

BTI 2012 | Ukraine Country Report

Status Index	1-10	5.96	# 54 of 128	
Political Transformation	1-10	6.10	# 60 of 128	↘
Economic Transformation	1-10	5.82	# 60 of 128	→
Management Index	1-10	4.64	# 76 of 128	

scale: 1 (lowest) to 10 (highest) score rank trend

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Key Indicators

Population	mn.	45.9	HDI	0.729	GDP p.c.	\$	6721
Pop. growth ¹	% p.a.	-0.4	HDI rank of 187	76	Gini Index		27.5
Life expectancy	years	69	UN Education Index	0.858	Poverty ³	%	<2
Urban population	%	68.1	Gender inequality ²	0.335	Aid per capita	\$	14.5

Sources: The World Bank, World Development Indicators 2011 | UNDP, Human Development Report 2011. Footnotes: (1) Average annual growth rate. (2) Gender Inequality Index (GII). (3) Percentage of population living on less than \$2 a day.

Executive Summary

The period under review can be divided into two distinct phases, separated by the watershed presidential elections in January and February 2010. Throughout 2009, Ukraine's political sphere continued to be marked by constant constitutional and political crises and the institutional and personal competition between Prime Minister Yulia Tymoshenko and President Viktor Yushchenko, which hampered political decision-making. Both sides used the institutional ambiguities caused by the post-Orange Revolution constitutional amendments of December 2004 to widen their power and prerogatives. Moreover, rules and laws were often disregarded as politicians continued to play with the rules and not by the rules. In 2009, the parliament (Verkhovna Rada) was at times unable to function and important reforms and political decisions were blocked. Tymoshenko's government had to deal with the severe consequences of the economic crisis, leading to decreasing tax revenue, rising social spending and a rising budget deficit.

Viktor Yanukovich won the presidential election run-off with 48.95% against Yulia Tymoshenko's 45.47%. Both international and domestic monitoring commissions assessed the elections as reasonably free and fair. There was a peaceful transition of power; Yanukovich was inaugurated on 25 February 2010. The subsequent monopolization of political power took place in several steps, making use of legal and extra-legal means, and gives serious concern about the new leadership's commitment to democracy and the rule of law. At the beginning of March 2010, Yanukovich managed to oust Tymoshenko's government by forming a new "Reforms and Stability" coalition in parliament, which not only included factions (the Party of Regions, the Communists, and the Lytvyn Block) but also individual members of parliament. The Constitutional Court endorsed this legislative change. A new government under Prime Minister Mykola Azarov was formed, in which most ministries are led by representatives of the Party of

Regions, the majority of whom come from Ukraine's industrial east. The president leads the cabinet's work, and the presidential administration takes all key decisions. So far, the opposition has been unable to counteract the legislative shift due to internal rivalries and divisions.

On 1 October 2010, the Constitutional Court annulled the 2004 constitutional amendments, having deemed them unconstitutional. Ukraine returned to the 1996 constitution, reinvesting the president with considerably more power both in government formation and policy-making. Parliament was urged to bring existing laws in line with the 1996 constitution (e.g., the law concerning the cabinet of ministers). Moreover, while the conduct of the local elections on 31 October gave cause for concern, the results contributed to the further monopolization of power by the Party of Regions, strengthening its power vertically while marginalizing other parties. In December 2010, Yanukovich started to reform the public sector, radically changing its structure. The result may be the further concentration of policy-making power among fewer actors.

Following these political upheavals, advocacy organizations have reported more harassment and attacks on CSOs by the authorities. Moreover, media coverage of political events has become even more unbalanced, with the largest outlets largely shunning the opposition. Former officials, mainly from Tymoshenko's government, have been charged with abuse of office when in power. The accusations are selective and seem to be politically motivated. All in all, there are strong signs of an erosion of democracy, which have, however, not sparked public protest. Yanukovich's attempts to improve governability take place at the expense of democracy.

In 2009, the Ukrainian economy suffered from the international financial crisis and ushered into deep recession with a steep decline of industrial output and rising unemployment. The high external dependency of the Ukrainian economy and its structural imbalances became more apparent. In 2008, Ukraine and the IMF concluded a stand-by agreement of \$16.4 billion to mitigate the crisis. After serious conflicts with regard to budget formation, which led to the discontinuation of disbursements in late 2009, cooperation resumed in summer 2010 under much stricter conditionality. In 2010 the Ukrainian economy began to recover. However, just as the economic crisis was caused by external factors, so Ukrainian economic growth in 2010 was mainly due to signs of recovery in the global economy, in particular the rising prices for steel, the main Ukrainian export product. The new government inherited a difficult economic situation. Many necessary reforms will result in painful social consequences.

In April 2010, Ukraine and Russia signed the Kharkiv Accords, extending the Russian Black Sea fleet's leases of ports in the Crimea until 2042. Simultaneously, Russia agreed to a 30% drop in prices for natural gas until 2019. While the government praised this as stabilization for Ukraine's budget, the opposition claimed it was a sell-out of national interests. The new Ukrainian leadership has officially abandoned the aim of NATO membership, seeking "freedom from alliances". Negotiations with the European Union on an association agreement continued as scheduled.

History and Characteristics of Transformation

Ukraine's post-independence transformation was largely determined by old nomenklatura elite groups who kept their positions in the state administration and the economy after 1991. They shaped the new institutional framework according to their own interests, relinquishing conflict-laden economic policies, avoiding any hardships for themselves and failing to achieve collective action because they were busy competing among themselves for wealth and power. Simultaneously, new opportunities for individual and group enrichment such as rent-seeking emerged and were partially sustained by international – Western and Russian – support.

From 1996 until 2005, Ukraine was formally a semi-presidential system. Leonid Kuchma's second term (1999 – 2004) was characterized by increasing authoritarian tendencies and the informalization of power relations. Various protests against the Kuchma regime galvanized a set of opposition movements and served to organize the Orange Revolution. The 2004 presidential election was contested by two main candidates: then Prime Minister Viktor Yanukovich, who was supported by outgoing President Kuchma, and Viktor Yushchenko, former Prime Minister and head of the national bank. The fraudulent run-off on 21 November, officially won by Yanukovich, led to mass protests. The repeat election on 26 December 2004, which was assessed as free and fair, was won by Yushchenko. Yushchenko's inauguration as president on 23 January 2005 and the parliamentary approval of Yulia Tymoshenko's candidature as prime minister in February 2005 marked a significant shift in power. However, few of the expectations and promises raised by the new order (more democracy, transparency and socioeconomic change) have been realized, and public disillusionment has ensued. Constitutional amendments that had been rubber-stamped on 8 December 2004, took effect on 1 January 2006, essentially establishing a parliamentary–presidential system, reallocating power and competencies between president, government and parliament. According to the amended constitution, a new government was formed after parliamentary (not presidential) elections, which took place every five years on a proportional-representation basis. Within one month of the elections, the Verkhovna Rada had to form a parliamentary majority in order to elect a government. The parliamentary majority not only elected the government and approved the prime minister, it could also dismiss them, and individual ministers too. The president proposed candidates for the positions of the prime minister as well as for the ministers of defense and foreign affairs.

Since 2005, most Ukrainian governments have suffered from internal disunity and constant competition for power, facilitated by unclear distribution of competences and a lack of checks and balances in the amended constitution. The first Tymoshenko government received a vote of no confidence in autumn 2005 following a corruption scandal. A new “Orange” government was formed with Yuri Ekhanurov as prime minister. The 26 March 2006 parliamentary elections changed the composition of the Verkhovna Rada significantly. The Party of Regions emerged as the winner while coalitions of Orange parties (i.e., Bloc Yulia Tymoshenko (BYuT) and Our Ukraine – People's Self-Defense (OU-PSD)), fared less well. Attempts to establish an Orange

government failed after the Socialist Party defected to the Party of Regions with whom, together with the Communists, they created the “anti-crisis coalition” in July and a government in August 2006. They nominated Yanukovych as prime minister, while the leader of the Socialist Party, and Oleksandr Moroz became chairman of parliament. Having become prime minister, Yanukovych attempted several times to increase his own powers by informal and extra-legal means, which led to serious conflicts with the president. In April 2007, Yushchenko dissolved parliament and called for early elections. Parliament did not accept the dissolution and continued its work, and two months of confrontation followed. In late May 2007, the situation deteriorated significantly as the armed forces became involved. Only after Yushchenko and Yanukovych reached an informal agreement, were early parliamentary elections scheduled for 30 September 2007. The elections were assessed as free and fair. All relevant political forces accepted the result. A new government was only successfully formed in December 2007 when a coalition between BYuT and OU-PSD came together under the premiership of Tymoshenko. The Orange coalition collapsed in September 2008 just as BYuT and the opposition Party of Regions were about to amend the constitution, further limiting presidential powers. As a result, the pro-presidential OU-PSD left the coalition and Yushchenko issued a decree dissolving the Verkhovna Rada on 8 October 2008 and announcing early elections once again. The government challenged the lawfulness of the dissolution. Due to the acute global financial and economic crisis which had hit Ukraine hard, new elections were postponed indefinitely and the Tymoshenko government continued to operate. In December 2008 a coalition between his Lytvyn Bloc, BYuT and OU-PSD was created and Volodymyr Lytvyn was elected chairman of the Verkhovna Rada. Despite having little capacity to act, the government remained in office until after the 2010 presidential elections.

Under President Kuchma (1994 – 2004), Ukraine conducted a balanced foreign policy between Russia and the West. After the Orange Revolution, the Ukrainian government drew closer to NATO and the European Union, while relations with Russia deteriorated. Ukraine’s request for prospective E.U. membership was rebutted by the European Commission. Ukraine was included in the European Neighborhood Policy and later the Eastern Partnership. Meanwhile, then Russian President Vladimir Putin tried to influence the 2004 presidential elections by supporting Viktor Yanukovych. In recent years, the relationship between Russia and Ukraine has been marked by repeated conflicts over gas deliveries, transit and payments as well as the extension of the Russian Black Sea fleet’s leases in the Crimea.

In 2005, the private sector’s share of GDP reached 65 %. Oligarchic capitalism had developed in the second half of the 1990s and was reinforced by large-scale privatization, especially in 2003 – 2004. Due to flawed procedures and favoritism, many large enterprises were sold below their value and ended up in the hands of financial-industrial groups or large companies close to the Kuchma regime. Large parts of the economy (especially heavy industry) continue to be dominated by financial-industrial groups and in some cases by foreign investors. The Ukrainian economy continues to suffer from structural imbalances. While light industry was negligible in the late 1990s, it has improved considerably because of the increasing purchasing power of the

Ukrainian population and the more sophisticated demands of the consumer market. In addition, simplified rules for registration and simplified tax regulations have prompted many companies to emerge from the shadow economy.

Socioeconomic development in Ukraine was disastrous until 2000. A severe decline in production and living standards dominated the 1990s. The economy has been recovering from this downward trend since 2000. Ukraine experienced rather high growth rates, rising household incomes and investment until the end of 2008. GDP rose by 7% in 2007, while industrial production increased by 10.2%. Poverty was reduced and cash incomes increased. But the gap between the rich and the poor remain pronounced. Industrial production, imports and exports declined significantly after the 2008 financial crisis, while unemployment and public spending increased.

Until 2005, serious civil rights violations occurred frequently: Murders, attacks and the intimidation of journalists, parliamentarians, members of the political opposition and rival trade union representatives. After the Orange Revolution freedom of expression improved. State and self-censorship and the harassment of critical journalists became less pronounced. However, civil society actors have little noticeable influence on politics. It had seemed that pluralism had become a defining feature of Ukrainian political life, but the Orange forces failed to use this window of opportunity to implement genuine reforms and establish irreversible political structures.

The BTI combines text analysis and numerical assessments. The score for each question is provided below its respective title. The scale ranges from 10 (best) to 1 (worst).

Transformation Status

I. Political Transformation

1 | Stateness

The state monopoly on the use of force is in place. All territorial units are penetrated by the state. Ukraine's territorial unity is not endangered, but the country faces specific problems with regard to its notorious regional diversity, which political elites time and again instrumentalize and perpetuate for short-term political gains, especially during election campaigns. In Crimea, a pro-Russian secession movement supported by Russia is active, but unsuccessful. Other secessionist movements operate in the Donbas and in Transcarpathia, albeit with little success. Furthermore, state power is partially impaired by the power of interest groups which regard politics as business. The influence of special interests weakens the political system through corruption and by filling key political positions with representatives of various interest groups.

The Ukrainian nation-state is accepted by all relevant actors and groups in Ukraine. Identification has been growing in recent years. All citizens enjoy the same civil rights. In 1991, every person residing in Ukraine was entitled to Ukrainian citizenship, regardless of nationality. Ukraine thus emerged as a civic nation, and the nation-state's legitimacy is accepted by all relevant groups. Ukraine does not recognize dual citizenship, but the law on citizenship does not punish it. As a result, there are cases of acquisition of Russian, Romanian and Hungarian citizenship by Ukrainians, especially in the Western Ukraine and Crimea. Starting in the late 1980s, Crimean Tatars have returned to Crimea to claim their right to Ukrainian citizenship, but they continue to face legal and financial difficulties. Many (elderly) members of the Roma minority do not have Ukrainian passports.

Church and state are separated and the political process is secularized. The heterogeneous religious landscape combined with the secular Soviet past prevents the impact of religious dogmas on state policy. There are five major churches: The Ukrainian Orthodox Church (Moscow Patriarchate); the Ukrainian Orthodox Church (Kiev Patriarchate); the Ukrainian Autocephalous Orthodox Church and

Question
Score

Monopoly on the
use of force

9

State identity

9

No interference of
religious dogmas

9

two Catholic churches (Greek and Roman Catholic). None of them function as a state church. In addition, there are Jewish and Muslim communities and a growing number of Protestant as well as Evangelical groups. There are no conflicts between the churches and the state, but rather between the individual denominations. The Ukrainian Orthodox Church (Moscow Patriarchate) has the largest number of parishes of any denomination but the majority of these are located in western and central Ukraine. Polls show that the Ukrainian Orthodox Church (Kievan Patriarchate) has the largest number of adherents. While President Yushchenko sought rapprochement with the Orthodox Church of the Kievan Patriarchate, Viktor Yanukovich is inclined to support the Orthodox Church of the Moscow Patriarchate. During election campaigns, political parties and individual politicians use the support of certain religious organizations. For example, President Yanukovich invited the leader of the Russian Orthodox Church Patriarch Kirill to hold a service to mark Yanukovich's inauguration in February 2010.

Courts and law enforcement bodies work at all administrative levels; the same applies to tax authorities. With regard to public infrastructure, 98% of the population have access to running water and 95% have adequate access to improved sanitation facilities. However, only about 30% of households in rural areas were connected to the centralized water supply in 2008, according to UNDP data.

Basic
administration
8

Public administration functions on all administrative levels, albeit with varying degrees of effectiveness and state capture by economic actors. Within the political reform discourse, Ukraine's regional cleavages have repeatedly served as an argument for the reinvigoration of the central executive force as a means of holding the country together. However, there have never been any serious and publicly supported separatist challenges, with the exception of the Crimean peninsula. Ukraine is a unitary state with four tiers of government: National, oblast, raion/city and municipal. At the municipal level, mayors are publicly elected while the heads of oblast and raion administrations are centrally appointed. Dependence on the center is reinforced by the system of budget formation. Despite continuous reform discussions, lower-level budgets remain dependent on higher-level budgets, and the formal political autonomy of municipal authorities becomes a farce. Publicly elected bodies (parliaments) at oblast and raion levels have few competencies and do not possess their own executive bodies, which makes them dependent on the respective state administrations.

The results of the October 2010 local elections meant a vertical strengthening of presidential power, making it easier to rule the country at the price of further limiting weakly developed local government.

2 | Political Participation

The distribution of political offices takes place through general and mostly free elections, which are widely accepted. According to national and international assessments, the most recent nation-wide elections (the presidential elections of 17 January 2010, and the run-off between Yulia Tymoshenko and Viktor Yanukovich on 7 February 2010) were almost entirely free and fair, but the OSCE pointed out a deficient legal framework, which among other things left various administrative procedures undefined and open to interpretation. The central election commission operated in a non-partisan manner. All candidates had access to the media to present their programs, even though broadcasting was not always balanced, but depended instead on editors and journalists' political and financial considerations. According to the OSCE's observer mission, voting and counting in polling stations were conducted in an efficient, transparent and honest manner. Voter turnout had declined to 66.8%/69.1% (first/second round) in comparison with 2004 (74.9%/80.8%).

Free and fair
elections

7

The local elections originally scheduled for May 2010 and then re-scheduled for 31 October 2010, were generally interpreted as a step backwards. Regulations were changed shortly before the elections and favored large established parties with extensive structures. Observers recorded more irregularities and the misuse of administrative resources. Successful mayors were forced into the Party of Regions; election commissions were mainly staffed by members of the Party of Regions; public officials were told not to support the opposition. In some major cities, opposition parties were banned from participation on shaky legal grounds. The results were rather unambiguous: The ruling Party of Regions won in most regions and large cities, except for Western Ukraine, where the ultra-nationalist Svoboda party was successful. However, Tymoshenko's party remains the main opposition force. Voter turnout was extremely low, declining further to about 50%. Elections were used to further marginalize the opposition and some observers fear that they were only a dress rehearsal for the parliamentary elections scheduled for October 2012.

Elected rulers have the power to govern, but big business and politics are not independent of one another in reality. As a result, heads of financial-industrial groups exercise influence over the course of political action either by filling official positions themselves or by sending their representatives. In Ukraine, the military does not interfere in politics. Instead, veto players can be found in parliament, within the public administration, the government and the presidential administration. They instrumentalize and bend the formal system and undermine it without challenging the system as such. Until the end of 2009, the mutual blockades between the government and the presidency and in the parliament led to a very low

Effective power to
govern

6

legislative outcome. In 2010, the new president restored capacity to rule at the expense of democratic and pluralist principles. Yanukovich not only controls the presidency but also the government and parliament. He changed the basic rules of government formation, the law concerning the cabinet of ministers, electoral rules and the constitution. Since then, he has had a decisive influence on government formation and policy by both formal and informal means.

However, the new leadership is a rather heterogeneous group, comprising opposing camps which hold partly conflicting economic interests, and also have ideological differences. The two main groups are represented by two oligarchs: Rinat Akhmetov and Dmytro Firtash. While Akhmetov controls some of Ukraine's major export companies, Firtash controls the gas trade and chemical industry. Their respective spheres of activity result in different priorities – and contradictions – with regard to foreign policy. Yanukovich has to conduct a balancing act and satisfy both camps. By the end of 2010, internal competition led to a strengthening of Firtash. This might result in a continuation of state interventions – on which his fields of activity depend – into the economy. President Yanukovich started a comprehensive administrative reform in December 2010. As a consequence, some ministries were abolished, while others were enlarged. These reforms could result in a situation in which only few major players are involved in policy-making.

Freedoms of association and assembly are guaranteed in the constitution. While the Law on Civic Associations was adopted in 1992, there is still no respective law on freedom of assembly. In 2005 – 2009, rights of political organization and assembly were in general respected. Since early 2010, however, pressure on certain groups such as human rights activists has grown. The same applies to foreign donors and foundations, some of which have been accused of violating Ukrainian laws. Some Ukrainian NGOs have been targeted by the Ukrainian Security Service.

Association /
assembly rights

5

The new regime clearly limits freedom of assembly. Human rights organizations have reported on the courts' prohibition of various assemblies on invalid grounds, and on local authorities that restrict peaceful public assemblies by making difficulties over venues and terms of advance notification, etc. Law-enforcement agencies such as the security service and the militia have put pressure on activists and organizers of peaceful demonstrations and on the heads of organizations in which activists work or study. On several occasions, people have been prevented from taking part in peaceful demonstrations. For example, in May 2010, traffic police officers obstructed access roads to Kiev and transport companies were warned that they would lose their licenses if they took people to a rally organized by the opposition. In November 2010, there were protests nationwide against the new tax code. The demonstration in Kiev was not forbidden, but tolerated only until a certain moment (the presidential veto of the tax code) and then forcibly disbanded.

Subsequently, several protesters were arrested and charged with damaging public property. In general, national TV channels have ignored public protests.

The prohibition of censorship in Ukraine is guaranteed by the constitution, by the Law on Information and the Law on Television and Radio. In 2005 – 2009, there was no obvious state censorship. However, the situation started deteriorating in 2010 under the new. According to the Reporters Without Borders' Press Freedom Index 2009, Ukraine was in 89th position among 175 countries of the world, but by 2010 it had already been relegated to position 131 (of 178 countries). In October 2010, the Parliamentary Assembly of the Council of Europe (PACE) issued a warning to Ukraine over infringements on the freedom of speech and press.

In principle, Ukrainian citizens have access to a variety and plurality of both print and electronic media, at least at the national level, and about 16% of the population use the internet on a regular basis (2009). At the local level, many media outlets continue to be owned by the authorities. However, due to low profitability, many private media outlets are financially dependent on single financial-industrial groups. Currently, most of them belong to the pro-presidential camp (one of the major channels is owned by Valeriy Khoroshkovsky, the head of the security service) or experience administrative pressure, mainly from the security service. In June 2010, a court decision stripped two opposition TV channels of their frequencies. In consequence, the coverage of political events is very imbalanced: The major TV channels do not carry reports on the opposition or public protests. Moreover, certain topics can obviously no longer be dealt with, for example historic events such as the famine of the 1930s or the Ukrainian Insurgent Army of World War Two. Likewise, any criticism of authorities is objectionable. Private media outlets seem to introduce new editorial policies to protect their businesses from administrative pressure. As the incidents of censorship grew in 2010, they were better monitored. For example, such projects as U-Media (operational since June 2009) and Stop Censorship (since July 2010) provide this kind of information on a regular basis, albeit mainly online.

Attacks on journalists both by the authorities and unidentified assailants continue and are rarely investigated. In August 2010, an investigative reporter called Vasily Klimentyev disappeared from Kharkov. At the time of writing, the journalist is still missing. The Commission for Establishing Freedom of Expression, which was attached to the president's office in 2006, was dissolved without explanation on 2 April 2010 by a presidential decree. The planned introduction of a public television and radio channel has not yet happened, but the new leadership has declared its intention to create it. According to the draft bill, however, it will in fact resemble a government broadcaster.

Freedom of
expression

6

3 | Rule of Law

The Ukrainian constitution provides for the division of powers and an independent judiciary. However, these constitutional provisions are not deeply anchored in the minds of the political elite: Fights about the rules often take precedence over political competition within the rules. Moreover, the Ukrainian political elites evince zero-sum thinking – that is, that power has to be absolute.

Separation of powers

5

The political compromise made in December 2004 brought about the constitutional amendments that became effective on 1 January 2006. Loopholes and institutional frictions remained, as some competencies were not sufficiently delineated between the president, the cabinet of ministers and the parliament. Before 2010, checks and balances did not result from state institutions' capacity to exercise their competencies independently, but from the fact that there was competition for control from rival political forces. Furthermore, in 2006 – 2009 the parliamentary opposition had, de jure, the opportunity to control the government. It could influence agenda setting, had the primary right in filling positions in some parliamentary committees and could form a shadow government.

The 2010 return to the 1996 constitution gave more formal power to the president. Moreover, rules have been bent for the sake of power expansion. Together with the coalition of factions, the concept of a parliamentary opposition was abandoned. Yanukovich has been quick to form a strong executive consisting of loyal and trustworthy people at the national, regional and local levels. As all major institutions are now in the hands of the presidential team, the de facto separation of powers is clearly endangered.

The constitution stipulates the principal makeup of the judicial system. On paper, the functional and regional differentiation of the judiciary is in place. There are local courts of general jurisdiction (combining criminal and civil jurisdiction), appeal courts in different regions as well as arbitration courts. In addition, there are high courts with specialized jurisdiction (high administrative court and high arbitration court). The Constitutional Court decides whether laws and other legal acts conform with the constitution. Its decisions are final and cannot be appealed. The Supreme Court is the highest judicial body. As a result of the July 2010 judicial reform, military courts were abolished and a new high court with specialized jurisdiction was created to decide on civil and criminal cases.

Independent judiciary

5

According to the law, all citizens have the right to a fair, timely and open trial. For several reasons, this is not respected in practice. The judiciary's pressing problems include insufficiently trained judges, low salaries and dependence on the executive branch in matters of enforcement. Moreover, Ukrainian courts are faced with overwhelming and ever-growing caseloads, but the number of judges has remained

relatively constant. There is a lack of transparency in proceedings. One serious problem is the lack of funding even for basic equipment, and financial constraints with regard to training. Constantly changing laws (both related to interest politics and the necessity to adapt to international standards and E.U. law) impair jurisdiction.

Although the independent judiciary is anchored in the constitution, its actual independence is impaired. The situation has deteriorated even further under the new leadership. In July 2010 the new leadership devised a new law on the judicial system, which passed swiftly through parliament without any public and parliamentary debate: Evidence of a new way of dealing with the judiciary. While it contains a number of new procedures that could ensure the independence of the judiciary, it also envisages the de-facto abolition of the Supreme Court.

Individual courts of general jurisdiction are established and liquidated by the president. Judges and their deputies (with the exception of the Supreme Court) are appointed by the Supreme Council of Judges (SCJ). Unfortunately, this body's composition is determined by political considerations and comprises many politicians and other non-judges (e.g., the prosecutor general – ex officio – and his two deputies). Moreover, its functions were enlarged after the judicial reform of July 2010 – a decision strongly criticized by the Venice Commission of the Council of Europe. The 18 judges of the Constitutional Court are appointed in equal shares by the parliament and the president. The appointments of judges and court chairmen are subject to political considerations and judges are often dependent on or affiliated with political camps. The new leadership shed four inconvenient judges – they resigned. Since July 2010, the Constitutional Court has been chaired by Anatoly Holovin, one of Yanukovich's allies from Donetsk. In 2010 the Constitutional Court played a crucial role in Yanukovich's consolidation of power. Its two judgments first made the concentration of power possible, and then brought it to a new level. The first decision of the Constitutional Court legalized the pro-presidential coalition in the parliament, which was created in March 2010 and consisted of factions and individual deputies. The manipulation was obvious, since in 2008 the Constitutional Court took the opposite decision on that matter, stipulating that only deputy factions and not individuals can form a coalition. The second decision of the Constitutional Court – to return to the 1996 constitution – and the resignation of non-compliant judges is also a clear sign of the politicization of this branch of power and its further deterioration. Overall, the judicial system of Ukraine has been systematically misused by various political forces, which evince an instrumental attitude towards the law. On the whole, the independence of the judicial system is impaired by political leverage.

One of former President Yushchenko's declared top priorities was to prevent future abuse of power. But those responsible for the falsifications during the 2004 presidential elections remained exempt from investigations and possible punishment. No high profile case was brought to court. As members of parliament, many of them enjoy immunity from prosecution.

Prosecution of
office abuse
4

None of the substantial number of anti-corruption regulations and programs have taken a systematic approach or articulated an overall long-term strategy. Different state agencies have a legal mandate to fight corruption, but they are insufficiently protected from political interference. Corruption scandals have been publicly exposed, but not accompanied by changes in structural incentives or legal guidelines to regulate the private interests of public servants. Only lower-ranking officials have been put on trial. Until the end of the Yushchenko era, no senior officials had ever been charged with abuse of office. However, the situation changed with Yanukovich's presidency. In December 2010, Yulia Tymoshenko and Yuriy Lutsenko (the former minister of the interior) were charged with abuse of office and embezzlement of state funds when in power, arrested and questioned. The same happened to other former members of Tymoshenko's government. Prosecutor General Viktor Pshonka, a Yanukovich intimate, reported that cases against current and former high-level officials had been launched, accusing them of having caused damages of \$2.1 billion to the state. The charges and possible law-enforcement are selective and therefore obviously politically motivated. The apparent aim is to seriously weaken the opposition before the next parliamentary elections – scheduled for October 2012. According to Ukrainian law, no person convicted of a crime may serve in parliament or become prime minister or president. Thus, the accused might not even go to jail, but be prevented from pursuing public office. Human rights activists have asked the government to end such practices, but to no avail.

In the period under review, the observance of civil liberties has deteriorated. Freedom of movement and freedom of religion are by and large ensured. In addition, there is no noteworthy ethnic discrimination, with the partial exception of the Crimean Tatars and the Roma. However, there has been an alarming rise in xenophobic violence including assault and murder since 2007, mostly against visible minorities such as foreign students, migrants, refugees and Jews. Most of the perpetrators belong to neo-Nazi groups. Under pressure from international organizations and foreign governments, the Ukrainian authorities started to tackle the issue more seriously in 2009. According to Human Rights Watch, Ukrainian refugee law contradicts the Universal Declaration of Human Rights. Moreover, trafficking in women and children is a serious problem which the authorities are combating with limited success.

Civil rights
6

According to World Prison Brief 2010, Ukraine has one of the highest arrest rates in Europe – 334 prisoners per 100,000 people. The human rights situation in penitentiaries continues to give cause for concern. For example, Ukraine's ombudsman registered seven cases of death by torture in 2008 – 2009 and eight in 2010. Currently, there is no functioning mechanism to address this problem. Institutions created under Yushchenko's presidency, such as the Ministry of Internal Affairs human rights monitoring department or Assistant Interior Minister for Human Rights, were liquidated in 2010. Moreover, under the new leadership, public, mobile groups were significantly impeded in monitoring human rights.

Due to the high level of corruption and politicization in the judiciary, equal access to justice and due process under the rule of law is not a given. Some charges against human rights activists, journalists and other non-compliant individuals have clearly been fabricated by law enforcement bodies. Moreover, injustices that were committed under the Kuchma regime have not been systematically investigated, not those under Yushchenko or under Yanukovich.

4 | Stability of Democratic Institutions

The effectiveness of most democratic institutions has become seriously impaired. In 2009, the parliament scarcely functioned because it was paralyzed by the political crisis. As a consequence, necessary reform measures were not taken, resulting in a legislative backlog. Instead, parliament turned into a stage for the presidential election campaign. Up until the beginning of 2010, the president and the government blocked each other's decisions and made them subject to (personal) power expansion. In 2009, the positions of the foreign, finance, transport and defense ministers were vacant and could not be filled due to conflicts between the prime minister and the president.

Since the change in the presidency and the government there has been less overt conflict, but also fewer checks and balances as the new regime not only controls the presidency, but also the government and the parliament. The latter is being marginalized and might turn into a technical tool to endorse and implement presidential policy. Important decisions (such as the state budget or the agreement with Russia) were no longer discussed in parliament but simply rubber-stamped. Moreover, parliamentary procedures are disregarded or changed frequently according to "current needs".

Performance of
democratic
institutions

6

All influential political actors formally accept the democratic institutions – at least in rhetoric and in political programs. No political force claims that democracy is alien to Ukraine because it was imposed from outside, as is the case in Russia.

Commitment to democratic institutions

5

Until the end of the Yushchenko presidency, politicians and interest groups regularly re-opened the discussion on political and constitutional rules. The constitutional amendments which were agreed upon during the Orange Revolution and which came into force on 1 January 2006 were questioned. Attempts at delineating power and competencies between the government and the president were largely driven by the personal interests of the actors involved (especially Tymoshenko and Yushchenko). Under President Yanukovich, the basic rules were once again changed, leading to more presidential power. This was accompanied by political rhetoric that favors more stability and control over society under a strong president versus “democratic chaos”. The fact that Yanukovich opposed a strong presidency when he was in opposition or acted as prime minister, shows that there are no general beliefs but only situational preferences influenced by power interests.

5 | Political and Social Integration

There are no clear programmatic differences between party platforms. The parties and voting blocs continue to be primarily political vehicles for individual leading politicians. Their role in aggregating and representing societal interests is not very effective. Election campaigns are characterized by mostly populist slogans. On the whole, the battle lines between parties are blurred and change frequently, driven by power interests rather than ideology or party programs. Despite that, the level of voter polarization remained at approximately the same level during the 2010 presidential elections as in 2004, and was characterized by a distinct regional split with the Party of Regions, which was strongest in the eastern and southern parts of the country.

Party system

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Moreover, the number of parties with sufficient influence at the national level has declined even though influential individuals continue to found new parties. The proportional voting system has contributed to the stabilization of the party system as such. During the last parliamentary elections (September 2007) many parties did not achieve the 3% threshold. Leftist parties have become weak. Before 2010, a two-party system appeared to be emerging, composed of BYuT and the Party of Regions. However, the local elections in October 2010 might even indicate a tendency towards a one-party system as the changes in the electoral law favored the Party of Regions. Tymoshenko’s party was also considerably weakened in 2010 as many parliamentarians switched to the pro-presidential coalition.

In its present composition, parliament no longer reflects societal interests. During the last parliamentary elections in 2007, deputies were elected on the basis of closed

party lists and under strict faction discipline prescribed in the 2004 constitution. However, the ban on changing factions was abolished in 2010. Since then, many deputies have switched sides, which significantly reduced the parliament's legitimacy and might increase the fragmentation of the party system in future.

Electoral volatility is declining, but party membership remains at a low level. Party elites have only weak grassroots connections and intra-party democracy is barely developed. People have little trust in parties, which are considered to serve the self-interest of their leaders. According to opinion polls (October 2009), 40% of Ukrainians fully mistrust parties and 38.1% mistrust them somewhat, while only 14.9% somewhat trust parties and a mere 1.9% fully trust them.

The political elite shows little willingness to cooperate with civic organizations. At national level, the formal channels for communicating societal or group interests are not well defined and access to government information remains poor. The network of interest groups is relatively close-knit, but their possibilities for influence are very unequal. Only few interest organizations possess sufficient intellectual and institutional capacity to potentially influence the government through policy analysis and recommendations, one example being the Committee of Voters of Ukraine. In contrast, financial-industrial groups and other strong economic groups are well represented in the political sphere. With the change in leadership after the presidential elections in 2010, two economic groupings which supported Viktor Yanukovich have gained representation in the presidential administration and the government. One, led by Rinat Akhmetov, is a fairly diversified and increasingly export-oriented financial-industrial group, the other, led by Dmytro Firtash, is active on Ukraine's energy markets and more interested in direct state support.

Other societal interests are less well represented. Ethnic, nationalist and religious mobilization has not played a role in the constellation of interest groups in Ukraine. Despite relatively high trade union membership levels, most workers are skeptical about the ability of unions to protect their rights. Their membership is largely formal. The largest trade union confederation in Ukraine is the Federation of Trade Unions of Ukraine (FTU), with origins in the Soviet era and more than 8.5 million members. There are a number of other trade union confederations that criticize the FTU for being pro-government and that call themselves "independent". In 2009, the three confederations of independent trade unions (all together about four million members) created a joint representative body for collective bargaining, while the FTU created its own. At the same time, several national associations of employers formed their own joint representative body, which is led currently by the Ukrainian oligarch Dmytro Firtash.

The general tendency towards monopolization of power in 2010 has also been reproduced in the relations between trade unions. The old rivalry between the FTU and "independent" trade unions seems to have shifted in favor of the former. The

Interest groups

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new Law on Social Dialogue (adopted in December 2010) divides national associations of trade unions into representative and non-representative ones. All associations that have less than 3% of employees in particular industry and 2% of the employed population in a region will be considered as non-representative and thus excluded from participation in the tripartite social dialogue. Independent trade unions which have much fewer members than the FTU might fall victim to this regulation.

On the whole, the people of Ukraine endorse democratic norms, but with specific connotations. Surveys show that quality of democracy is mainly assessed by the state's ability to deliver social welfare and keep the economy running. Respondents attached most importance to social rights, while political rights were mentioned less often. In addition, there is a strong correlation between the assessment of the economic situation and of democratization in Ukraine. In fall 2010, a representative survey revealed that people consider the economy (73%), corruption (62%) and abuse of office (50%) the most important issues, while human rights violations and democratic deficits as well as freedom of the press are of less concern. Furthermore, the severe economic crisis and the political crisis contributed to the rise of authoritarian attitudes in society in 2009 – 2010. According to polls, the belief that Ukraine needs a “strong hand” was widespread among citizens in early 2009 (80%), while almost every third was ready to accept some restriction of civil liberties in order to stabilize the situation in the country.

Approval of
democracy
6

Public trust in political institutions remains low and was the lowest in 2009 since 2000. Representative surveys (2009 – 2010) show that almost 80% of Ukrainians distrust political parties. More than 50% do not support the activity of the courts and the police in Ukraine. People supported the Orange government only to some degree. Initially, the new government enjoyed higher support; However, support declined to 13.2% (fully support) and 34.8% (support some activities) in November 2010. There is a similar development with regard to support for the new president – 40.9% supported him fully in April 2010 compared to 20.4% in November 2010. Currently, the activities of parliament are not supported by more than 50% of the population. Politicians and police officers are among the most distrusted professions.

According to the Law on Associations of Citizens, Ukrainian citizens can form political parties and public organizations. State interference is prohibited by law. There is a developed network of self-organizations. However, as a rule, social and political integration does not take place via the aggregation and representation of (societal) interests, but by the integration of people into vertical clientelist networks. These are hard to dissolve, especially in the countryside and in mono-industrial towns where people depend on local economic leaders for their socioeconomic well-being. Many self-help initiatives have a local character and are directed towards short-term goals, and often disintegrate after the attainment of those goals.

Social capital
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There is a low level of institutionalization. There are more than 50,000 registered NGOs in Ukraine, of which only about 10% are active. Many NGOs depend on external funding by international organizations, (private) charity organizations, or international projects related to technical assistance. Until the financial crisis of 2008, the significance of foreign funding was declining at the expense of domestic support; domestic sponsorship then plummeted again. NGOs have little impact in the political sphere as they can scarcely find willing and reliable counterparts in politics and public administration, especially after the change in leadership 2010. Additionally, the competition for scarce funding renders cooperation among NGOs difficult. Recently, however, bigger coalitions and networks of NGOs have developed, especially in the sphere of human and civil rights.

Internally, most NGOs are characterized by weakly developed democracy and a lack of financial transparency. There is generally a low degree of professionalization – with the exception of a few large well-established NGOs. Fewer than 2,000 NGOs are represented on a nation-wide scale and thus have permanent staff. Moreover, only about 20% of the population trust CSOs (2009). According to the World Value Survey, interpersonal trust in Ukraine is on a medium level.

II. Economic Transformation

6 | Level of Socioeconomic Development

The results of the transformation include the growing segregation of rich and poor in society, reflected by a Gini index rating of 27.6 (2008). Ukraine's HDI is 0.8 (2007). Poverty reduction started in 2001, when economic growth began to benefit the poor. According to the World Bank it fell from 32% (2001) to 8% (2008) of the population, whereas the Multidimensional Poverty Index puts it at 2% of the population (2007). In 2008, less than 2% of the population had to live on less than \$2 a day. In recent years, pensions and minimum wages have been raised, mostly as populist pre-election measures. In 2008, social benefits constituted about 40% of household incomes. In 2009, real wages declined by 10% – for the first time for a decade – but grew again by 10.2% in 2010. The once substantive pension and wage arrears – both in state and private companies – started to rise again in 2009. It is too early to tell what effect the 2009 financial crisis had on the labor market and income levels. Although the new president did not give up his populist rhetoric, the official inflation rate of 9.1% in 2010 was higher than the increases in the minimum wage by 6%. In 2011, a real wage and pension freeze is envisaged. Food price increases observed in Ukraine by the end of 2010 primarily hit the poor, who spend more than

Question
Score

Socioeconomic
barriers

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60% of monthly income on food. During the period under review, more than 50% believed that the overall situation in Ukraine worsened. In contrast, in 2010 Forbes listed eight billionaires from Ukraine with the overall net worth of \$27.8 billion – up from four in 2009.

Because of the large share of the shadow economy (according to Vice Prime Minister Borys Kolesnykov, it amounted to 55% – 60% in 2010) there is serious underreporting of household incomes in official statistics. Social inequality, however, remains pronounced. Moreover, poverty is mainly a rural phenomenon. Remittances of Ukrainian labor migrants are becoming an increasingly important factor in the country's economy, both from Russia and the European Union. According to World Bank data, remittances totaled \$4.7 billion in 2009, or almost 5% of GDP.

Gender inequality is rather pronounced. In the World Economic Forum's 2010 Global Gender Gap Index, Ukraine was ranked 63 out of 134 countries, with a value of 0.6869. Overall, there are no specific barriers based on ethnicity or religion, with the partial exception of the Roma and Tatar populations as well as refugees and (undocumented) migrants, who do not have equal access to resources.

Economic indicators		2007	2008	2009	2010
GDP	\$ mn.	142719.0	179992.4	117227.8	137929.3
GDP growth	%	7.9	2.3	-14.8	4.2
Inflation (CPI)	%	12.8	25.2	15.9	9.4
Unemployment	%	6.4	6.4	8.8	-
Foreign direct investment	% of GDP	6.9	6.1	4.1	4.7
Export growth	%	3.2	5.7	-22.0	4.5
Import growth	%	19.9	17.0	-38.9	11.1
Current account balance	\$ mn.	-5272.0	-12763.0	-1732.0	-3018.0
Public debt	% of GDP	12.3	20.5	35.3	40.5
External debt	\$ mn.	77481.5	96695.7	103434.5	116808.2
Total debt service	\$ mn.	11905.0	17932.3	22822.8	30100.8

Economic indicators		2007	2008	2009	2010
Cash surplus or deficit	% of GDP	-0.9	-1.5	-5.6	-
Tax revenue	% of GDP	16.5	17.9	16.4	-
Government consumption	% of GDP	18.3	17.0	20.1	20.1
Public expnd. on edu.	% of GDP	5.3	-	-	-
Public expnd. on health	% of GDP	6.8	6.8	7.0	-
R&D expenditure	% of GDP	0.85	-	-	-
Military expenditure	% of GDP	2.9	2.7	2.9	-

Sources: The World Bank, World Development Indicators 2011 | International Monetary Fund (IMF), World Economic Outlook 2011 | Stockholm International Peace Research Institute (SIPRI), Military Expenditure Database 2011.

7 | Organization of the Market and Competition

Ukraine has been slow to establish the necessary institutions to use its resources efficiently. Nevertheless the essential elements of free market competition have been established. Most price controls have been eliminated. In 2010 the government – under pressure from the IMF – reduced some state subsidies and raised gas prices for private households by 50%. State ownership is still relevant in several sectors regarded as strategically relevant. For example, gas imports are conducted by the state-owned Naftohaz Ukraina. Recently, the state has proposed introducing a state monopoly on grain trade, including exports, which private traders oppose.

Moreover, direct and indirect state subsidies and the dominance of financial-industrial groups result in unequal treatment of market participants and distort the allocation of resources. According to World Bank data, the informal economy's share of GNI was 52.2% (2003), while national authorities rated it at 34% of GDP (2004). A 2010 estimation by the Ukrainian government showed a GDP share of 55% – 60%.

In 2005, market entry barriers for small companies were reduced by cutting the number of necessary licenses. In some economic spheres – especially heavy industry – strong vertical integration of production chains does not allow for the market entry of new companies.

The national currency of Ukraine – hryvnia – is partially convertible. Ukraine adopted current account convertibility under the IMF's Articles in 1997, but foreign investors still face numerous currency control difficulties, as its regulations remain very restrictive. During the period under review, developments in the currency control regime were ambivalent. In 2009, the anti-crisis legislation tightened up the

Market-based
competition
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Ukrainian currency control rules (especially with respect to foreign currency loans and foreign investments to Ukraine), which were partly lifted in late 2010. At the same time, new restrictions on currencies in which foreign investments can be made, was imposed in December 2010.

Administered pricing is restricted to utilities, alcoholic beverages, telecommunications and public transport. The government also imposes the minimum and maximum intervention prices for some agricultural products (mainly grains).

The many Ukrainian sectors with weak competition include heavy industry, fuel and energy or infrastructure (such as mining, transport, water utilities, district heating and telecommunications), where capital requirement creates high entry barriers and privatization has only taken place to some degree. In 2010, there were monopolization tendencies compared to previous years. Total output of firms working in sectors with competitive structures decreased by 6% to 48.3%. Markets share of “pure monopoly” increased by 2% to 8.5% and markets with “signs of dominance” by 8% to 30.7%.

Anti-monopoly
policy

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The Anti-Monopoly Committee (AMC) established in 1994 monitors abuse of market power and prevents unfair competition. It is staffed with about 850 regular employees. As for other political institutions, in 2005 a public (advisory) council was established to exercise public control over AMC activities, and comprised of 38 members representing Ukraine’s major industry associations and NGOs. Its composition changed in January 2011.

The AMC is vested with law enforcement and advocacy powers and has a wide jurisdiction over all business entities in Ukraine and all executive agencies below the highest organs of power. In 2006 – 2008, it has also fulfilled certain duties in administering the public procurement system. Yet in March 2008, this function was transferred to the cabinet of ministers. In August 2010, the AMC regained its influence over the public procurement, as parliament adopted a new law under pressure from the European Commission and the World Bank. Mergers and acquisitions which exceed certain thresholds have to be sanctioned by the AMC. However, the Council of Ministers may grant permission based on public interest to allow mergers rejected by the AMC. AMC decisions in permit application and violation cases are subject to judicial review. Appeals are filed against 11% of all decisions.

Despite operating reasonably successfully, the AMC has several shortcomings, mainly in the institutional and legal environment. The AMC has to handle many questions and cases which could otherwise be dealt with in court, and is also involved in law-making. In addition, the actions of different state bodies, such as courts and the state property fund, are not synchronized and often counteract the

AMC's efforts. Existing legislation (such as the Ukrainian Commercial Code) still conflicts with the competition laws, and other legislation (such as control mechanisms for state aid) must be passed if Ukraine is to meet international norms. Further critical issues concern budget allocation, autonomy, investigative tools and transparency. Future challenges include competition advocacy, harmonization with the European Union's competition laws and the elimination of contradictory terms in Ukraine's Commercial Code. Finally, the AMC itself does not always make use of the imposition of harsh sanctions and fines to deter cartels.

The Ukrainian economy is highly internationalized. After years of negotiations and reforms, Ukraine joined the WTO in May 2008, and foreign trade is liberalized according to WTO rules. However, import tariffs of an additional 13% were introduced in February 2009 for a period of six months to improve the balance of payments under the global financial crisis. In October 2010, the government set quotas for grain exports until the end of the year. These were later extended until 31 March 2011. The total size covered by the quotas was also increased from 2.7 to 4.2 million tons. Ukraine's weighted average tariff rate was 2.4% in 2009. The Heritage Foundation (2011) rated trade freedom at 85.2 on a scale of 1–100 (100 meaning complete freedom). This indicator improved by 2.6 points compared to 2010.

While Ukraine has few export barriers, imports are partly restricted in the form of import licenses, especially for alcohol products and some sugar products. Free trade is further restricted by service-market access barriers, import taxes and fees, non-transparent government procurement, complex standards and certification regulations, while weak enforcement of intellectual property rights adds to the cost of trade. Some non-tariff barriers such as certification, sanitary regulations and veterinary controls, are duplicated. While customs procedures have been improved they can still result in questionable customs valuation.

Ukraine has concluded free trade agreements with all CIS countries. In 2010, the country signed a free trade agreement with the European Free Trade Association (EFTA). Under the terms of Ukraine's Partnership and Co-operation Agreement with the European Union, Ukraine enjoys most favored nation status with the European Union, but is not forced to bind its own tariffs. In 2008 Ukraine started negotiations on a new association agreement with the European Union which will include a Deep Free Trade Area. In November 2009, the European Union–Ukraine Cooperation Council adopted the European Union–Ukraine Association Agenda which replaced the former Action Plan and will prepare for and facilitate the entry into force of the new agreement. It will also pave way for extensive harmonization of Ukraine's regulatory framework with that of the European Union. Negotiations are proceeding slowly.

Liberalization of
foreign trade

7

With regard to the volume and structure of foreign trade, the developments in 2009 and 2010 were mainly determined by the global financial and economic crisis. In 2009, Ukrainian exports declined by 36.6%, imports by 43.7%, in the wake of higher growth rates in 2008. In 2010 exports increased again by 25.4% and imports by 34.5%.

Ukraine has a two-tier banking system with the independent National Bank of Ukraine (NBU) as a supervisory and regulating body and commercial banks that serve economic actors and private households. In the period under review, Ukraine's banking sector has undergone a severe crisis, some restructuring and a slight recovery. Its profitability ratios were negative in 2009/2010.

Banking system

6

In January 2011, 176 banks operated in Ukraine and another 18 banks were under liquidation. The share of foreign-owned banks in the banking system capital increased from 36% at the beginning of 2010 to 40% by the end of the year. According to Standard & Poor's and the Financial Initiatives Agency, the transparency of the Ukrainian banking sector worsened substantially in 2010. Moreover, the overall rankings for regulatory filings disclosure and financial and operating information were the lowest since 2005.

Several weaknesses of the banking system were revealed and worsened by the global financial crisis in 2009, which further undermined Ukrainian banks' capitalization and profitability.

Before the crisis, credit, mainly in foreign currency, grew strongly and was mostly financed by international donors – a very lucrative business for Ukraine's banks. Banks were dependent on foreign funding (mostly short-term borrowing), but possessed little equity capital. Due to the global liquidity crisis, Ukrainian banks and companies lost access to overseas loans. However, domestic resources were also swiftly decreasing. Mass depositors' demands on pre-term repayment led to intensive cash outflows from the banking system, nearly resulting in the collapse of the sector. The NBU reacted to this situation with the introduction of a six-month ban on early withdrawal of time deposits in October 2008. The deposits of the non-financial enterprises also declined due to the economic downturn. From October 2008 to April 2009, deposits decreased by about 20%. As a result of these developments, NBU loans became the major source of financing for banks during the crisis – the volume of refinancing reached about 7% of GDP in 2009.

At the same time, strong devaluation of the national currency against the dollar negatively affected the highly dollarized banking sector and led to quick deterioration of its asset quality.

In 2009, credit rating agencies further downgraded the country's banks. Several banks came under direct control of NBU and received liquidity aid. Of the 39 large banks, 26 were found to be undercapitalized. Recapitalization by shareholders took

place in 19 cases, and four banks were de facto nationalized. Thus, the state's role in the banking sector has increased. The Deposit Guarantee Fund, which has existed since 1998, received further funding from the NBU to pay out insured deposits. However, it was unable to effectively and efficiently liquidate insolvent banks jointly with the NBU. During the crisis, banks dismissed more than 16,000 employees and closed about a quarter of all branches.

Following the crisis, the banking sector remains highly dollarized and deleveraged and continues to rely on short-term funding. Nevertheless, deposits and liquidity in the banking system increased in 2010. Although interest rates were lowered, they remained high throughout 2010 (15% – 20% for loans in national currency for non-financial enterprises), constraining lending activities. During the period under review, lending to enterprises as well as to individuals remained weak. Under such conditions, the banking sector directed part of its excess liquidity to the high-yield (26% – 29% in 2009/2010) and less risky government bond market and thus became involved in financing the budget deficit. The most important tasks for banks are cost reduction and non-performing loan management. In 2010, the external debt of the banking sector reached its pre-crisis level, falling from almost \$40 billion in early 2009 to \$28 billion by the end of 2010.

The Ukrainian stock market remains underdeveloped. Most investment is financed from bank credits, not from the sale of stocks. Presently, the financing of small and medium businesses is insufficient. The supervision of non-bank financial institutions, notably the insurance companies, remains problematic.

8 | Currency and Price Stability

In general, the NBU has faced problems combining price and exchange rate stability. Until 2008, the NBU kept the exchange rate fixed to the dollar, but allowed for rather high inflation rates. However, in late 2008, this strategy became ineffective when large capital outflows, a sharp decline in exports and the credit crunch created tremendous devaluation pressures. The NBU had to intervene repeatedly and sell large amounts of foreign currency to stabilize the exchange rate. Such actions, however, did not prevent the devaluation. From October 2008 until October 2010, the hryvnia lost about 40% of its value against the dollar.

According to law, the NBU is not allowed to give credit to the government, including financing the budget deficit. Nevertheless, during the financial crisis the NBU in fact monetized the fiscal deficit by repurchasing government T-bills. This practice continued in 2010.

Anti-inflation /
forex policy

7

In 2009, the real effective exchange rate index was 97.0 (In 2005, 100). The IMF aims to strengthen the NBU's independence. The 2010 IMF memorandum limits the NBU's leeway with regard to monetary policy. The NBU agreed to introduce greater flexibility in the foreign exchange market and focus, its monetary policy more directly on price stability. The national currency is projected to moderately depreciate to 8.5 hryvnia per dollar by the end of 2011.

In 2009, the economic recession and the weak credit demand created an environment of generally reduced inflationary pressures, but an unbalanced budget policy and priority financing of social expenditures contributed to consumer inflation. In 2010, export growth and economic recovery helped stabilize the currency exchange and inflation rate. In 2009, the inflation (CPI) rate was 12.3%, declining to 9.1% in 2010. The government program for 2010 – 2014 aims to bring core CPI inflation to single digits. However, the expected credit growth on the Ukrainian market and the ongoing money supply growth will contribute to an acceleration in inflation in 2011, probably at 12%.

To reduce the dollarization of the national economy, the general population was not allowed to receive foreign currency credits from November 2009 until 1 January 2011. The NBU plans to prolong this prohibition.

Legislative changes in 2010 formally strengthened NBU independence. De facto independence is contingent on both the commitment of NBU leadership and government pressure. Former Governor Volodymyr Stelmakh rather successfully resisted attempts to constrain independent NBU decision-making by former Prime Minister Tymoshenko. In December 2010 President Yanukovich replaced Stelmakh with Serhiy Arbuzov from his home Donetsk region. Ukrainian experts expect growing political influence on central bank policy.

According to the Budget Performance Reports, during the period under review, state budgets initially foresaw a deficit at about 3% of GDP in 2009 and 5% in 2010, but it eventually grew to about 4% in 2009 and 6% in 2010. According to estimations, however, the broad fiscal deficit (including losses of Naftohaz Ukraine and the State Pension Fund, capitalization of commercial banks, etc.) amounted to about 11% – 13% of GDP in 2009 and 7.2% of GDP in 2010, exceeding the targeted and IMF-required 6.5% of GDP. The budget for 2011 envisages a deficit target of 3.1% of GDP in compliance with IMF requirements. However, public finances will remain under strain in 2011.

Throughout 2009, economic and budgetary policy suffered due to the ongoing political crisis and the upcoming presidential elections. During the economic crisis, the government did not optimize costs, but even increased planned budget expenditures by 12% in 2009. Among the main objectives of the government were maintenance of the social protection level, expansion of subsidies to selected

industries and bank recapitalization. In order to meet these obligations, the Tymoshenko government resorted to fiscal pressures, increasing excise taxes, demanding advance tax payments and not refunding VAT. Together with IMF Special Drawing Rights allocations, these sums were credited as revenues. In addition, the government issued bonds to finance the capitalization of banks and the energy concern Naftogaz Ukrainy. All this led to the real budget deficit being much higher than that given in official data in 2009. Furthermore, contrary to the IMF program targets agreed in November 2008, the government abstained from increasing gas prices for the population, and the parliament raised pensions and minimum wages by 20% in November 2009. As a consequence, cooperation with the IMF was discontinued, leading to the suspension of further loans by the European Union, the World Bank and the European Bank for Reconstruction and Development (EBRD).

Although economic recovery contributed to higher budget revenue collections, expenditures and especially financing grew even faster. For the first time in many years, the parliament – under the pressure from the IMF – sequestered the budget in 2010, reducing both revenues and expenditures by about 5% eventually. Moreover, failed attempts at privatizing major state-owned companies led to additional shortfalls in budget revenues.

In summer 2010, the IMF resumed cooperation with Ukraine and agreed on a new stand-by arrangement of \$15.15 billion for a period of two and a half years to overcome the country's economic crisis and to facilitate the implementation of structural reforms. Ukraine received the first two tranches in 2010 (\$3.42 billion altogether). The further allocation of funds depends upon the Ukrainian government's success in meeting IMF conditionality, including the increase of the retirement age, reforms in the energy sector and public utilities, reducing the budget deficit to 3.5% of GDP by the end of 2011 and to 2.5% by 2012.

The gross external debt of Ukraine grew by 2% to \$103.7 billion in 2009 and by 13.5% to \$113.4 billion in 2010 (about 86% of GDP). The IMF rates Ukraine's ability to repay its external debt as positive. However, there is some concern about the fast-growing domestic debt, increasing from about \$6 billion (2008) to \$17.8 billion (2010). Due to restricted access to foreign financing (until summer 2010), Ukraine had rapidly accumulated domestic public debt by issuing government bonds.

In order to meet the projected deficit targets and repay public debt in compliance with IMF conditionality the government has prepared fiscal austerity measures, including the containment of social spending, further increases of natural gas tariffs for the public and a pension reform.

9 | Private Property

The Ukrainian Constitution and the Civil Code and Commercial Code guarantee the right to private property, including non-agricultural private land. Registering a property in Ukraine takes 93 days and requires 10 different procedures.

Property rights
6

The 2008 law on joint stock companies (JSC) established a framework for the functioning of the JSCs, and guarantees a higher degree of protection of shareholders', employers', and creditors' rights. It is expected to stimulate the development of the stock market and lead to a reduction in counterfeiting. The introduction of this law explains the improvement in Ukraine's World Bank Doing Business ranking in the "protecting investors" category, leaping from 143 (2009) to 108 (2010), declining slightly to 109 in 2011. Nevertheless, the Property Rights Index, a part of the 2011 Index of Economic Freedom by the Heritage Foundation, gives Ukraine only 30 points (on a scale of 1–100), indicating that property ownership is weakly protected because the court system is highly inefficient, corruption is extensive, and the judiciary is strongly influenced by other branches of government. The situation is especially worrisome with regard to intellectual property rights. Despite Ukraine's WTO commitments, practical enforcement of existing laws for copyright industries remains weak and ineffectual.

According to the World Bank, private enterprise is difficult and costly in terms of time and money. Ukraine's standing on the ease of doing business has not improved much recently. A World Bank report (2011) ranks the country 145 out of 181 countries, up from 147 (2010). Relevant indicators include the time and cost of meeting government requirements for business start-up, operation, trade, taxation, and closure. It takes 27 days and 10 procedures to start a business. According to the Heritage Foundation's 2011 Index of Economic Freedom, Ukraine is ranked 164 out of 179 countries worldwide, owing to its low property right protection, weak judicial system, high corruption, and poor contract enforcement. It is ranked 43rd of 43 countries in the European region.

Private enterprise
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About 63% of the employed population work in private enterprises (12.5 million in 2009), of which 40% work in SMEs (5 million), 34% as individual entrepreneurs (4.2 million) and 26% in big companies (3.3 million). However, output is very unevenly distributed, with large enterprises producing almost half of it. SMEs have little influence on policy-making, and lobbying continues to be dominated by big companies.

Tax payment is the most intricate issue: There are too many different taxes. Further grievances include frequent single tax payments, time spent on dealing with tax authorities, high labor tax and contributions. The total tax rate amounts to 55.5%. The new tax code introduced in late 2010 seems ambiguous. There has been some

streamlining of taxes, but exemptions have been remained. This does little to reduce the complexity and burden of tax administration. The tax codes have been strongly criticized by the opposition and many entrepreneurs, leading to public demonstrations.

Foreign investors are entitled to repatriate profit, income or other funds relating to investments without any restrictions, after the payment of applicable taxes.

During the period under review, attempts to privatize major companies failed. For example, the privatization of Odessa Portside Plant, Ukraine's second largest producer of ammonia, was spun out and eventually cancelled in September 2009. The inter-executive conflict and personal antagonisms between Yushchenko and Tymoshenko impaired the process while the nontransparent links between political and economic actors became apparent. According to the privatization plan for 2010, the budget was to be met with UAH 6.35 billion from successful tenders and auctions. Until the end of September 2010, however, only UAH 517.85 million had been received – less than 10%. Ukraine's main telecommunication provider, Ukrtelekom, was sold at the beginning of 2011 without a tender as there was only one bid by an Austrian investor, and the government was interested in rapidly securing budget revenues of \$1.4 billion. According to experts, the energy sector will be subject to privatization in 2011 and 2012. The new leadership also plans to lift a moratorium on selling agricultural land.

10 | Welfare Regime

According to the UNDP Human Development Report 2009, the HDI for Ukraine is 0.8, which gives Ukraine a rank of 69th out of 177 countries (both numbers are for 2007). Ukraine's position has remained fairly stable. The welfare net has been improved – mainly for populist reasons before elections. Nevertheless, surveys (2008) show that the population considers state support absolutely inadequate.

Social protection expenditures accounted for about 21% of state budget expenditures in 2009 (5.6% of GDP). Ukraine's social safety net consists of two main components: services and cash transfers. The social assistance system suffers from several shortcomings that undermine efficiency, burden the budget, and impede equality. The authorities grant many categories of aid and benefits to a wide range of citizens, so that the total financial obligations exceed the country's means. Social transfers are poorly targeted – about 30% of transfers are made to those who do not actually qualify. People receive benefits not because of their individual needs but because they belong to a defined social group.

Social safety nets

6

The public pension system might be jeopardized by a lack of fiscal sustainability. Poorly designed features on both the revenue and expenditure sides of the system are ill-equipped to respond to such threats as an aging population. In 2009, Ukraine spent 20.5% of state budget expenditures on pensions (5.4% of GDP). In general, Ukraine spends about 18% of GDP on pensions. The pension system presently consists of two pillars: The solidarity system and a non-state pension provision system based on voluntary participation. The planned introduction of the third pillar (the accumulation system) in 2009 was delayed, and a new deadline set for 2012. Moreover, voluntary pension funds are limited by the development of stock market, low incomes and mistrust of financial institutions. In 2010, under pressure from the IMF the government decided to gradually raise the retirement age – first for women –from 55 to 60 years.

Public expenditure on health was 4.0% of GDP in 2007. Ukraine's health care system does not provide universal access to quality health care, spending patterns are inefficient, and informal payments are common. Adequate medical service is in fact only available in the private sector, making it too costly for most people. Ukraine has the most severe HIV/AIDS epidemic in the region, with an estimated adult prevalence of about 1.6%. Despite the efforts of stakeholders, the coverage and effectiveness of most HIV/AIDS programs in Ukraine remain too limited to have a significant impact on the epidemic. They mostly focus on treatment of infected people but neglect preventive measures. Even though handicapped people are entitled to social benefits, they normally live in poverty.

In general, all ethnic groups – with the partial exception of the Crimean Tatars and the Roma – have equal access to the labor market and public office. However, new immigrants (from Africa and Asia) are largely excluded from the official labor market and face strong discrimination. Moreover, Ukraine's structurally ingrained poverty leads to exclusion based on place of residence, age, social status and family size.

Ukraine's gender inequality index (UNDP, 2010) is 0.463 (on a scale of 0–1, 1 signifying complete gender equality). The World Economic Forum's Corporate Gender Gap Report (2010) places Ukraine at position 62 out of 130 countries with an index of 0.6856 (on a scale of 0–1, 1 signifying complete gender equality). Women are underrepresented in economic and political leadership positions. Women earn 27.6% less than men for equal work. The sixth convocation of the Verkhovna Rada (after the 2007 elections) has only 34 women among its 450 deputies, or 7.6%. There is a distinct tendency for councils to be more gender-balanced the lower they are in the government hierarchy. Women are overrepresented in tertiary education, but have inferior positions on the labor market. The new government opposes women's participation in politics, relegating them to their "proper places" in the domestic sphere.

Equal opportunity

6

According to the law, disabled persons enjoy equal rights, which are, however, often not realized.

11 | Economic Performance

The global financial crisis exposed Ukraine's macroeconomic vulnerabilities – a one-sided export structure and high capital needs which largely depend on developments in international markets for metallurgical products and inflows of foreign capital. A tremendous economic downturn set in during the last quarter of 2008 and continued in 2009. In 2009, GDP decreased by almost 15%. At the same time, GDP per capita in PPP declined to \$6,327 in 2009 from \$7,288 in 2008. The economy started recovering in 2010 with GDP growing by about 4.2%. According to forecasts, GDP will increase by about 4% in 2011. Industrial production declined by 21.8% in 2009, but grew again by 11.2% in 2010. Besides low base effect, exports have been the main driver, but domestic demand has also begun recovering, albeit much slower. Construction and financial activities, however, continued to decline in 2010. Ukraine's current account balance was negative in 2009, amounting to \$1,801 billion.

The unemployment rate (according to ILO standards) reached 9.6% in 2009 and 8.8% in 2010 compared to 6.9% in 2008. Inflation (CPI) amounted to 15.9% in 2009 and 9.1% in 2010 with somewhat higher inflation expected in 2011 and 2012.

In 2009, investment declined tremendously in all sectors, on average by almost 50%. Gross capital formation (gross domestic investment) amounted to 18.8% of GDP (2009), down from 25.3% in 2008. FDI amounted to 4.2% of GDP in 2009, declining from 6.1% (2008). In 2010, investment spending remained very weak, but grew for the first time since 2008 (3.2%) mainly due to preparations for UEFA European Football Championship 2012. Bank lending to the real economy virtually stopped in 2009 and continued to stagnate in 2010.

In 2009, only 19.2% of manufacturing enterprises used technologies aged less than five years old. About a quarter of companies used five- to 10-year-old technology, while the remainder used older technology. In other words, it was the employment of under-utilized capacity and underemployed people that led to growth. Presently, however, most companies work at the capacity limit and more investment in industrial production is urgently needed.

Output strength
6

12 | Sustainability

Ukraine's environmental performance index was 58.2 (of 100) in 2010, ranking it 87 out of 163 countries. The country's numerous environmental problems are the legacy of Soviet industrialization and insufficient investment in clean technology and energy efficiency. The Donetsk–Dnepr industrial region has one of the highest levels of water and air pollution in Europe, mainly caused by the operation of antiquated iron and steel plants and power plants. Air pollution in the big cities has become a major problem, followed by inadequate supplies of potable water and inefficient energy use. The ecological situation improved somewhat due to the economic decline in the 1990s. As a signatory to the Kyoto Protocol, Ukraine can trade its emissions certificates to finance investment in the industrial modernization and reduce dependency on energy imports. However, international environmental organizations have criticized Ukraine for blocking negotiations at the World Climate Summits in Copenhagen and Mexico City. The Ukrainian government agreed to reduce greenhouse gases by 20% compared to 1990, although this will in fact mean an increase of 75% between 2007 and 2020. Industrial decline rather than the modernization of production facilities has led to the recent reduction of emissions.

Ukraine ranks as one of the most energy-intensive countries in the world. According to Enerdata, its energy intensity of GDP at constant PPP was 25% higher than the Commonwealth of Independent States average and almost four times higher than in the European Union. As the main energy source, gas is relatively cheap, and there are almost no incentives to reduce consumption rates. There is considerable potential for energy saving both in private households and in the corporate sector: Past rises in gas prices have not led to a feared decrease in industrial production, but instead caused companies to invest in energy-saving technology. This situation also has a political dimension, because most energy resources have to be imported – mainly through Russia – making Ukraine politically vulnerable. The share of renewable energy was only 0.6% in 2008.

Although environmental objectives are anchored both legally and institutionally, thus far they have been implemented selectively. A drive for sustainability stems both from Ukrainian civil society and the international community. The main donors in this field are the European Union and UNDP; major lenders are the World Bank and the EBRD.

During the period under review, there were positive developments in Ukraine's environmental policy, albeit, as a result of external proposals and pressures rather than the government's own drive. In 2009 a law on "green" tariffs came into force and should promote the use of alternative energy sources at power plants. A state energy efficiency program for 2010 – 2015 and the first National Environmental

Environmental
policy
5

Policy Strategy since independence (lasting until 2020) were approved in 2010. The objectives set in the programs are unrealistic and require substantial investments.

State and private institutions for education, training and development exist in all fields and at all levels, but standards vary greatly. As a rule, quality management is not implemented. According to a Gallup poll in August 2010, only 40% of respondents were satisfied with the quality of education. The number of private secondary education institutions is growing steadily. In 2004/2005, 61% of those enrolled in post-secondary education paid tuition fees. Access to high-quality, recognized education institutions often requires significant financial capability or corruption. Life-long education is planned in the framework of the Millennium Development Goals. In 2007, public spending on education amounted to 5.3% of GDP, equaling 20.2 % of total government expenditure. Ukraine achieved 0.96 (on a scale of 0–1) on the U.N. Education Index in 2007, for adult literacy (99.7%) and enrollment. The gross enrollment rate in tertiary education is relatively high at 79% in 2008.

Ukraine is suffering a brain drain, particularly in technology and the natural sciences, both to Russia and the West. Expenses for R&D have decreased: They amounted to 1.1% of GDP in 2003 and to 0.85% of GDP in 2007. More than 50% came from the public sphere, about 30% from private business and the rest from nonprofit organizations or from abroad. One major problem is the protection of intellectual property rights. The Global Innovation Index 2009/2010, which measures the business outcomes of innovation and government's ability to encourage and support innovation through public policy, ranked Ukraine 61 out of 132 countries.

Education policy /
R&D
6

Transformation Management

I. Level of Difficulty

Structural constraints emanate from the ecological, social and economic spheres. The Chernobyl nuclear power plant is still an ecological and humanitarian burden for Ukraine, with lasting social, medical and environmental (radiation) effects. In the economic sphere, the export-dependent economy and energy dependency are structural constraints that cannot be removed quickly. Ukraine depends on Russia as a supplier of both gas and oil, either directly or indirectly, because pipelines from Central Asia go through Russian territory.

Structural
constraints
5

Ukraine is undergoing a severe demographic crisis characterized by an aging and shrinking population. According to WHO, the average life expectancy was 61 years for men and 73 for women in 2006. At 1.22 children per woman (2008), the country's fertility rate is among the lowest in the world, which will cause economic and social problems in the future. So far, policies and institutions are ill-equipped to deal with the consequences of this development, such as higher expenditures in health care, elderly care and pensions as well as a declining labor force. Ukraine has the highest prevalence rate of HIV/AIDS in the former Soviet states. Since 1995, the virus has spread dramatically, first among drug addicts, but increasingly through sexual transmission. According to UNAIDS, the estimated percentage of Ukrainian adults and children living with HIV/Aids at the end of 2008 was about 1.6%. The policy response of the Ukrainian state is viewed positively, but remains insufficient. The epidemic will also contribute to higher costs for health care and a decline in the labor force.

Ukraine has become a transit – and increasingly a destination – country for refugees and asylum seekers who hope to enter the European Union (to apply for asylum there). These refugees pour in from the former Soviet Union (Armenia, Chechnya), Asia (mainly China and Afghanistan) and Africa (e.g., Somalia). The European Union considers Ukraine a safe third country. In October 2006, the European Union and Ukraine concluded a readmission agreement requiring Ukraine to readmit undocumented third-country nationals who traveled through Ukraine before gaining access to E.U. territory, even though Ukraine seems incapable of meeting human rights standards. Support for refugees is negligible and human rights abuses are regularly observed. Simultaneously, Ukraine is a country of labor emigration.

Several million Ukrainians work (temporarily) abroad, mainly in the European Union and Russia. Trafficking in women and children also plays a role; estimates vary from several dozen thousands to half a million victims.

Civil society traditions date back to pre-Soviet times. During the Soviet era, civil society was suppressed and controlled by the party state. Some major human rights organizations such as the Ukrainian Helsinki Human Rights Union or the Kharkiv Human Rights Protection Group have their roots in the Soviet human rights movement. The same applies to some charitable foundations. In recent years, popular acceptance of and involvement in civil society improved, even though few people have become NGO members. However, public trust of NGOs remains low, ranging between 25% – 35%, and the public disillusionment which followed the Orange Revolution led to a fresh retreat to the private sphere. In general, there are some differences in the history and current formation of civil society across Ukraine's various regions, with the western regions being more exposed to international contacts and experience. Moreover, there is a clear – historically developed – divide between urban centers and the countryside, with the latter having less developed NGO networks.

Civil society
traditions

5

Presently, only about 10% of Ukrainian NGOs work on a steady basis. Many CSOs depend on support from outside agencies. Legislation – mainly in the field of taxation – continues to be detrimental to the development of CSOs. There is only a limited choice of sources from which they can generate incomes without risking a forfeit of their nonprofit status. Moreover, many NGOs depend on (local) administrations. Their heads not only cooperate with the state, but also often personally depend on the state for their livelihood, while administrations tend to co-opt NGO members. A legacy of distrust – especially at the administrative level – remains an impediment to the development of civil society.

Even though Ukraine is an ethnically, linguistically and religiously diverse country, ethnopolitical conflicts remain insignificant. None of Ukraine's five major churches constitutes a state church. Ukraine has liberal laws regarding religion, which also guarantee freedom of religious practice.

Conflict intensity

3

Although they are deplorable, the racially motivated crimes mentioned earlier do not have the potential to develop into serious conflicts encompassing larger parts of society. Also the east–west political polarization has little conflict potential – even during its highest peak in 2004, there was no violence.

However, Ukrainian politics are perceived as a zero-sum game and are therefore rather confrontational, as proved by political instability in 2005 – 2009. The political style of the new President Yanukovich does not add much to stability, despite his rhetoric. His fairly successful attempts at monopolizing political power go hand in glove with the suppression of opposition forces. The ruling group acts

according to the principle “If you’re not with us, you’re against us” and is obviously not willing to accept the legitimate role and rights of the opposition.

II. Management Performance

14 | Steering Capability

Question
Score

Ukraine’s political leadership claims to pursue long-term aims, but these are often replaced by the short-term preoccupations of political bargaining and office-seeking, which regularly result in populist measures. Until 2010, constantly shifting political alliances rendered prioritization difficult, and few long-term goals have been pursued over time – for example WTO membership, which was an uncontroversial issue among the political leadership.

Prioritization
5

Other strategic goals such as E.U. and NATO membership were not achieved during Yushchenko’s presidency due to external constraints and lack of domestic consensus. In 2010, the new leadership officially abandoned the aim of NATO membership. It is now primarily striving for the economic integration with the European Union, and in particular the creation of a Free Trade Area and the abolition of the visa regime.

The new economic strategy for 2010 – 2014 includes a number of mid-term goals, but the need to balance different economic interests leads to a distortion of the planned reforms or their protraction.

In certain policy fields, political priorities are partly induced by external actors which provide financial and other incentives, such as the European Union or international lenders.

Although the former government (December 2007 – March 2010) was in principle committed to democracy and a market economy, it had only medium success in implementing its reforms. This was partly due to institutional blockades. In addition, the periods between elections were not used productively. Legislative outcome was very low.

Implementation
6

After the change in leadership, the parliament has passed an impressive number of laws, albeit mostly without any debate. Several new initiatives are, however, not based on parliamentary decisions but solely on the initiative of the government and the presidential administration. For example, the new leadership launched administrative reforms at the end of 2010, cutting central executive bodies from 112 to 63 and reducing the number of ministries by four to 16. The staff of the

presidential administration was cut by 20%. The central aim is to reduce administrative spending starting from 2012 and to improve the structure of the central government administration. Local administrations will be targeted in the future.

Public administration continues to suffer from a rather high degree of politicization while professionalism remains underdeveloped. This new consolidation of power renders it potentially easier to implement policy at the expense of democracy, pluralism and the rule of law. Moreover, the new authoritarian style might prove detrimental in the long run.

External influence mainly by the European Union, Russia and the United States continues to determine policy formulation. The European Union and the United States are also Ukraine's main donors. Recently, the IMF has gained more influence on budget formation.

Frequent staff turnover renders political learning difficult. The new leadership under Yanukovich quickly reshuffled many top officials in ministries and other public bodies.

Monitoring and evaluation of public policies are conducted primarily by independent think tanks or other analytical institutions, but are rarely taken into consideration by officials. Moreover, the role of expertise in governance processes seems to be diminishing still further under the new leadership. In order to optimize personnel costs, President Yanukovich liquidated the Institute of National Security Problems and the National Institute for International Security Problems and cut the staff of the National Institute for Strategic Studies by 20% in early 2010.

15 | Resource Efficiency

The government has used only some of its available resources efficiently. The Ukrainian state remains much too centralized to adequately produce administrative and budgetary alternatives for efficient government action in the regions. The new budget code adopted in 2010 envisages more financial independence for subordinated government units, but entered into force in January 1, 2011.

After the election of the new president, there was a high fluctuation of office holders in the higher political echelons. As a consequence, state action is often linked more closely to special political and economic interests than to the common good. Moreover, recruitment into the civil service does not always follow the principle of merit, but is often determined by politics and loyalty. Thus, many experts point to the fact that a lot of new officials come from Donetsk, the home city of the President Yanukovich. There is also a skill mismatch on the labor market as the educational system is insufficiently oriented at labor market needs.

Policy learning
6

Efficient use of
assets
4

The administrative reform initiated by the new government aims at reducing personnel expenses by at least 20%. In general, Ukraine spends about 18-20% of its GDP on the public sector. Yet, the modernization and professionalization of personnel in ministries and public administrations is very uneven. There are enclaves within the administration which are fairly transparent, energetic and innovative. They are mostly to be found in new policy fields, often related to EU integration. Others adhere to a Soviet style of administration and are therefore amenable to the top-down leadership style of the new government.

In 2009, the parliament did not pass the 2010 budget, mainly due to the presidential campaign. Prime Minister Yulia Tymoshenko was not willing to implement the cuts demanded by the IMF in order not to weaken her chances in the presidential race. The 2010 budget was only approved in April 2010. The 2011 budget was passed in a short period of time, however without any parliamentary debates. Both the 2009 and 2010 budgets were in deficit. According to the Budget Performance Reports, in 2009 it amounted to about 4% of GDP, while in 2010 - 6%. Yet the planned budget expenditures are often many times revised during the year and adjusted to the current situation. In 2010 subsidies and other expenses were cut due to pressures by the IMF. Yet, most expenditures are pre-assigned; social transfers, which constitute a large part of government spending, are not sufficiently targeted to the poor.

Until the end of 2009, the obstructive conflict over competencies between the prime minister and the president, partly caused by the imprecise division of powers in the amended constitution, had a paralyzing effect and made policy coordination between different executive branches practically impossible. Moreover, due to the weakly institutionalized coordination between the government and the parliament, draft laws were rarely promptly adopted and then actually implemented, despite efforts within relevant ministries.

Policy
coordination
5

With each leadership turnover, the institutional framework has been restructured and responsibilities have been shifted and often duplicated. The formal executive structure has been regularly supplemented by a set of advisory bodies, committees and associations, which have often been short-lived.

The policy coordination improved in 2010, but mainly due to the monopolization of power by Yanukovich and his allies. The Ukrainian Parliament has been very quick in adopting legislation proposed by the government or the President. In December 2010, Yanukovich – under pressure from the IMF – signed a decree on administrative reform, which is mainly about streamlining the administration. He reduced the number of central executive bodies from 112 to 63 and restructured the public sector according to the functional rather than sectoral principle, which should help eliminate redundancies and overlaps.

Yet, despite the monopolization of power, the new leadership is far from homogeneous but supported and influenced by various business interests. So far, Yanukovich managed to balance these interests and there were no open conflicts over policy coordination as it was the case during the former President Yushchenko. Because business representatives are concentrated in different branches of government, policy approaches might become incoherent as they are subject to immediate, often competing, interests.

Ukraine remains a classic case of a state in which private interest groups colonize important parts of the state, patronage networks determine the distribution of state resources, and corruption permeates state and administrative culture. Corruption is sustained by over-regulation, which opens opportunities for the extortion of bribes not only for illegal actions but also for timely and proper performance of legitimate services.

During the period under review, initially positive developments in anti-corruption policies turned around into a negative trend with the new government. In 2009, Tymoshenko's government introduced the post of a Government Commissioner on Anti-Corruption Policy. After the presidential elections in 2010, the new government created the Bureau of Anti-Corruption Policy within the Cabinet of Ministers. Yet, both agencies were liquidated in early 2011. In March 2010, President Yanukovich established a National Anti-Corruption Committee under his chairmanship. As a consequence, anti-corruption efforts are now solely under presidential control. Although the parliament adopted a package of anti-corruption laws in June 2009, its entry into force was postponed twice and in December 2010 parliament abolished it altogether. The adoption of the new draft law initiated by the president, which in contrast to the old anti-corruption laws provided no mandatory reporting of income for the family members of officials, was postponed until March 2011. Anti-corruption policy is currently being instrumentalized by the ruling party to weaken the opposition as many members of the former government were accused of abuse of office. In general, corruption seems to be rising under the current government. The Ukrainian Helsinki Human Rights Union reported more complaints about corruption at the local level.

Anti-corruption
policy
3

16 | Consensus-Building

After the 'Orange Revolution', the major political and economic actors have had a basic consensus about general goals, despite frequent government changes and significant political volatility. The principles of market economy and democracy as such were not questioned. But they frequently took a back seat when short-term interests related to power preservation or enhancement were concerned – a tendency that was again especially pronounced in 2009. There is more consensus between the Yanukovich presidency and the Azarov government – as they are both

Consensus on goals
7

from the same political camp and share similar visions and interests. However, they are less oriented to democracy than to ‘stability’, which is to be achieved by authoritarian means. The new leadership commits itself to market economy, at least on paper, as reflected in the economic program for 2010-2014 “Prosperous Society, Competitive Economy, Effective State”. Yet, recent developments in the economy indicate that the existing “capitalism for the few” most likely will not change in Ukraine. The opposition, which is more committed to democratic and pluralist principles, is divided by internal rivalries and ideological differences and has been largely marginalized in 2010, thus not capable of promoting democracy and the development of market principles on a broad scale.

A 3%-threshold for access to parliament served to exclude some veto powers from political representation and to consolidate the party system. Recently, however, the ultra-nationalist party ‘Svoboda’ did well during several elections in Western Ukraine. In March 2009, it won the elections for the regional council in Ternopil’ with 34.69%. During the local elections in October 2010, it also gained 35.3% and 15.8% of the votes in the L’viv and Ivano-Frankivsk regional councils respectively. Nationwide it was elected by only 1% of the electorate, but polls show its growing popularity - 3.4% in October 2010, largely due to both the political development under President Yanukovich and the disunity and weakness of the opposition.

Anti-democratic
actors

5

After the presidential elections 2010, all relevant institutions and some politicians who belonged to the opposition opportunistically realigned with the new ‘party of power’. This is a clear indicator that for many politicians, democracy is not a value on its own, but can be strategically disregarded. Some economic interest groups factually undermine democracy without explicitly fighting or questioning it.

None of the current social cleavages pose a threat to the state. However, a central challenge is to overcome the socio-cultural and socio-political cleavages between the different regions that resulted from different historical experiences and institutional legacies. Different popular and elite attitudes to democracy, the free market and key issues of foreign policy stemming from these cleavages have inhibited progress or are used as smoke-screens to hide specific interests and ambitions for power. These cleavages are partly reflected in the party system (with the Party of Regions being especially strong in the East and the South) and have repeatedly been misused by politicians, who claimed to reunite the country. Yushchenko’s history policy disaffected many people in Eastern and Southern Ukraine, while the new leadership presently alienates the Western part of the country, especially with regard to language and history policy. For example, the former President Viktor Yushchenko sought international recognition of the 1932-1933 famine, called in Ukraine the Holodomor, as genocide of the Ukrainian nation. Yet the new President Victor Yanukovich believes that the Holodomor was one of many famines which inflicted the Soviet Union in the 1930s. History textbooks are planned to be re-written in this ‘neo-Soviet’ reading. Moreover,

Cleavage /
conflict
management

5

statements of some politicians such as the Russophile Education and Science Minister Dmytro Tabachnyk, who does not consider Western Ukrainians as ‘real Ukrainians’ and considers the Holodomor an invention of Western scholars, exacerbate the regional cleavage even further.

In general, NGOs have little impact on political decisions. The political leadership frequently ignores civil society actors and formulates its policy autonomously. One notable exception was the formulation of the law on gender equality, where civil society groups were involved. Some scholars or think tanks, which are clearly affiliated with political parties, are consulted more frequently, and some have been co-opted into the new government and presidential administration.

Civil society
participation
4

Under the new president, many consulting bodies which existed at the national level (presidential office, government) and comprised civil society actors and experts – such as the National Committee for Freedom of Speech, the National Center for Euro-Atlantic Integration or the National Constitutional Council – have been abolished, further diminishing the influence of civil society on decision-making.

The Ukrainian legislation foresees the formation of Public (Advisory) Councils in state agencies that should ensure civil society control over the political process. Yet, many of these councils exist only formally and their effectiveness remains very low.

To date, many historical injustices in Ukraine – mostly related to Stalinist or Nazi crimes – have not been discussed comprehensively or systematically. Under former President Yushchenko, the ‘Holodomor’ became an exception. While parliament adopted a law on the famine in 2006, the Communists and the meanwhile ruling Party of Regions refused to back it. The issue served as a tool in dissociating Ukraine from its Soviet past, what increased tensions with Russia that does not perceive this as genocide. The new leadership under Yanukovich adopted a new vision and policy, refusing to recognize the Holodomor as genocide against the Ukrainian people. Furthermore, Soviet historiography is being re-established and commemoration days are celebrated in a Soviet style.

Reconciliation
4

Crimean Tatars and Germans who were forced into exile during the Stalinist period have been allowed to return to Ukraine. A further thorny issue is the role of ethnic Ukrainians in the murder of Ukrainian Jews during the Holocaust. So far, the Jewish minority has largely been excluded from Ukrainian historiography.

17 | International Cooperation

The Ukrainian government cooperates with bilateral and multilateral international donors and tries to make use of international technical and financial assistance. Ukraine receives substantial amounts of aid to improve governance and living standards and humanitarian issues. More than 30 donors are involved in Ukraine with the EU being the largest one.

Effective use of support

6

Ukraine is one of the major recipients of assistance from the United States. Several United Nations organizations are present in Ukraine, including UNDP, UNHCR, IOM and others. Moreover, Ukraine cooperates closely with and profits from financial assistance from the IMF, the World Bank and EBRD. Total net disbursements of Official Development Assistance amounted to almost 800 million US\$ in 2008; aid per capita was 13.4 US\$.

Even though Ukraine is a signatory to the Paris Declaration on Aid Effectiveness, aid coordination is weakly developed and harmonization with its own reform agenda is insufficient. Related government programs lack prioritization and sequencing of measures. Moreover, aid disbursed for the government sector is mostly not included in the annual budget and either under- or over-estimated. Effectiveness of foreign aid is only measured by donors, not by Ukrainian authorities. Often, donors establish project implementation units because they perceive a lack of capacity within the government agency for effective project implementation. However these units often have a ‘capacity depleting’ effect for government agencies. Finally, a comprehensive database or information source on foreign aid is lacking.

With political stabilization after the presidential elections in 2010, the situation improved to some extent. International partners regained some confidence in Ukraine and there was intensification of different aid and loan programs, the agendas of which, however, are set mostly by external actors.

After the Orange Revolution, the will for swift integration with Western institutions seemed beyond doubt. However, there have been numerous setbacks – mainly due to failed internal reforms in Ukraine. Therefore, Ukraine has lost some of its credibility. Until the end of 2009, the government was hardly able to deliver on its declared aims of further democratization and market reforms due to the continued political crisis and the intensification of the political battle due to the up-coming presidential elections.

Credibility

6

The recent political developments under President Yanukovich and the government under Prime Minister Mykola Azarov have cast serious doubts on the leadership’s commitment to the aim of full-fledged democracy. Both the US (Secretary of State

of the United States Hillary Clinton) and single EU governments (such as Germany) have criticized the new Ukrainian leadership with regard to the freedom of expression, harassment of civil society actors and the opposition. Even the EU warned Yanukovich in an unusually harsh manner. During his visit to Ukraine in January 2011 Commissioner for Enlargement and European Neighbourhood Policy Stefan Füle called for independence of the judiciary.

Many political decisions continue to be donor-driven or compelled by conditionality set by international organizations such as the EU, the World Bank or – especially – the IMF. The level of commitment on the Ukrainian side depends on the policy field. Moreover, it is often subject to short-term considerations.

Ukraine has concluded good neighborhood agreements with all of its adjacent states. Ukraine is a founding member of the Commonwealth of Independent States (CIS) and a member of the security alliance GUAM. But these organizations, the latter mainly founded to counteract Russian influence in the region, are not very active and integration is superficial.

Regional
cooperation
8

In 2009, relations with Russia remained difficult. Tensions arose out of the gas conflict of January 2009, Russia's six-month delay in sending the new ambassador to Ukraine and an open letter of the Russian President Dmitry Medvedev to his Ukrainian colleague Yushchenko, in which the latter was among others blamed for failing to adhere to the principles of friendship and partnership laid down in the treaty of 1997.

Under the new Ukrainian leadership, relations with Russia have changed dramatically. Two sources of tensions between Russia and Ukraine have been eliminated in 2010, reducing the potential for conflict in the region. First, in April 2010, Ukraine agreed to extend the lease of the Russian Black Sea Fleet's base in Sevastopol (Crimea) until 2042 in exchange for a 30% discount on gas prices until 2019. Second, Ukraine officially abandoned the NATO membership goal in June 2010 - a strategy perceived by Russia as threatening its security. More cooperation and joint ventures are envisaged in the nuclear and aviation industries as well as growing investment and ownership of Russian companies in Ukraine.

Moreover, Ukraine has been cooperating with many Western neighbors – first and foremost Poland – to strengthen its integration into EU structures. There are also cross-border projects with Poland, Hungary and Romania, mainly within the framework of the European Neighborhood Policy and the Eastern Partnership. These include simplified border crossings for people living within 30 km of the border with Poland.

Strategic Outlook

Recent developments in Ukraine have been rather unsatisfactory in many respects. Both structural constraints and political developments are serious challenges. Ukraine's population will continue to decline and overage. EU harmonization will certainly continue. However, the troublesome regression in democracy and freedom will not contribute to Ukraine's ability to join the EU even in the long run. Energy dependency will remain one of the most crucial factors determining economic development.

Ukraine's transformation strategy should focus on the following issues:

Politics: Decentralization should be implemented as soon as possible to improve the delivery of services to citizens and complement the introduction of the new Budget Code. Both the President and the current government should stop the erosion of democracy and the rule of law, including the de-facto instrumentalization of the judiciary as well as the marginalization and harassment of the opposition, civil society actors and journalists. The political opposition is weak and divided. It should cooperate in order to counteract the disturbing tendencies towards authoritarianism under Yanukovich's leadership.

Economy: Further diversification of the economy is necessary to reduce Ukraine's vulnerability to external (trade) shocks and to reap higher revenues. Resource and energy efficiency could be improved; there is a high saving potential in both industry and private households. In addition, the government should pursue an active labor market policy that takes into consideration the human and intellectual resources that lay idle and invest in human capital. Most steps taken by the current government are aimed at short-term stabilization, but not at structural reforms. However, financial dependency and conditionality, especially by the IMF, will force the Ukrainian government to tackle much needed reforms.

International Relations: Ukraine should carry on with EU-harmonization, especially with regard to free trade and the free movement of people. Ukraine should continue its negotiations toward the association agreement. To attract additional funds and programs and to ensure a more efficient and effective use of external assistance, Ukraine should develop a more coherent external assistance coordination system. In its relationship with Russia, the Ukrainian government should avoid trading short term advantages for long term economic and political dependency.

Social sphere: The government should protect disadvantaged people according to individual needs by rendering the social security system more targeted to the poor. With regard to the demographic change, the government must adjust social security systems and public infrastructure and take unpopular measures. The problem of the HIV/AIDS epidemic needs to be addressed more seriously. More public awareness campaigns are necessary, as prevention seems the only possibility to slow down the spread of the disease.