprehensive reform in years. Its broad scope attempted to address most of the challenges facing Ukraine, ranging from the stabilisation of the economy following the severe economic crisis, through changes in the energy sector and agriculture, to social issues, such as new funding rules for health care and education[1]. The two and a half years that have passed since the announcement of the programme, and the recent parliamentary elections, seen as an important milestone in Yanukovych's presidency, provide a good opportunity to take stock and evaluate the work done by the president and the Party of Regions.

This paper is an attempt to discuss the reform measures undertaken by Ukraine's new government. It should be stressed, however, that the authors do not aim to offer a detailed and comprehensive analysis of the extent to which the individual reforms have been completed; instead, the focus here is on the actions taken by the government and the observable outcomes in several key areas: changes to Ukraine's political system, the economy and the energy sector. This analysis can then be used to discuss the overall changes witnessed in Ukraine since the beginning of 2010, and an attempt will be made to answer why the reforms have been stalled, and what the future holds for Ukraine.

[1] Full version available from: Заможне суспільство, конкурентоспроможна економіка, ефективна держава. ПРОГРАМА ЕКОНОМІЧНИХ. РЕФОРМ НА 2010 - 2014 роки; http://www.president.gov.ua/docs/Programa_reform_FINAL_1.pdf

I. POLITICAL REFORMS

1. Constitutional reform

One of the conditions that made it possible for the Orange Revolution to succeed in late 2004 was Viktor Yushchenko's consent for an amendment to the 1996 Constitution, which would change the country's system of government from presidential to parliamentary-presidential. However, the changes, which took effect in 2006, removed the certainty of cooperation between the central bodies of the Ukrainian state. Although the new system left the president significantly weakened, he still wielded sufficient powers to, for instance, block the work of the government. Consequently, when an overt conflict ensued between President Viktor Yushchenko and Prime Minister Julia Tymoshenko (as well as between President Yushchenko and the then Prime Minister Yanukovych – in 2006-2007), the work of the executive was virtually paralysed. The problem later spilt outside the arena of Ukraine's domestic politics. Throughout this period, Kiev pursued two parallel foreign policies: one coordinated by the Ministry of Foreign Affairs, controlled by the president, and the other, shaped by the deputy prime minister for foreign relations. On many occasions this had rather embarrassing consequences for Ukraine in its dealings with other countries[2].

After 2004, the Ukrainian political elite was aware of the need to reform the country's political system, but could not agree on the direction of these changes. Some politicians argued for the restoration of the presidential system. Among the strongest proponents

[2] For example, during a meeting of the Ukraine-NATO Commission in Brussels, 5 March 2009, attended by Ukraine's acting Foreign Minister Volodymyr Khandogiy. Deputy Prime Minister Hryhoriy Nemyria also travelled to Brussels but he was not allowed to enter the room since the Ukrainian delegation was officially headed by Khandogiy; Огрызко рассказал, как Немырю унизили в штаб-квартире НАТО, Униан, 16.03.2009, http://www.unian.net/news/306014-ogryizko-rasskazal-kak-nemyiryu-unizili-v-shtab-kvartire-nato.html

of strong presidential powers was Yulia Tymoshenko. Before the constitutional amendments came into force in 2006, Tymoshenko urged Yushchenko to ignore them. The Party of Regions also proclaimed the need to return to a presidential system, and during the presidential election campaign in 2010, announced plans to restore the 1996 version of the constitution. Meanwhile, other political groups (including the Communist Party of Ukraine) were in favour of reforms that would further limit presidential powers and increase the powers of Parliament.

After Yanukovych's victory in the 2010 presidential election, it was not clear whether he would be able to take full political control of the country. At the time, Tymoshenko still served as prime minister, and enjoyed extensive powers granted to the Prime Miinister by the 2004 amendment to the constitution, and the Ukrainian parliament was dominated by a majority coalition formed around the Yulia Tymoshenko Bloc (BYuT). Many political commentators believed at the time that the political deadlock would continue, even if Yushchenko was replaced by Yanukovych. The situation however unexpectedly changed. In early March 2010, Verkhovna Rada altered the rules under which political parties could form coalitions, by scrapping the previous requirement that coalitions could only be formed by whole parliamentary factions[3]. This enabled the dissolution of Tymoshenko's government and the appointment, in March 2010, of a new cabinet led by Mykola Azarov. The change to the parliamentary regulations was introduced even though it violated a 2008 ruling of the Constitutional Court which explicitly prohibited individual MPs from joining parliamentary coalitions. In April 2010, however, the Constitutional Court issued a new ruling that permitted the practice. The Party of Regions was able to convince 17 MPs from Our Ukraine and the BYuT, as well as the Volodymyr Lytvyn Bloc and

[3] "The Ukrainian parliament's new procedural rules pave the way to the formation of a new coalition", *EastWeek*, OSW, 10/03/2010, http://www.osw.waw.pl/en/publikacje/eastweek/2010-03-10/ukrainian-parliaments-new-procedural-rules-pave-way-to-formation-a-ne

the Communists, which was sufficient to give it a majority in parliament[4]. Putting an end to several years of cohabitation paved the way for a more effective government, but Yanukovych decided to introduce changes that would grant him political monopoly in the country. Since the Party of Regions did not have enough votes to carry out constitutional reform (i.e. at least 300 votes), it decided to use Ukraine's Constitutional Court to achieve its goals. In October 2010, the Court reversed the 2004 constitutional reform (even though in 2008 the Court refused to consider a similar motion) claiming that the changes had been carried out unlawfully, and thus restored the 1996 constitution[5]. A few months later further changes to the constitution were introduced, including a move to extend the parliamentary term from four to five years[6].

Changes to Ukraine's system of government have contributed to the strengthening of presidential powers to an extent that gave opposition politicians grounds to accuse Viktor Yanukovych of authoritarianism. Serious concerns have also been voiced over the very manner in which the changes were introduced. Amendments to the constitution are not a result of a consensus reached by Ukraine's main political parties, but on the basis of a decision of the Constitutional Court, only five years after the reform was implemented. It is important to note that the Constitutional Court is an institution that enjoys little public trust in Ukraine, and few people believe in its independence. And although no laws have actually been broken, there is little doubt that laws have been bent. On the other hand, it is clear that the constitutional amendments introduced after the Orange Revolution have 'spoiled' Ukraine's

4 Рада призначила новий уряд: список міністрів, 11/03/2010, ТСН, http://tsn.ua/ukrayina/rada-priznachila-novii-uryad.html

5 The concerns raised by the Constitutional Court, regarding the manner in which the 2004 changes were made, were well-founded. For more, see Ukraine's Constitutional Court reinstates presidential system, *EastWeek*, OSW, 06/10/2010, http://www.osw.waw.pl/en/publikacje/eastweek/2010-10-06/ukraine-s-constitutional-court-reinstates-presidential-system

6 In this case, the Party of Regions easily found 300 votes, as many of the MPs were worried they might not be able to return to Parliament after election.

constitutional system and have consequently become one of the main causes of the current paralysis of the country's executive, preventing any real reform during Yushchenko's presidency. Ukraine's 1996 constitution, restored in 2010, provides for a more transparent relationship between government agencies and allows for more effective governance. This is likely to be the main reason why the West raised no serious criticism about the manner in which the constitutional amendments had been reversed.

2. Administrative reform

Following the changes to Ukraine's system of government, the authorities planned to carry out deep administrative reform, reducing bureaucracy (including a significant reduction in the number of civil servants) and streamlining the functioning of the state. In December 2010, President Yanukovych reduced the number of ministries from twenty to sixteen; he also cut the number of deputy prime ministers from six to three, and significantly increased the responsibilities of those who kept their posts. A number of central government bodies were closed down, but over a dozen new services and government agencies were created[7].

At the moment, it is difficult to say whether the reform has managed to reduced central government's operating costs; it is clear, however, that in most cases the changes were merely cosmetic. Many individuals have been moved to other posts, some offices were entirely eliminated by combining them with others; many other departments have been renamed. Despite the changes, the government has failed to significantly reduce the number of civil servants[8] and it is hard to talk about qualitative changes or increased efficiency of the respective ministries.

[7] УКАЗ ПРЕЗИДЕНТА УКРАЇНИ № 1085/2010 Про оптимізацію системи центральних органів виконавчої влади, Президент України Віктор Янукович – Офіційне інтернет-представництво, http://www.president.gov.ua/documents/12584.html

[8] For example, the number of redundancies inside the Tax Office reached 11%

The government "advertised" the above changes as the first stage of a large administrative overhaul, which would lead to the decentralisation of power and be linked to a long overdue local government reform[9]. However, despite being a long-standing slogan of the ruling Party of Regions, the changes to local government in Ukraine have remained in the drafting stage for years. Meanwhile, the form of government adopted by President Yanukovych has been leading to further centralisation of power, limiting the already weak decision making powers of the country's regions and local councils.

In effect, the administrative reform announced by Yanukovych has been little more than a reorganisation of central government bodies. Many of the acts adopted by Parliament to pave the way for the aforementioned reforms have been criticised as unconstitutional (including, the so-called Cabinet Bill of 7 October 2010, which gives the president powers to appoint even deputy ministers and deputy heads of other central government bodies). Together with the earlier changes to the constitution, these laws were another step towards even greater centralisation of power and extension of presidential prerogatives[10] (under current law, the president also appoints the heads of hundreds of regional and local governments).

instead of the 30% requested by the president. ГНСУ лишь на треть выполнила план по сокращению аппарата, *Зеркало недели*, 11/02/2012, http://news.zn.ua/ECONOMICS/gnsu_lish_na_tret_vypolnila_plan_po_sokrascheniyu_sotrudnikov-97168.html
According to Ukraine's Civil Service Agency, at the end of 2011 the number of civil servants was reduced to 268,100 from 279,500 at the end of 2010. See: ДЕРЖАВНА СЛУЖБА В ЦИФРАХ 2012, http://issuu.com/faina/docs/ds__v_c2012?mode=window&pageNumber=6

9 See: Урядовий Кур'єр, Спеціяльний Випуск, 31.05.2012: Адміністративна реформа: нова архітектура держуправління і територіальної організації влади: http://ukurier.gov.ua/media/documents/2012/05/30/adminspez.pdf

10 See: Административная реформа, или Обратно в СССР, *Зеркало недели. Украина*, №5, 11 февраля 2011, http://zn.ua/POLITICS/administrativnaya_reforma,__ili_obratno_v_sssr-75351.html

Finally, a series of personnel changes made inside the cabinet during Ukraine's 'administrative reform' have allowed Yanukovych to complete his plan to monopolise political power in the country. His decision to remove from the cabinet the representatives of the Party of Regions' coalition partners (the Communist Party of Ukraine, and particularly, the Lytvyn Bloc) was another clear sign of effective marginalisation of the role of coalition partners.

3. Anti-corruption measures

Among the pledges made by the Party of Regions during the presidential election campaign was the introduction of effective anti-corruption measures in Ukraine. Although the president's reform programme for 2010-2014 did not specifically address this issue, the campaign pledge was delivered when the Verkhovna Rada passed a law on preventing and combating corruption in April 2011 – which was subsequently signed into law by the president on 7 June 2012[11]. On the same day, the president also signed a bill that paved the way for a series of amendments to existing legislative acts on criminal responsibility for acts of corruption.

Between 2010 and 2011, the new measures allowed prosecutors to bring high-profile corruption charges against several politicians and hundreds of minor government officials. The anti-corruption zeal was relatively strong at the start of Yanukovych's presidency, but as is often the case, it dwindled rather quickly. The most likely reason for this is that in countries where corruption is rife at all levels of government and public administration, a strict implementation of anti-corruption measures can upset the system, leading to high levels of discontent among rank and file officials

[11] The law has increased the scope of such inspections; a greater number of officials are now monitored, and new restrictions have been added (for example, civil servants are no longer permitted to accept "gifts" from individuals or businesses). The legislators have also introduced compulsory annual asset declarations for officials – which now also monitor expenses.

and party members, whose loyalty is essential to Yanukovych's presidency.

The two most publicised arrests were those of Party of Regions activist, Anatoliy Hrytsenko, and the head of the State Commission for the Regulation of Financial Services Markets, Vasyl Volha. In Hrytsenko's case, the arrest was orchestrated by a group of his political opponents within the Party of Regions[12], and although Volha was officially charged with accepting a bribe of $500,000[13], it is likely that his arrest was also a result of competition between individual business groups. An additional motive for both arrests was to show that the fight against corruption in Ukraine was not directed only at the government's political opponents.

No investigations were launched by Ukraine's law enforcement authorities, however, concerning a series of scandals which surfaced after Yanukovych came to power. Media reports often highlighted highly suspicious relations between top Ukrainian politicians and businessmen, unfair tendering processes, and other practices which led to the loss of billions of hryvnia in state budget revenue. Among the key figures mentioned in such reports were Deputy Prime Minister and Infrastructure Minister, Borys Kolesnikov (regarding tenders ahead of EURO 2012), former Deputy Prime-Minister and current secretary of the Council of National Security and Defence of Ukraine, Andriy Klyuev (regarding the use of EU funds to develop his own business), and Energy Minister, Yuriy Boyko (regarding the purchase of oil rigs at a significantly inflated cost[14]). Based on the media reports alone, it is im-

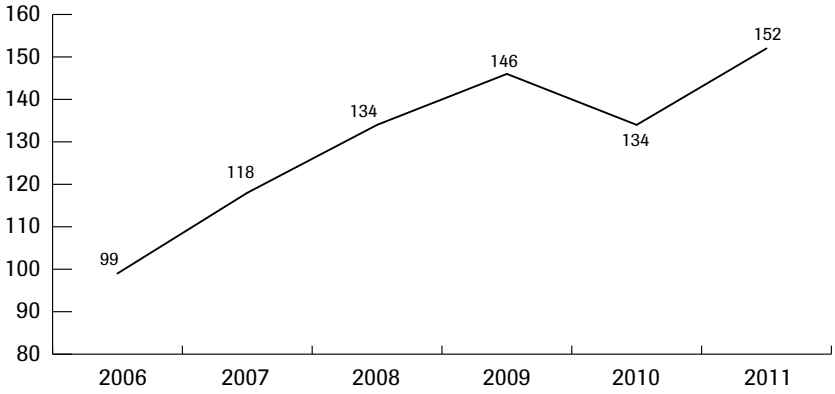
[12] Party of Regions activist arrested in Crimean, *EastWeek*, OSW, 02/02/2011, http://www.osw.waw.pl/pl/publikacje/tydzien-na-wschodzie/2011-02-02/aresztowanie-krymskiego-dzialacza-partii-regionow

[13] Ильченко Александр, Рафал Анастасия, Волге шьют взятку на полмиллиона долларов, *Сегодня*, 20.07.2011, http://www.segodnya.ua/news/1426-9556.html

[14] The first oil rig cost the state-owned Naftogaz $400 million, despite its market value of approximately $250 million.

possible to determine whether the politicians were in fact guilty of these charges, but the lack of any official response from the prosecutor's office or the Security Service of Ukraine might suggest that the authorities are not interested in investigating cases of alleged corruption among Ukraine's top state officials.

Figure 1. Corruption Perceptions Index, Ukraine



Source: Transparency International

The continued lack of effective anti-corruption measures in Ukraine has translated into the country's performance in international corruption perceptions rankings. In the 2011 Transparency International Corruption Perceptions Index, Kiev ranked 152nd out of 183 countries, receiving just 2.3 out of 10 points[15]. As shown in Figure 1, the situation has been steadily deteriorating since 2006, when Ukraine recorded its best result ever. It is clear, however, that corruption has been a big problem not only for the current government but for previous administrations also, as Ukraine's performance in Transparency International's ranking began to fall in the days of the "Orange" government. A small improvement in Ukraine's performance in 2010 was due to the anti-corruption campaign launched by the then new government;

[15] http://www.transparency.org/country#UKR_DataResearch

nonetheless, as the campaign proved to be more about propaganda than real change, this upward trend was short lived.

Nevertheless, the index compiled by Transparency International does not measure the real level of corruption in the country but only public perception of this phenomenon. Reports produced by other organisations, however, are equally damning. A study carried out by the Organization for Economic Cooperation and Development (OECD), for instance, described Kiev's progress between 2008-2011 as negligible. The OECD report presented an evaluation of the Ukrainian reforms as part of a larger project developed under the Istanbul Anti-Corruption Action Plan. According to this report, Ukraine had managed to meet only one of the twenty-four recommendations made by the OECD. In a separate report covering twenty-five European countries, Ernst & Young put Ukraine last but one, ahead only of Russia. As many as 91% of businesses reported that bribery was commonplace in Ukraine. More than half of them (55%) believed that in 2011 the situation had got even worse. Similarly, the European Business Association[16], which measures corruption levels in terms of the total cost of bribes to individual businesses in relation to their total revenue, reported that between 2008 and 2011 corruption had increased by almost 70% and companies were now spending up to 10% of their income on bribes[17].

Some legislative measures, such as the Public Procurement Act, which introduced a relatively transparent system of bidding for government contracts, have been positively assessed in the West. However, the Verkhovna Rada has gradually introduced a series of exemptions to the bidding process, thus creating conditions for large-scale fraud. On 1 August 2012, the president signed an

[16] Ukraine's largest organisation representing the interests of foreign investors in the country.

[17] http://zn.ua/ECONOMICS/investklimat_vesna_otkladyvaetsya-100872.html

amendment to the Public Procurement Act, which repealed the mandatory tendering procedures for state-owned companies.

Interestingly, the authorities are well aware of the scale of corruption and the damage caused by it. In the spring of 2012, the Ministry of Justice produced a special report on corruption in Ukraine, in which it acknowledged that the corrupt practices had remained at a consistently high level for 10 years and affect virtually all spheres of life. The document also highlighted that for 83% of Ukrainians, corruption has become a fact of life[18]. In his address to the nation earlier this year, President Yanukovych also noted that bureaucratic inertia and corruption were the two major obstacles to Ukraine's modernisation efforts[19].

[18] Юлия Рябчун, Во взятках несчастье. Минюст отчитался об уровне коррупции в Украине, *Коммерсант-Украина*, 18.04.2012, http://www.kommersant.ua/doc/1918091

[19] Януковичу-реформатору заважають «інертні, корумповані бюрократи», Униан, 03.07.2012, http://www.unian.ua/news/512577-yanukovichu-reformatoru-zavajayut-inertni-korumpovani-byurokrati.html

II. ECONOMIC REFORMS

1. Macroeconomic stabilisation

Ukraine's economy remains heavily dependent on the exports of low-processed products, particularly steel products and iron ore, which account for 30-40% of the total value of Ukrainian exports. These types of products are very sensitive to fluctuations in world markets. Neither Leonid Kuchma's government, nor the new political leaders who came to power after the Orange Revolution, did much to change the structure of the country's economy, even though this was a period of economic growth in the world, which also translated into rapid growth in Ukraine.

The negative consequences of excessive reliance on foreign economic trends became particularly clear after the 2008 global financial crisis, whose ripples reached Kiev several months later. In 2009, Ukraine's economy collapsed, with GDP figures plummeting by almost 15%. This was caused mainly by a combination of factors described earlier. Some of the responsibility though also lay with the then Prime Minister Yulia Tymoshenko, whose populist policies, pursued in the midst of an election campaign, had a particularly negative impact on local businesses and the banking sector. Following Kiev's failure to meet its obligations, the International Monetary Fund decided to suspend its cooperation with Ukraine in November 2009.

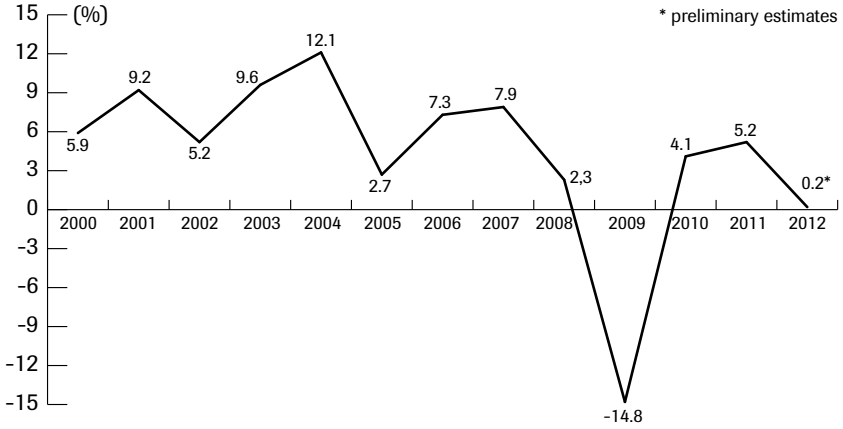
Mykola Azarov's government, which came to power in March 2010, was able to stabilise Ukraine's economy quite quickly. It should be noted though that Azarov was aided in this task by an economic upturn in Ukraine's major export markets that started in the second half of 2009, and the assistance Kiev received from the IMF. In 2010, the government resumed its cooperation with the IMF and was granted a credit line of $15.1 billion. IMF's support for Ukraine and favourable ratings by credit rating agencies allowed the government in Kiev to attract funds from abroad.

Thanks to an upward trend in global markets, Ukraine's growth reached 4.2% in 2010 and 5.2% in 2011. The Azarov government also managed to reduce the budget deficit to 1.4% of GDP. The economic revival did not last long, however, and in 2012 Ukraine's economy began to slow down (see Figure 2).

The IMF loans for Ukraine were granted on the condition that Kiev would carry out a series of reforms. In 2010, the government met most of the conditions set by the IMF with regard to budget stability, monetary policy and changes to tax law. Other conditions included raising the retirement age for women and increasing gas tariffs for individual consumers to reflect the market prices of gas. Although (after much hesitation) the authorities eventually agreed to press ahead with state pension reform (more on this in subsection Pension reform), the government kept delaying the agreed gas price hike. This subsequently prompted the IMF to suspend the disbursal of the remaining loan instalments at the end of 2010[20]. The government's reformist zeal was further blunted in late 2010 by the largest wave of protests to sweep Ukraine during Yanukovych's presidency, sparked by the reform of Ukraine's tax law (see subsection "Tax reform").

[20] Sławomir Matuszak, "Ukraine's cooperation with the IMF – unfulfilled hopes for deeper reforms", OSW Commentary, 15/06/2011, http://www.osw.waw.pl/en/publikacje/osw-commentary/2011-06-15/ukraines-cooperation-imf-unfulfilled-hopes-deeper-reforms

Figure 2. Ukraine's GDP growth rate between 2000-2012



Source: The Ukrainian Office for National Statistics

After the IMF suspended its cooperation with Ukraine, the government in Kiev began to struggle to service its national debt. Although Ukraine's national debt level remains relatively low, especially when compared with most EU countries (36% of GDP at the beginning of 2012; but 16 percentage points higher than in 2008), the problem lies in the fact that much of Ukraine's national debt is short-term debt. Kiev's falling credit rating means that government bonds have very high interest rates (an average of 14% for domestic holders). In the last two quarters of 2012, Ukraine's economic downturn has turned into a full-blown recession[21], raising concerns about the solvency of the Ukrainian state in 2013, with its highest foreign debt repayments and servicing charges in years[22]. Given the deteriorating relations between Kiev and the West (where economic problems are also quite serious), Russia might turn out to be the only country willing to help Ukraine.

[21] Arkadiusz Sarna, "Ukrainian economy on the verge of recession", OSW Commentary, 21/11/2011, http://www.osw.waw.pl/en/publikacje/osw-commentary/2012-11-21/ukrainian-economy-verge-recession

[22] In 2013 the Ukrainian government will have to pay on this account about $9 billion. See: http://www.kmu.gov.ua/control/uk/publish/article?art_id=245876222&cat_id=244823857

In the past, Moscow has on several occasions provided financial assistance to the government in Kiev, and in contrast to the IMF, its loans have never been conditional on the implementation of unpopular reforms[23].

Meanwhile, Kiev has also been facing a series of other challenges. Ukraine's grey economy, for instance, has been estimated at 40-60% of the country's GDP. And although both the current and the previous governments have pledged to reduce it, in practice this has entailed an increase of the tax burden on small and medium-sized businesses (while offering preferential conditions for big business linked to Viktor Yanukovych), thereby provoking many SMEs into evading their tax liabilities. Directly affected by the global economic crisis, Ukraine's banking sector has been described by international financial institutions as the weakest in the region. Although in the first half of 2012, local banks posted the first profit in three years ($210 million), the sector is still struggling with high levels of bad loans[24]. The instability of Ukraine's banking sector is further compounded by low levels of trust among their customers, which could easily turn into panic and a mass withdrawal of deposits.

2. Tax reform

In the autumn of 2010, the Verkhovna Rada adopted Ukraine's new Tax Code, consolidating into a single document all the individual tax regulations previously contained in various statutes. Ukraine's previous tax laws had been described as among the most complex in the world, and in the World Bank's 2010 Doing Business report, Ukraine's tax system was ranked 181st in the

[23] Sławomir Matuszak, "Ukraine is becoming dependent on Russian loans", *EastWeek*, OSW, 04/04/2012, http://www.osw.waw.pl/en/publikacje/east-week/2012-04-04/ukraine-becoming-dependent-russian-loans

[24] Елена Губарь, Банки накопили проблем, *Коммерсант Украина*, 06.08.2012, http://www.kommersant.ua/doc/1996123

world (out of 183)[25]. The new tax code has reduced the number of state taxes from 29 to 18, while the number of local taxes has dropped from 14 to 5. The corporate income tax rate has been cut from 25% in 2010 down to 21% in 2012 (towards a target of 16% by 2014 – which will make it the lowest in Europe). The new tax code has also created two tax bands for individual taxpayers at 15% and 17%, although one of its most important innovations has been the introduction of automatic VAT refunds for businesses. This provision is the first serious attempt in years to tackle Ukraine's national debt towards local businesses, which resulted from overdue VAT refunds. (The government addressed the problem by issuing its debtors with so-called VAT-bonds in summer 2010).

Although the new Tax Code simplified the country's tax rules, it sparked violent demonstrations by small businesses (the so called Tax Maydan action), which were attended by tens of thousands of people[26]. The largest opposition was voiced to the abolition of a lump-sum tax and the introduction of restrictions on the use of simplified taxation. The Tax Code also significantly increased the powers of tax inspectors dealing with businesses. The new law was also accused of favouring big business, although it would be fairer to say that the lawmakers simply chose not to increase the tax burden on large companies any further.

It is hard to provide a clear evaluation of the Tax Code, especially since hundreds of amendments have already been made to the document, and proposals for further changes are continuously being put forward. The new tax law does indeed increase the tax burden on small and medium-sized businesses, but it should be noted that the previous rules on a lump-sum tax actually fuelled

[25] http://www.doingbusiness.org/~/media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB10-FullReport.pdf

[26] Mass protests by Ukrainian entrepreneurs against a new tax law, OSW, *East-Week*, 17/11/2010, http://www.osw.waw.pl/en/publikacje/eastweek/2010-11-17/mass-protests-ukrainian-entrepreneurs-against-a-new-tax-law

tax avoidance. The main positive outcome of the reform is the codification of the Ukrainian tax law, which allows for greater transparency.

3. Pension reform

Although the Ukrainian state pension is relatively low, pension spending remains a heavy burden on the country's budget, with the Ukrainian Pension Fund permanently in the red. In 2011, the Pension Fund's deficit reached $3.8 billion, which amounted to nearly 10% of the Ukrainian budget[27]. In addition, as mentioned previously, the issue of pensions for women was one of the main stumbling blocks in Kiev's negotiations with the IMF. Before the reform, the state pension age for men was 60 and 55 for women, making it among the lowest in the world. The average life expectancy of people reaching retirement age, meanwhile, was 62 for men and 80 for women[28].

It came as no surprise that the Party of Regions tried its hardest to avoid making such an unpopular decision. In September 2011, however, after months of preparation, the Verkhovna Rada finally passed a pension reform bill that increased the state pension age for women from 55 to 60[29]. The MPs also limited the maximum size of the state pension to ten times the minimum wage (currently, the equivalent of $955 dollars). The restrictions, however, will apply only to new pensioners, while existing pensions

[27] Дефіцит Пенсійного фонду за 2011 рік перевищив 30 млрд.грн., 16.03.2012, http://news.liga.net/ua/news/economics/627778-def_tsit_pens_ynogo_fondu_za_2011_r_k_perevishchiv_30_mlrd_grn.htm

[28] http://www.worldlifeexpectancy.com/country-health-profile/ukraine In Ukraine, the average life expectancy for men remains low at 62, the average life expectance for women is 74; http://www.who.int/countries/ukr/en/

[29] The government has also extended the minimum contribution period for the basic earnings-related pension, from 20 to 30 years for women and from 25 to 35 years for men. While, the minimum contribution period for the basic state pension (set at 50% of the minimum SERPS pension) has been extended from 5 to 15 years.

exceeding this amount will remain unchanged. The new pension rules took effect from 1 October 2011, although a three-year transition period was introduced during which women can choose whether they want to take early retirement on less favourable terms, or take advantage of the new rules[30]. The reform has been welcomed by a number of international financial organisations (including the EBRD).

In practical terms, the reform has raised the state pension age and increased the period of contribution, but has not changed the pension system itself. Of interest here will be the planned launch of occupational pensions and private pension funds, which would undoubtedly create conditions for the development of the Ukrainian financial market and would generate capital that could be used for domestic investment. Although the pension reform bill does provide for the introduction of occupational pensions, it is difficult to predict when such a scheme could be rolled out. The two-year timeframe initially proposed by the legislators has become completely unrealistic due to the current economic situation and the state of public finances in Ukraine. Under these proposals, contributions to occupational pension schemes[31] were to be charged from the moment the state managed to balance the budget of the state Pension Fund. So far, however, any attempts to reduce its deficit have been unsuccessful; in mid-2012 the government took the decision to increase the deficit from $0.9 billion to $2 billion[32].

[30] Новая пенсионная реформа в Украине: на ком хотят сэкономить?, Mojazarplata.com.ua, 24.08.2012, http://mojazarplata.com.ua/ru/main/work-legislation/novaja-pensionnaja-reforma-v-ukraine-na-kom-hotjat-sekonomitq

[31] Starting at 2% of monthly earnings, with an annual 1% increase, up to 7%. Initially, the contributions would be administered by the state-run Pension Fund, and after two years – following the launch of private pensions – contributions could be transferred to private pension funds.

[32] Дефицит Пенсионного фонда Украины будет увеличен почти в два раза, *Корреспондент.net*, 19.07.2012, http://korrespondent.net/business/economics/1362086-deficit-pensionnogo-fonda-ukrainy-budet-uvelichen-pochti-v-dva-raza

In 2012, the Ukrainian authorities also failed to adopt a new Labour Code. A draft of the Code was submitted to Parliament back in 2007 and successfully passed first reading a year later; in September 2012, however, the bill was taken off the parliamentary agenda. Consequently, the repeatedly amended 1971 Labour Code adopted by the Verkhovna Rada of the Ukrainian Soviet Socialist Republic still remains in force.

4. Investment climate

Each new Ukrainian government announces measures aimed at improving the country's investment climate, hoping to obtain the foreign capital necessary to modernise the country. In the aftermath of the Orange Revolution, during a period of economic boom in Ukraine, several large Western investors entered the country, especially in the banking and the steel sectors. This did not mean, however, that investment conditions were attractive. Foreign investors complained about corruption, bureaucracy and a complex legal system and selective application of the law.

Improving the investment climate in Ukraine was therefore one of the most important aspects of Yanukovych's economic reform programme. Two years later, it is clear that the government has failed completely in this area. Compared to 2010, Ukraine has slipped in almost all the rankings of economic freedom and investment conditions[33]. A survey of foreign companies operating in Ukraine, conducted by the European Business Association, suggests that the investment climate in the country is worse now than during the economic crisis of 2009.

In order to improve the situation, however, Ukraine does not necessarily need new legal frameworks but rather a complete overhaul of its business practices. A common problem faced by companies operating in the country is the behaviour of various local

[33] See: Sławomir Matuszak, Oligarchic democracy, OSW Studies, p.60.

control institutions, that issue permits and licenses, the law enforcement agencies, or even the local secret service officers, who use their positions to extort bribes from businesses. In addition, state agencies are often used to remove unwanted business competitors from the market. Unable to seek justice in the highly corrupt local courts, most businesses have no choice but to pay the bribes. The investment climate has also been adversely affected by the increasing anti-market tendencies in Ukraine's economic policy, for example with regard to privatisation[34].

In the long term, some improvement could come from the implementation of the 2011 Deep and Comprehensive Free Trade Area (DCFTA) agreement negotiated between Kiev and the European Union (initialled on 19 July 2012[35]). It is believed that thanks to the implementation of some parts of the EU's acquis communautaire, the DCFTA should help create a better business environment in Ukraine. However, despite Kiev's success in completing these negotiations, at present the signing and the ratification of an Association Agreement (of which the DCFTA is an integral part) seem rather unlikely. Further progress on the EU-Kiev agreements will depend primarily on a lasting solution to Ukraine's internal political problems, which were the reason for the EU's decision to freeze the process of signing and ratifying these deals.

[34] Over the past two years, privatisation in Ukraine focused mainly on electricity companies and the natural gas distribution sector. In both cases, winning bids were often unofficially announced before the bidding process was closed. Consequently, Ukraine's big business (with close links to the president) monopolised both sectors (Rinat Akhmetov took control of the electricity sector; while Dmytro Firtash bought up Ukraine's gas distribution networks).

[35] Rafał Sadowski, "The prospects for the EU-Ukraine free trade agreement", OSW Commentary, 18/10/2012, http://www.osw.waw.pl/en/publikacje/osw-commentary/2012-10-18/prospects-euukraine-free-trade-agreement

5. Land market reform

Ukraine has some of the most fertile soils in the world and a climate favourable to agriculture. So far, however, the food and agricultural sector has not contributed to the Ukrainian economy on a scale reflecting its potential. One of the obstacles to its development has been the long-lasting land reform, particularly with regard to land ownership and the possibility of unrestricted sale and purchase of agricultural land. Consecutive Parliaments have voted to extend the moratorium on the free sale of agricultural land. Regardless of the political opposition, mostly based on the negative social perception of agricultural reforms, the extension of the moratorium has been justified by the lack of legal and institutional frameworks that would allow unrestricted sale of land. As a result, the development of agriculture in Ukraine has been based on the leasing of land from small landowners (namely, villagers who, in the 1990s, were given ownership of so-called "Pai" holdings, that is, small plots of land inherited from Ukraine's now dismantled collective farms). Farmland lease agreements have enabled the creation of large-scale farms and agricultural companies, some of which now control hundreds of thousands of hectares of agricultural land. It has been estimated that Ukraine's twenty largest agricultural companies are currently leasing an area equal to the size of Belgium[36]. The creation of "super farms" in Ukraine is a characteristic feature of the way in which this sector has been developing since the 1990s, and it also sets out the likely direction of its further development.

President Yanukovych's government has announced plans to complete the land reform and introduce civilised rules for the sale and purchase of agricultural land. This announcement was partly the result of pressure from the farming lobby, which seeks to

[36] Составлен рейтинг самых крупных землевладельцев Украины, lb.ua, 15.07.2012, http://economics.lb.ua/food/2012/06/15/156433_sostavlen_reyting_samih_krupnih.html

legalise its "super farms", and partly because Ukraine's left wing parties (the most vocal opponents of the reform) have gradually lost their influence. In addition, although the Ukrainian society is split on the issue (roughly in half), it seems that the reform attracts less controversy than in the 1990s. Significant progress was made with the passing of the Land Register bill in August 2011, which introduced a simplified mechanism for the keeping of land records[37]. The land registration process is expected to be completed by 2015. Meanwhile, Parliament has received a draft bill on the land market, which, if passed, would create the legal basis for the introduction of unrestricted sale and purchase of farmland in Ukraine – this is the last of the bills, without which a free land market could not be established. Under the proposed law, Ukrainian farmland could only be purchased by Ukrainian nationals, although foreign investors would be allowed to lease agricultural land from local freeholders. The bill also includes a series of restrictions aimed at hindering market speculation and over-concentration of land ownership (for example, through the levying of high taxes on sales within five years of purchase)[38]. The bill was successfully passed at first reading in December 2011, but despite plans to move it forward, its second reading was not scheduled before the 2012 parliamentary elections. The plans to permit land sale in Ukraine have attracted criticism from a number of political parties. Among the main opponents of the reform have been the national-democratic political forces, as well as the Communists, who in the 2007-2012 Parliament helped form the ruling coalition and are also now seen as potential allies of the ruling Party of Regions in the newly elected Verkhovna Rada. The work on bill has also come under a fair amount of pressure from the different lobbies trying to affect the final shape of its individual provisions.

[37] "Towards the introduction of free land trade in Ukraine", *EastWeek*, OSW, 10/08/2011, http://www.osw.waw.pl/en/publikacje/eastweek/2011-08-10/towards-introduction-free-land-trade-ukraine

[38] ВР приняла в первом чтении закон о земле, Униан, 09.12.2011, http://www.unian.net/news/473413-vr-prinyala-v-pervom-chtenii-zakon-o-zemle.html

Consequently, the Party of Regions has decided to postpone the vote on the bill until after the parliamentary elections (held on 28 October 2012). On 20 November 2012, however, the Verkhovna Rada voted to once again extend the moratorium on the sale and purchase of agricultural land – this time until 2016. The prospect of completing the Ukrainian land reform in the near future has become rather unrealistic.

III. ENERGY SECTOR

1. Gas sector reform

One of the main causes of Kiev's financial difficulties has been the high price of natural gas imported from Russia – the source of about two thirds of all gas consumed in Ukraine. The current pricing formula used by the Russians, however, is based on the 2009 gas contracts signed by former Ukrainian Prime Minister Yulia Tymoshenko. The other important reason why the state-owned Naftogaz has been making a loss and requires heavy subsidies from the state budget[39] has been insufficient transparency and the lack of reforms in the Ukrainian gas sector.

Although any change in the pricing formula would require a renegotiation of the current contracts, a reform of Ukraine's gas sector depends entirely on the will of the government in Kiev. Furthermore, given that approximately 75% of the EU's gas imports are transported through Ukraine, Brussels is also interested in helping to create a transparent gas market in the country. To this end, Brussels has suggested that Kiev adopt the EU's internal regulations on the energy sector. The first document paving the way for such cooperation was adopted by Tymoshenko's government back in March 2009. At the time, the EU and Ukraine signed the so-called Brussels Declaration, in which the EU endeavoured to guarantee that international financial institutions would provide the funding for the modernisation of the Ukrainian gas pipelines, as long as Ukraine agreed to reform its gas sector. However, due

[39] The exact budget deficit at Naftogaz is hard to estimate. The 2011 figure stood at $2.5 billion, while the 2012 estimates range from $1.5 billion (according to the government) to as much as $5.7 billion (according to some experts).
See: Бойко нашел способ уменьшить дефицит «Нафтогаза», lb.ua, 11.06.2012, http://economics.lb.ua/state/2012/06/11/155594_boyko_nashel_sposob_umenshit_defitsit.html
and, http://www.rbc.ua/rus/finance/show/v-2012-g-defitsit-naftogaza-sostavit-47-mlrd-grn---analitiki-27042012173400

to the outbreak of the economic crisis in Ukraine and the start of another election campaign, the government in Kiev never even started the reforms.

Later, Yanukovych's government did implement some changes that brought Ukraine's gas sector regulations in line with EU standards. In July 2010, for example, the president signed into law a bill reforming the national gas market, which included legal provisions for the separation of extraction, transportation and sales into different financially and legally independent companies. In addition, in February 2011, Kiev joined the Energy Community (EC)[40]. Despite the obligations stemming from Ukraine's membership of this organization and the earlier adoption of the gas market law, Kiev took its time before implementing any of the changes. In fact, the first real change did not come until 2012. In April of last year, Parliament adopted amendments to the Ukrainian law on pipeline transport, removing an earlier ban on the restructuring of Naftogaz and its subsidiaries involved in gas transit. Under the amendments, changes to the structure of the group can now be made by the government without Parliament's approval. The amended law, however, keeps in place the earlier restrictions on the privatisation of those parts of the Naftogaz group which are responsible for transit (namely, the pipelines carrying Russian gas to the rest of Europe). In June 2012, the government separated from Naftogaz two of its subsidiaries: Ukrtranshaz responsible for transportation, and Ukrgazvydobuvannya focusing on extraction. And finally in autumn 2012, Naftogaz lost its monopoly

[40] An organization established in 2005 to create a common energy market under EU regulations. Its members include the EU member states, seven Balkan states, as well as Ukraine and Moldova. Kiev has agreed to adopt EU regulations (the so-called third energy package) by January 2015).
See: Wojciech Konończuk and Sławomir Matuszak, "Ukraine & Moldova and the Energy Community", *EastWeek*, OSW, 28/03/2012, http://www.osw.waw.pl/en/publikacje/eastweek/2012-03-28/ukraine-moldova-and-energy-community

on the import of gas to Ukraine (introduced in 2008 by Yulia Tymoshenko's government).

The legislative changes do not however indicate the future direction of the gas sector reform. The Ukrainian government claims that the reform will be carried out in accordance with the requirements of the Energy Community, although Russia will undoubtedly play an important role in this reform. Yanukovych's ministers have been trying to renegotiate the unfavourable conditions agreed in the 2009 gas contracts – albeit without much success. In exchange for such concessions (including lower gas prices), Moscow seeks effective control over the Ukrainian gas sector. So far, Kiev has resisted the pressure from Russia, but it is possible that in the future Ukraine will be forced to give in to Moscow. For years, the lack of reform to the gas sector has limited transparency, which some businessmen (with links to the successive governments) have used to their advantage. Therefore, if the separation of extraction, transportation and sale of gas into different financially and legally independent companies were to go ahead as planned by 2015, Ukraine could witness fierce competition for the takeover of the most profitable of the new companies – particularly in the gas extraction sector. This, however, could have highly unpredictable consequences.

The reform of the energy sector requires decisive and courageous decisions, including significant gas price hikes for individual consumers and district heating schemes, as part of a comprehensive strategy to modernise Ukraine's municipal housing sector. Although these changes are seen as one of the priorities in the president's reform programme, their implementation has been as slow and inconsistent as the reform of the gas sector. At the end of 2011, the government set up the National Communal Services Regulation Commision of Ukraine (an independent body regulating the provision of communal services market, which under the president's plans was to be established by the end of 2010). The Ukrainian business is getting ready for the privatisation of the

local services market. Meanwhile, in September 2012, the Verkhovna Rada took off the agenda a proposal for a new Housing Code, which is necessary to deal with the current complicated and extensive legal frameworks preventing change in the housing sector (including the creation of the so-called OSBBs, or associations of co-owners of multi-apartment residential buildings). Despite the significance of the document, Parliament has failed to pass it for the past eight years.

2. Attempts to diversify Ukraine's gas supplies

Ukraine has one of the most energy-intensive economies in the world. According to local estimates, the amount of energy required to produce one unit of GDP in Ukraine is 3 to 5 times higher than in Central Europe. The country is also heavily dependent on energy imports, mainly from Russia. As a result, successive governments in Kiev have been stressing the need to diversify the country's energy supply (especially gas) but little has been done to put words into action. Initially, after taking power in 2010, Viktor Yanukovych and his government did not treat this matter seriously: the president's 2010 reform programme made no mention of the need for the diversification of Ukraine's gas supplies. Kiev's failure in gas negotiations with Russia, however, has prompted a U-turn on the issue.

One of the "flagship" projects under the new policy was a planned construction of an LNG terminal with a target capacity of 10 billion m^3, which would allow Ukraine to import gas from Azerbaijan or the Middle East. Work on the project was launched in August 2010, under the so-called National Projects initiative – a series of state-run programmes aimed at modernising the country – but little progress was made over the next two years. In early 2012, the Spanish company Socoin completed a feasibility study which the government tentatively approved on 8 August 2012. Commenting on the signing of an agreement with Spain's Gas Natural Fenosa and US-based Excelerate Energy, under which the parties would

create a consortium of investors for the LNG terminal project, Prime Minister Azarov proudly announced on 26 November 2012: "This is a historic moment... We've taken the first really big step in securing Ukraine's energy independence". However, later that day, the Spanish company denied signing the deal with Ukraine and rejected reports suggesting that it had been represented at the meeting by the person named by Ukrainian officials as the company's official representative. Kiev tried to play down the scandal and quoted "technical difficulties" as the cause of the confusion[41]. Subsequently, the government was forced to admit that the Spanish signatory to the alleged "agreement" did not have powers of attorney to sign it, the documents did not mention any financial or legal obligations, and no "historic moment" ever happened. The scandal (and loss of credibility) notwithstanding, the project has raised a number of concerns. The expected timeframe and total cost of the project is believed to be too optimistic[42]. Another problem is the lack of adequate infrastructure in Azerbaijan to export its liquefied gas (Azerbaijan is being considered as the main LNG supplier for the project) as well as possible difficulties in securing Turkey's permission for transit of gas tankers through its straits.

In November 2012, Ukraine was able to, for the first time in its history, successfully import gas from across its western border. After months of negotiations, Kiev signed a contract with German's RWE for the supply of 56.7 million m^3 of gas to Ukraine. The gas was transported through Poland in November and December 2012. Due to the limited capacity of this particular transit route, Ukraine is currently in talks with RWE to re-route this year's gas

41 The Spanish signatory to the agreement was only asked to stand in when the official delegation from Gas Natural Fenosa was delayed on the way to the meeting.

42 On a visit to Qatar in November of last year, President Yanukovych said that the first shipment of gas under the new project could reach Ukraine at the beginning of 2015; which seems rather unrealistic due to delays at the planning stage. The official value of the project has been estimated at €865 million, although some commentators have suggested that, based on similar projects abroad, the real cost could be much higher.

supplies through Hungary. Ukrainian Energy Minister, Yuriy Boyko, has said that in 2013 Kiev would like to use this route to import 5 billion m^3 of gas. Regardless of whether these plans materialise, true diversification of Ukraine's gas supplies is severely limited by the amount of gas that could be imported to Ukraine from the West.

A more viable alternative might be to increase Ukraine's domestic production. Currently, locally extracted gas can meet about a third of the country's annual gas needs. A rise in domestic production, however, is being held back by the lack of appropriate technology and financial resources to cover the investment costs. Initially, the Ukrainian government was hoping to attract Russian investors to the project. In late 2010 and early 2011, Naftogaz and Gazprom signed a memorandum establishing a joint venture that would extract fire damp (mine gas) in Ukraine, while a separate agreement was inked by Chornomornaftogaz (a Naftogaz subsidiary) and Lukoil for joint prospecting on the Black Sea shelf[43]. However, it is not in the interest of Russian companies (especially Gazprom) to support gas production in Ukraine. As a result, Kiev has turned to the West with an offer to cooperate. In May 2012, the government selected the winning bids for shale gas exploration at two sites; the successful bids came from Chevron and Shell. If the actual size of shale gas deposits at the two sites matches earlier estimates, both companies may invest up to $7 billion in developing the fields[44]. The government has also invited Western companies to develop conventional gas deposits on its Black Sea shelf. In August 2012, a consortium of US companies led by Exxon Mobil won a tender for the extraction of oil and gas at the Skifsky field.

[43] "Ukraine: Naftohaz and Gazprom announce the establishment of joint ventures", *EastWeek*, OSW, 29/12/2010, http://www.osw.waw.pl/en/publikacje/eastweek/2010-12-29/ukraine-naftohaz-and-gazprom-announce-establishment-joint-ventures

[44] Sławomir Matuszak, "Western oil companies will invest in Ukraine", *EastWeek*, OSW, 22/08/2012, http://www.osw.waw.pl/en/publikacje/eastweek/2012-08-22/western-oil-companies-will-invest-ukraine

The site has been estimated to hold up to 35 billion m³ of gas, and the required investment may reach $10-12 billion[45]. In both cases, the start of production on an industrial scale would coincide with the ending of Kiev's gas contracts with Russia. If, by that time, Ukraine also managed to launch the planned LNG terminal, the country's relations with Russia could change dramatically.

The most tangible results in this area could be ensured through a significant reduction of gas imports from Russia. Based on data from late 2012, Ukraine imported about 34 billion m³ of Russian gas (down from about 40 billion m³ in 2011 and 36.5 billion m³ in 2010); of this, 26 billion m³ was purchased under the Naftogaz-Gazprom contract. In view of the continuing high prices Ukraine has to pay Russia for its gas, Kiev has indicated that in 2013 Naftogaz might reduce the level of Russian gas imports down to as little as 20 billion m³. The resulting gas shortage on the Ukrainian energy market could then be filled thanks to the "reverse-flow" supplies from Europe (RWE)[46]. Such a significant reduction in Russian gas imports, however, would violate the provisions of the 2009 contracts, which set the minimum annual purchase level at 33 billion m³[47]. Consequently, ensuring good relations with Russia – Ukraine's major gas partner – is seen as a top priority by the government in Kiev. In view of the above, Ukraine's "diversification policy" appears to be less of a conscious energy strategy, and more of a negotiating tactic aimed at creating an impression that Ukraine has access to alternative sources of gas, which might win it some concessions from Moscow.

45 Sławomir Matuszak, "Western oil companies will invest in Ukraine", *op.cit.*

46 http://news.zn.ua/ECONOMICS/ukraina_esche_bolshe_sokratit_zakupki_gaza_v_rossii_i_uvelichit_import_iz_evropy-112200.html

47 The contract contains a "take or pay" clause; although the addenda signed in 2010 effectively removed the provisions on the types and the size of penalties for contractual violations, they did not repeal the "take or pay" clause itself.

IV. ASSESSMENT OF THE CURRENT SITUATION AND PROSPECTS FOR THE FUTURE

1. Assessment of the current situation

A return to the presidential system, coupled with a stable and disciplined parliamentary majority, has given President Viktor Yanukovych unprecedented political powers. Even President Kuchma, who enjoyed equally extensive powers but was stalled by the fragmentation of his political base, could not match Yanukovych's capacity for implementing change. The concentration of power and relative stability of the Ukrainian economy between 2010-2011, created ideal conditions for the implementation of the deep reforms proposed by the president in 2010. Yanukovych's position was additionally strengthened by the fact that he had managed to completely marginalise Ukraine's opposition forces[48]. This was made possible in large part by eliminating the main leader of the Ukrainian opposition from the political scene, Yulia Tymoshenko. In addition, the opposition parties appeared to lack an even basic awareness of how to engage in serious politics, not to mention a complete lack of a viable and coherent political strategy for the country, which had been replaced by a series of populist slogans.

As a result, after years of political deadlock, Yanukovych's presidency created an opportunity to implement real reforms in the country. Several of them have now been completed while others are still in progress. Among them was the highly unpopular pension reform, which raised the state pension age. In 2010, after the initial chaos that followed the global economic crisis, the government managed to get the public finances under control. Several good decisions have also been made regarding the diversification of Ukraine's gas supplies, although it could be argued that the

[48] It should be noted that the situation in Ukraine is no longer comparable to the circumstances in Russia or Belarus.

government's actions came rather late and have not as yet produced tangible results. Nonetheless, compared with the governments that followed the Orange Revolution and failed to carry out any serious reform (between 2005 and 2010), Yanukovych's presidency has been quite successful. It should be noted, however, that during this period Viktor Yanukovych was briefly prime minister (2006-2007), while Yulia Tymoshenko never had the chance to govern alone and lacked a stable parliamentary base.

On the other hand, most areas of life in Ukraine have seen no significant change under Yanukovych, while in many other areas the situation has deteriorated. Contrary to the official policy of liberalisation and deregulation of the economy, protectionist tendencies favouring big business linked to the president and his political allies have intensified (as can be seen in the privatisation of the Ukrainian energy and gas sector). At the same time, the pressure on small and medium-sized businesses has been rising, both with regard to the tax burden as well as, for example, widespread extortion practices (often blamed on Yanukovych's political allies). The government has failed to implement effective anticorruption measures and the investment climate in the country is as bad as during the 2009 economic crisis.

On the whole therefore Yanukovych's performance between 2010 and 2012 leaves much to be desired. And although after coming to power, the current government did implement some unpopular but necessary changes, it is hard to determine the extent to which these measures were the result of a genuine desire for change, rather than a response to objective and external factors, including the economic crisis and the need for financial assistance from the IMF. Similarly, it is hard to resist the impression that the efforts towards the diversification of Ukraine's gas suppliers stemmed from the failure of Yanukovych's policy on Russia and the unsuccessful attempts to negotiation a revision of the 2009 gas contracts. It is safe to say though that the great potential and the favourable conditions mentioned earlier,

have now been wasted. The consolidation of political power, initially seen as a necessary condition for the implementation of real reforms in the country, was subsequently used to gradually remove Yanukovych's opponents from the Ukrainian political scene. This, in turn, scuppered Ukraine's chance to sign an Association Agreement with the EU in 2011 and build a Deep and Comprehensive Free Trade Area. Nonetheless, the completion of negotiations on both agreements should be seen as a significant achievement of the Ukrainian negotiators and an unclaimed success of Yanukovych's presidency.

Still, since political power in Ukraine is currently concentrated in the hands of the president, it is he who must take full responsibility for the outcomes of his policies. Viktor Yanukovych, despite his many accomplishments, turned out to be incapable of implementing complex, systemic change. It is difficult to say whether this stems from his reluctance to bring about change that could upset his supporters in big business, or whether he lacked the courage to push through unpopular reforms when public support for the government began to drop. This question also remains unanswered after the recent parliamentary elections.

2. Prospects for the future

The results of the parliamentary election held on 28 October 2012 suggest that there is little chance of substantial reforms in Ukraine, at least until 2015, when the country will hold its next presidential election. Despite securing a nominal victory, the pro-presidential Party of Regions may nonetheless struggle to maintain a stable majority in the Verkhovna Rada. This is simply because finding loyal coalition partners is always easier in times of economic prosperity than in times of crisis.

The economic situation in Ukraine remains very challenging. The country's GDP figures for the second half of 2012 showed the first signs of decline in years, while the preliminary figures for the

whole of 2012 show growth of just 0.2% - the worst performance of the Ukrainian economy since the 2009 crisis[49].

However, unlike in 2010, when the economy began to bounce back (having bottomed out during the crisis), the economic outlook for 2013, for both Ukraine and other markets, is rather subdued. This is particularly worrying for the government in Kiev because Ukraine's economic performance is directly linked to the economic conditions on Ukraine's main export markets. (As much as 60% of Ukraine's GDP is generated through exports).

These very harsh economic conditions require austere economic policies, without which Ukraine could not secure financial assistance from the West in the future. Such measures though, coupled with the expected intensification of radical and populist demands of the Ukrainian opposition, could drastically reduce Yanukovych's chances of re-election. It is therefore likely that the government will make only small changes addressing the most pressing issues and will refrain from carry out large reforms necessary to secure external funding, such as a rise in gas prices or a more flexible exchange rate. The government will probably press ahead with the gas sector reform, although the exact direction of this reform is not clear and will likely depend on the outcome of Kiev's negotiations with Moscow on changes to the 2009 gas contract. Work might also continue on the law legalising the sale and purchase of agricultural land, although the recent decision to extend the current moratorium until 2016 suggests the possibility of a long and fierce debate in Parliament, coinciding with a presidential campaign.

It is unlikely that as we move closer to the 2015 presidential election, the government will take any unpopular decisions or

[49] Arkadiusz Sarna, "Ukrainian economy on the verge of recession", OSW Commentary, 21/11/2012, http://www.osw.waw.pl/en/publikacje/osw-commentary/2012-11-21/ukrainian-economy-verge-recession

carry out reforms adversely affecting individual business groups. Therefore, small-scale changes are going to be directed at winning over the electorate and trying to maintain social spending above the level of inflation. This will undoubtedly lead to a bigger budget deficit and higher levels of public debt, which in itself will block any major reforms. Over the next two years, Yanukovych is going to focus on his re-election, and in order to win he will try to avoid antagonising local oligarchs. This last element will be particularly important as despite his best efforts he has so far failed to create a business empire that would end his reliance on campaign donations from big business[50]. Any attack on the interests of the Ukrainian oligarchs (which could be caused by the deepening economic crisis and the need for radical action to increase state revenues) would leave Yanukovych at Russia's mercy. Moscow's help would likely come with specific conditions attached, including membership of the Customs Union, which would end Ukraine's current pro-EU foreign policy.

Meanwhile, the victory of an opposition candidate in the 2015 presidential election would not give much hope for change. At the moment, the opposition has been taking a fairly populist and reactionary position towards the government's reform programme, and, for instance, has announced plans to reverse the recent pension reform[51]. So far, Ukraine's opposition parties have not proposed any alternative ideas about how the reforms should be carried out. Although it may be too early to try and guess what will happen in 2015, the most likely scenario is that the next presidential campaign will focus on the personal traits of the candidates, and the opposition will call for a change of leadership, without a coherent plan for what to do next. It has become quite difficult

[50] Sławomir Matuszak, "Oligarchic democracy", OSW Studies, p. 46.

[51] A statement by Oleksandr Turchynov, one of the leaders of the Batkivshchyna party. Турчинов пообещал отменить пенсионную реформу и ликвидировать налоговую милицию, *Українські Новини*, 28.07.2012, http://ukranews.com/ru/news/ukraine/2012/07/28/75656

to identify any opposition leader who could offer real (or even illusory) hope for systemic reform in Ukraine (as was the case with Viktor Yushchenko).

Meanwhile, radical reforms in Ukraine are essential, as Kiev lags ever further behind the rest of Europe (currently only Moldova and Kosovo are poorer). Immediately after independence, Ukraine's GDP per capita was higher than in Bulgaria and 40% lower than in Poland; in 2011 Poland's GDP per capita was already 3.7 times higher than in Ukraine, while Bulgaria's figures were 2 times higher – and there is no indication that this trend is likely to change[52]. The inability to implement systemic change is widespread across the CIS. It seems that the Ukrainian political elite (both the government and the opposition) are not able to set themselves apart from their CIS partners. However, Ukraine is currently in a much worse situation than, say, Russia or Azerbaijan, where the lack of sufficient reforms can be offset by high revenues from oil and gas exports. All of the above suggests that when it comes to modernisation and economic development, Ukraine's outlook for the coming years remains fairly bleak. The country runs a serious risk of being left behind, not only in comparison with other Central and Eastern European states but also with its direct neighbours, such as Russia.

SŁAWOMIR MATUSZAK, ARKADIUSZ SARNA

[52] In 2011, Ukraine's GDP *per capita* was $3615. In Bulgaria and Poland the figure stood at $7158 and $13463 respectively. Source: World Development Indicators & Global Development Finance, World Bank, http://databank.worldbank.org/ddp/home.do

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