

POSITION PAPER: SUSTAINABLE ECONOMIC GROWTH IN THE MIDST OF SUBOPTIMAL INSTITUTIONS IN UKRAINE

by Volodymyr Dubrovskiy and Dmytro Boyarchuk



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EXECUTIVE SUMMARY

The rule of law (RoL) in Ukraine is unreliable and suboptimal. This contrasts sharply with the diagnosis of foreign observers and international financial institutions (IFIs) that Ukraine's institutions are simply weak. Foreign observers often focus only on Ukraine's visible problems, such as corruption and oligarchic influence. However, these issues are symptoms of a much broader problem: a virtually nonexistent rule of law that has been replaced by a system of patronalism. This problem has deep historical roots, perpetuated by a system of feedback loops that create a path-dependent "bad equilibrium".

Informal networks, or customary law, often overshadow formal written rules in Ukraine's dysfunctional RoL. Sometimes customary law is consistent with written rules. This leads foreign observers to perceive Ukrainian institutions as functioning effectively. In most cases, however, there is a discrepancy between customary law and formal legislation. In these situations, the rule of law fails, and citizens resort to paying bribes to government officials to continue their traditional practices, which deviate from what is prescribed by written rules. There is no effective way to enforce compliance with written rules when they conflict with customary law due to the dysfunction of law enforcement agencies. Moreover, the same informal networks overshadowing the formal state institutions constitute actual mechanism for state's governance.

According to the World Bank's Rule of Law Index, **Ukraine fares much better in terms of its fundamental institutions than clearly failed states such as Afghanistan.** But it is significantly worse off than even the weakest countries in Eastern Europe, such as Bulgaria and Romania. In the modern history, no EU member state has ever been confronted with such a significant institutional gap as Ukraine faces now.

The current state of a nearly defunct RoL system in Ukraine is not a temporary situation. Nor is it caused solely by corruption. It requires a decade-long, intensive reform process. Ukraine's "bad equilibrium" stems from its more than 300-year history as part of the Russian Empire and later the Soviet Union. Although Poland and the Baltic states were also under the Russian Empire for a long time, they never fully adopted the Russian institutions, which were characterized by patronalism and arbitrary application of the law, as deeply as they have been integrated into Ukraine. This means that the unique challenges Ukraine faces in its efforts to break free from the negative legacy of its past cannot be fully addressed by the success stories of Eastern European countries in transforming their institutions.

There are no examples of successful breakaway from the deeply entrenched patronalism resulting solely from the conventional recommendations that are typically made by IFIs in the countries of Eastern Europe or anywhere else in the world. The only example of a successful dismantling of the Russian/Soviet-style discretionary institutional relationship was observed in Georgia. This success story, in contrast to the advice given to the country by the IFIs, was achieved thanks to unconventional and even innovative approaches.

To break the cycle of "bad equilibrium", economic policies in Ukraine should prioritize simplicity, straightforwardness, and liberalization in the context of an unreliable RoL. This should be done

until basic legal structures are firmly established. Institutions and policies that have been successful in countries with a functional RoL and a high level of bureaucratic quality need to be adapted with caution to the Ukrainian context. Given Ukraine's suboptimal institutional environment, this adaptation should involve a thorough assessment of their suitability. Tailored, unconventional or innovative approaches are needed to escape the current "bad equilibrium". Before more standard policies and institutions can be effectively implemented, it is crucial to establish functioning and reliable RoL in specific sectors.

The recipe for successful reform efforts in an environment of suboptimal RoL should include a drastic reduction in officials' discretion in implementing and enforcing the law, simplification and/or streamlining of procedures, and increased transparency. In addition, a complete overhaul of certain institutions is crucial. This should be done under the supervision of civil society and international experts. This is essential to bridge the institutional gap between Ukraine and even the weakest EU member states.

It is not corruption, but the rule of law that is the most acute problem of Ukrainian institutions. The rule of law in Ukraine is not only weak, but also suboptimal and unreliable. This leads to a serious deficiency in the system.

A foreign observer who is not deeply involved in Ukrainian affairs and who focuses only on the most important formal institutions might perceive Ukraine as a liberal democracy with a competitive market economy, the rule of law, and well-established property rights. Any "deviations" from these "ideal" written norms are usually attributed to corruption. As a result, such observers conclude that the solution to bringing actual practices in line with the written laws is to fight against corruption, primarily through punitive measures.

But this is only a superficial and largely inaccurate diagnosis, much like calling a situation "a fever". Like a fever, corruption in this and many other cases is not so much a disease in itself, but rather a symptom of more complex and deeply rooted problems that simple and seemingly direct treatments cannot resolve. These problems cannot be cured overnight, even with the political will of a non-corrupt leader. In the case of Ukraine, the underlying problem can best be described as a rule of law that is largely overshadowed by its antithesis – personal power – and thus effectively defunct.

The Encyclopedia Britannica defines the rule of law as "the mechanism, process, institution, practice, or norm that supports the equality of all citizens before the law, secures a nonarbitrary form of government, and more generally *prevents the arbitrary use of power*."¹ Thus, RoL stands in stark contrast to personal power, with the two concepts being mutually exclusive. No one, not even a supreme ruler, is above the law under an effective RoL. In contrast, the absence of RoL is tantamount to vaguely constrained personal discretionary rule, known as "vlast" (to which "power" is not a full equivalent) in Russian. Conversely, the establishment of RoL involves imposing strict and robust limits on such discretion, primarily by restricting actual discretion.

¹ See <https://www.britannica.com/topic/rule-of-law>.

There is a significant difference in how international organizations, such as the IMF, and those who actually use these services, i.e. Ukrainian citizens and businesses, view the RoL in Ukraine. RoL in Ukraine is perceived as weak and in need of reform by most foreign advisors, especially those from IFIs. They advocate greater efforts to combat corruption and non-compliance with written rules. However, they do not advocate changes to these rules. Reform of the judiciary, with a focus on the courts and prosecutors, is often seen as both necessary and sufficient for the establishment of a functioning RoL, sometimes together with reforms in other law enforcement agencies.

While we agree that reforms in these areas are essential and should be prioritized, we argue that reforming law enforcement and the judiciary alone is not enough for Ukraine. Describing the RoL as merely "weak" does not fully capture the situation. The term "weak" implies a certain level of functionality with occasional failures. In Ukraine, however, the law enforcement and judicial systems are, at best, unreliable in administering justice and are often used to selectively prosecute political and business opponents. In other words, it is not isolated cases of non-compliance with written rules that are exceptional. Rather, it is cases of effective application of the rule of law that are more rare than the norm. In practice, this quantitative difference becomes a qualitative one that fundamentally changes the rules of the game.

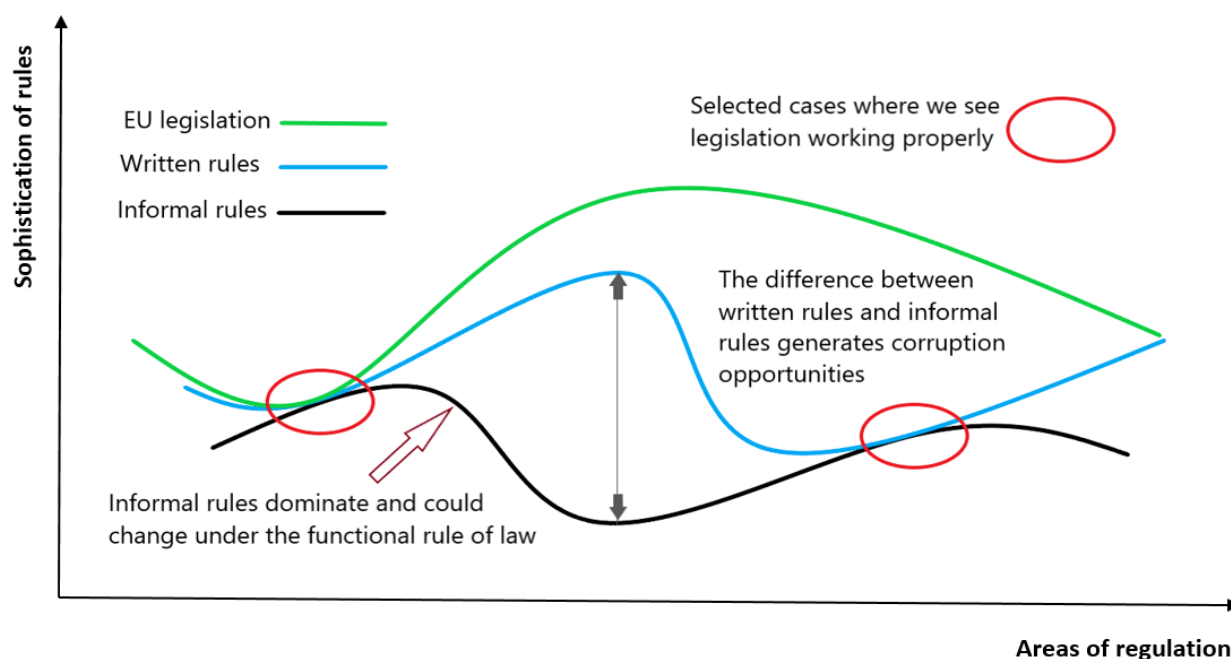
In Ukrainian society, where RoL is absent, informal networks overshadow formal written rules. As a result, the country is governed less by justice and more by: (a) a vertical hierarchy of rulers who govern through the same informal vertical networks partly by law with arbitrarily designed norms, but more often by discretionary application of the law²; and (b) informal horizontal networks (customary law). Despite these challenges, it remains a functioning system of governance that often resembles modern institutions.

We believe that two key steps are needed to move from the current system to one based on the RoL: (a) a comprehensive overhaul of the judiciary, law enforcement, and various government regulatory and inspection bodies, and (b) a concurrent anti-discretionary review of legislation to bring it more in line with customary law.

When state institutions effectively conform to written law, it usually means a harmony between formal and informal rules. However, when informal rules conflict with written rules, the informal rules prevail. This undermines the rule of law. Ukraine struggles with the institutional capacity to enforce adherence to written over informal rules. A widening gap between the two sets of rules leads to increased corruption and abuse of power. In addition, the complexity and cumbersome nature of written rules in such an environment tend to exacerbate corruption.

² Bálint Magyar and Bálint Madlovics, *The Anatomy of Post-Communist Regimes: A Conceptual Framework* (Budapest–New York: Central European University Press, 2020).

DIAGRAM 1. Written rules vs. informal rules under suboptimal rule of law



The practice of the tax and customs administrations illustrates the situation represented by the double arrow in Diagram 1. While the provisions of the Tax Code and the Customs Code are nominally in line with EU tax and customs legislation, there are significant differences in their application in practice. In particular, these codes recognize the presumption of lawfulness of taxpayers' decisions. This means that in cases where there is a difference of interpretation between taxpayers and tax authorities, the decision should be in favor of the taxpayer. This places the burden of proof on the tax authorities.

However, the reality is quite different. Tax and customs authorities often disregard the high-level provisions of the national legislation and the established legal practice. Instead, they rely on explanatory letters (which they write themselves) interpreting tax laws for taxpayers. The most notorious example of the presumption of guilt³ in tax administration is the System of Monitoring Tax Invoices/Adjustment Calculations by Risk Assessment Criteria (commonly known by its Ukrainian acronym – SMKOR). This system identifies potentially suspicious cases and preemptively blocks the taxpayer's tax consignments before examining these cases in detail. Taxpayers are then required to prove that they have no bad intentions. Decisions to unblock transactions are made at the discretion of tax officials. This practice is in stark contrast to EU practices of the administration of VAT credits. At times, the proportion of companies with tax consignments blocked has exceeded 40% of VAT taxpayers⁴, indicating that this allegedly risk-based approach has been applied to a wide range of business activities. In the meantime, the suspicious cases are not being investigated.

To understand how formal regulations work in an environment with unreliable RoL, CASE Ukraine conducted a study on the enforcement of the laws criminalizing drug and weapon smuggling⁵. In 2018, law enforcement agencies filed 125 criminal cases under the regulation on weapon smuggling, while 212

³ CASE Ukraine Working Paper, 'Presumption of guilt in tax and customs administration in Ukraine', November 2023.

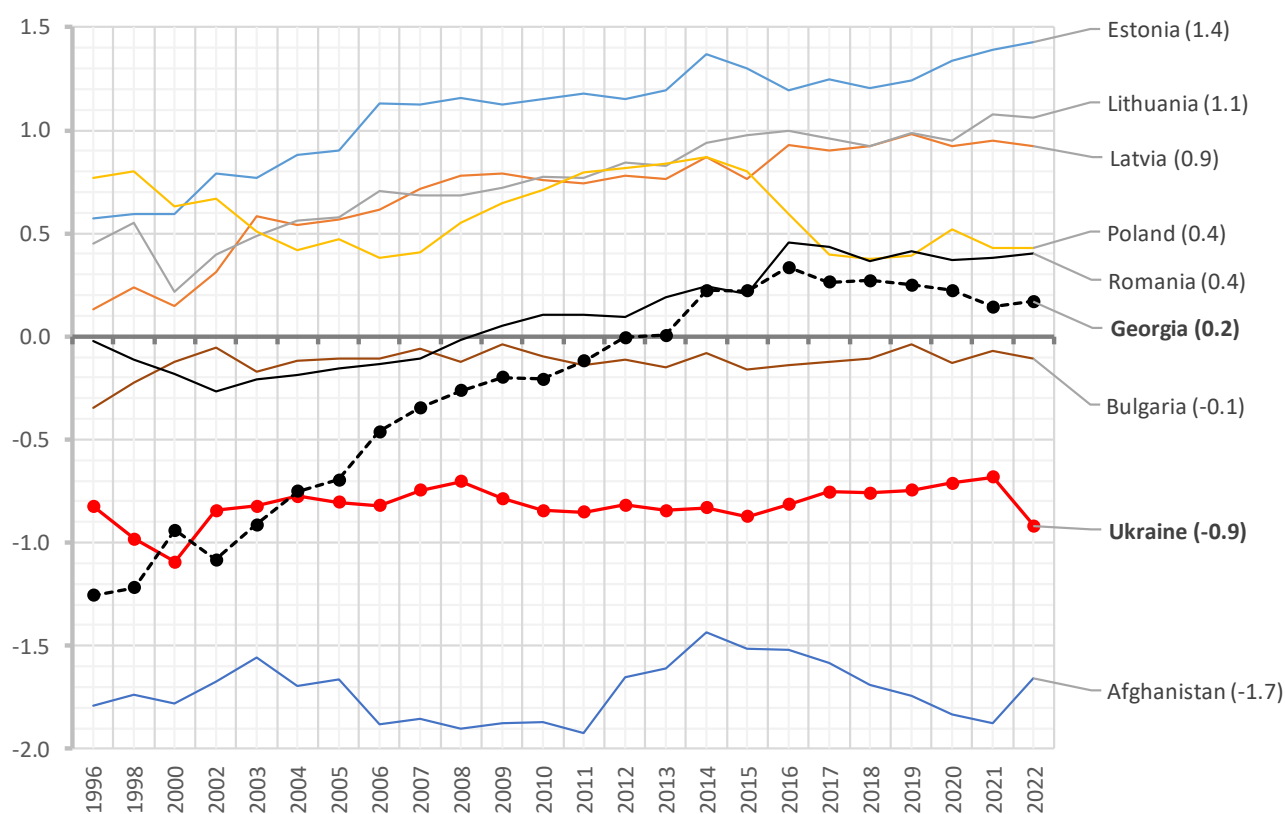
⁴ <https://boi.org.ua/en/news-post/results-of-business-ombudsmans-own-initiative-investigation/>

⁵ <https://cost.ua/news-762-kryminalno-nekarana-kontrabanda/>

cases were filed under the regulation on drug smuggling. Of the 125 weapon smuggling cases, only one person was sentenced to imprisonment, which is only 0.8% of all cases. Similarly, only 16 (7.5%) of the 212 drug smuggling cases resulted in actual prison sentences. It's worth noting that these provisions deal with real criminal activity, which tends to be more severely punished by law enforcement than "economic crimes" such as the smuggling of household appliances or alcohol. It's no surprise that customs abuses fraud is the largest avenue for tax evasion in terms of turnover, amounting to about \$8-11 billion in 2022.

The World Bank's Rule of Law Index, part of the World Governance Indicators, provides a clear picture of the current state of the RoL in Ukraine. This index also highlights the difference between the weak RoL that was seen in the Eastern European countries in the 1990s and the unreliable RoL that is evident in Ukraine today. In the 1990s, countries such as Poland and the Baltic states already had functioning judicial and law enforcement systems that provided a solid foundation for future reforms, as shown in Figure 1. In contrast, since the dissolution of the Soviet Union, Ukraine has made little progress in the RoL. Even by 2021, the RoL in Ukraine had yet to reach the standards enjoyed by Eastern European nations in the 1990s.

FIGURE 1. Rule of Law Index (World Governance Indicators), max 2.5, min -2.5



Source: <https://databank.worldbank.org/>

Note: Rule of Law captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. Estimates give a country's score on the aggregate indicator, in units of a standard normal distribution, i.e. ranging from approximately -2.5 to 2.5.

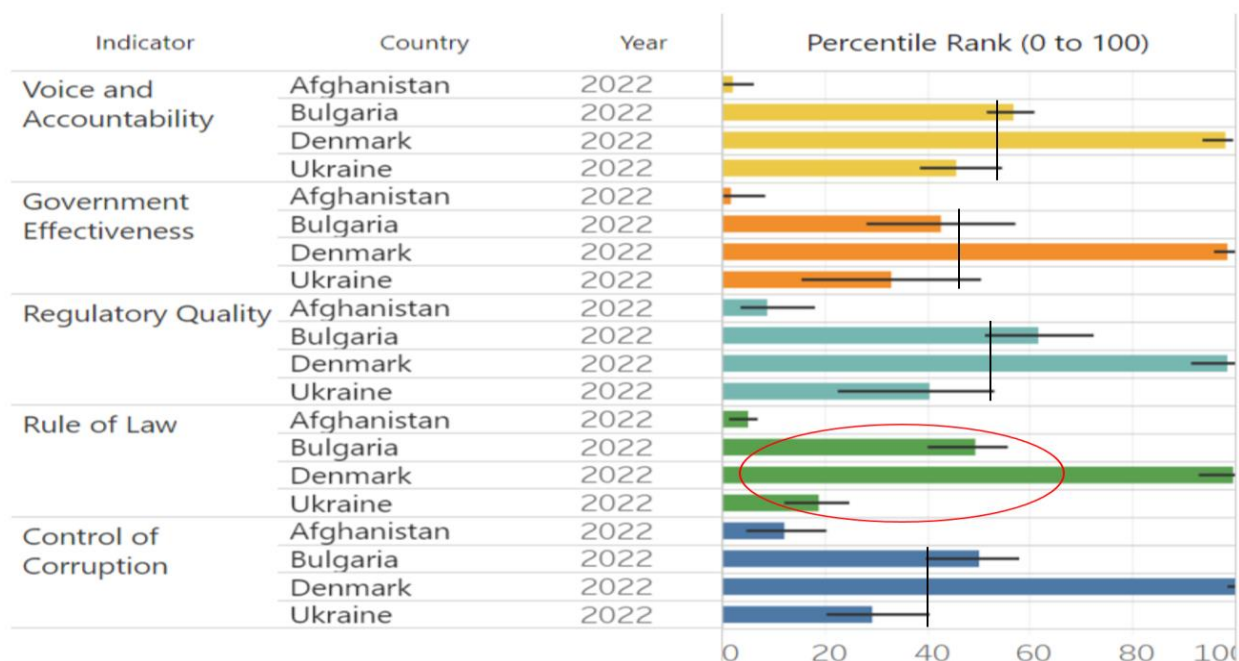
While Ukraine's RoL is nearly dysfunctional, it's important to recognize that the country is far from a failed state, contrary to Russian propaganda. The RoL is largely functioning effectively in some areas that

are crucial to the daily lives of ordinary people. In other areas, thanks to the functioning of informal institutions (customary law), Ukraine is able to maintain a certain level of social cohesion and functionality. This was particularly evident during the first weeks of the war in February-March 2022, when state institutions were virtually paralyzed. In spite of this, the resilience and functionality of the Ukrainian society has been clearly demonstrated. Life in the country went on, to a large extent independent of the capacities of official institutions, and often operated alongside or in parallel with the formal rules.

The World Bank's World Governance Indicators provide valuable insights into how Ukraine compares with countries ranging from those perceived as failed states, such as Afghanistan, to those known for exemplary governance, such as Denmark, and to those with weaker institutions, such as Bulgaria (the latter being the weakest among EU countries).

As Figure 2 shows, Ukraine outperforms Afghanistan but underperforms Bulgaria on all World Governance Indicators. The most striking disparity is in RoL. Interestingly, RoL is the only indicator where the difference is statistically significant⁶. To put this in context, Ukraine's percentile rank on the RoL drops to just 18.9% (between Honduras and Mexico), while Ukraine's percentile rank on the Control of Corruption indicator is 29.2%. This suggests that the primary challenge in Ukraine is not corruption per se, but rather the defunct RoL, making corruption largely a secondary issue.

FIGURE 2. Worldwide Governance Indicators for selected countries (2022)*



Source: databank.worldbank.org

* The indicators intentionally exclude 'Political Stability and Absence of Violence/Terrorism,' as this measure is not meaningful for Ukraine, as the country is a victim of military aggression.

Note: Black horizontal lines represent 90% confidence intervals. Thin vertical lines are added to better visualize the statistical significance.

⁶ Each bar on the graph is an estimate (approximate) value of the indicator. The black line shows the 90% confidence interval estimated by the WB methodology. This means that there is a 90% probability that the true value of an indicator lies within this interval. For the RoL indicator (and unlike all other cases), these intervals do not overlap for Ukraine and Bulgaria, meaning that these two figures differ with more than 90% probability.

Establishing a functional and reliable system of rule of law is a decades-long process, as the defunct RoL is neither a temporary situation nor caused by corruption.

A look at Ukraine's historical context is necessary to understand its struggle to establish RoL. Ukraine was part of the Russian Empire and later the Soviet Union for more than 300 years before gaining independence. Moscovia, the predecessor of Russia, had no tradition of the RoL. Instead, it adopted a system of absolute personal power. In this system, known as "samoderzhavie" ("I-am-a-state" in Russian), the all-powerful tsar owned all the land, controlled the church, made unilateral judicial decisions, and wielded the power to punish at will. This was in contrast to European absolutism, where a monarch was still somewhat constrained by law. Russia's historical legacy significantly influences the informal institutions in most areas under its control.

Adaptation to the imposition of foreign formal institutions also has a historical dimension. In the 18th century, Tsar Peter the Great, influenced by Western and Ukrainian ideas, introduced Western institutions such as bureaucracy and legal systems. These were modeled after Dutch examples. However, these institutions lacked RoL principles. Peter did not want to limit his own power. This led to a contradiction between formal and informal institutions (as shown in Diagram 1). The lack of true RoL led to widespread lawbreaking. This situation has provided the Russian rulers with an opportunity to maintain their enormous discretionary power (*vlast'*) by means of selective enforcement of the law. Amid formally "European" institutions the culture of abusing discretion has emerged and entrenched. The result is reflected in a Russian proverb that suggests that the severity of the law is lessened by its optional obedience⁷.

In this system, officials known as nachal'niki (sing., nachal'nik – a boss) – as opposed to 'public servants' in effective RoL democracies – still rule and exert their influence through informal networks, adhering to the adage that "the law is written for fools". In reality, the law is written by and for the benefit of nachal'niks. It is characterized by impracticalities that allow for selective enforcement. This is complemented by ambiguities in the law and the discretion allowed, thus ensuring the discretionary power of the nachal'niks, which lies at the heart of the system and is often referred to by scholars as "patronalism"⁸.

Those in power who benefit from this system have an incentive to maintain the impracticality of laws, along with ambiguity and discretion, to strengthen their authority. But compared to enforcing impractical laws, this discretion, including bribery, is seen as a lesser evil. The same mechanism undermines the enforcement of all kinds of laws, including reasonable and justified norms. When the law is less often obeyed than disobeyed, those who try to obey the law are at a disadvantage and lose⁹. In the absence of

⁷ Vadim Volkov, "Patrimonialism versus Rational Bureaucracy: On the Historical Relativity of Corruption," in *Bribery and Blat in Russia: Negotiating Reciprocity from the Middle Ages to the 1990s*, ed. Stephen Lovell, Alena V. Ledeneva, and Andrei Rogachevskii (London: MacMillan Press, 2000).

⁸ Magyar and Madlovics, *The Anatomy of Post-Communist Regimes*.

⁹ As, for instance, a conscious lawyer that unlike the most of his colleagues refuses to conduct bribes to the judges struggles to attract the clients – a real case from L'viv.

reliable legal means, people in need of protection have no choice but to turn to the same nachal'niks as patrons¹⁰.

Finally, the government bureaucracy, especially control and inspection agencies, as well as law enforcement and the judiciary, are staffed with individuals best suited to the role of nachal'niks, or loyal members of their patronage networks. They often lack management skills allowing them to govern without using informal orders, patronal networks, and blackmailing with *compromat* (dossiers of filed past sins not duly prosecuted yet) as their main means of the orders' enforcement. The same problem is pertinent to the whole political class, including top leaders of the state.

Corruption and oligarchs are superficial manifestations of this system. The nachal'niks abuse their power for personal gain not because they are simply bad guys, but primarily because they are informally empowered to a qualitatively greater extent than their Western formal counterparts. Moreover, they often have to violate the law themselves, even if they want to do good. Informal patronage networks carry out both corruption and informal orders to punish disloyalty (for example, political opposition) and to enrich the oligarchs (at various levels of the hierarchy) who are loyal to their patrons. Officials who are not members of these networks and/or who refuse to pay for their positions within the "corruption verticals" and carry out informal orders are dismissed and often prosecuted.

This self-sustaining "bad equilibrium"¹¹, in which informal institutions dominate and informal patron-client networks have more influence than formal structures, has persisted for centuries. The Communists, in particular, exacerbated the discrepancy between written law and customary practice when they overthrew the old system. They introduced even more impractical norms, especially in the economic sphere, leading to widespread evasion and a culture of 'optional obedience'. Meanwhile, clean cadres, on which the *compromat* was insufficiently strong, were not promoted for they were ungovernable in the patronal system.

Not all regions within the Russian/Soviet Empire were equally affected by the patronal system of governance. The Baltic states, eastern Poland, and Finland, which were later colonized, enjoyed considerable autonomy, and left the empire in 1917. Although the Baltic states were later occupied by the USSR and Poland became communist, Russian institutions, including patronalism, were perceived as alien in these countries. This was also the case in western Ukraine, which had never been part of the Russian Empire. Moreover, communism was less strict west of the Soviet border, with some countries allowing private ownership of productive assets, including agricultural land (as in Poland, for example). As a result, these countries retained some functional, though not very robust, RoL. After the collapse of the USSR, the Baltic states quickly replaced Soviet laws and reformed their governments, facilitating their integration into the EU.

During its time under the Great Lithuanian Duchy and the Polish-Lithuanian Commonwealth from the 13th to the 17th centuries, Ukraine has experienced living under imperfect RoL and inherited corresponding traditions, albeit weaker than in Central and Eastern Europe (CEE) and the Baltic States.

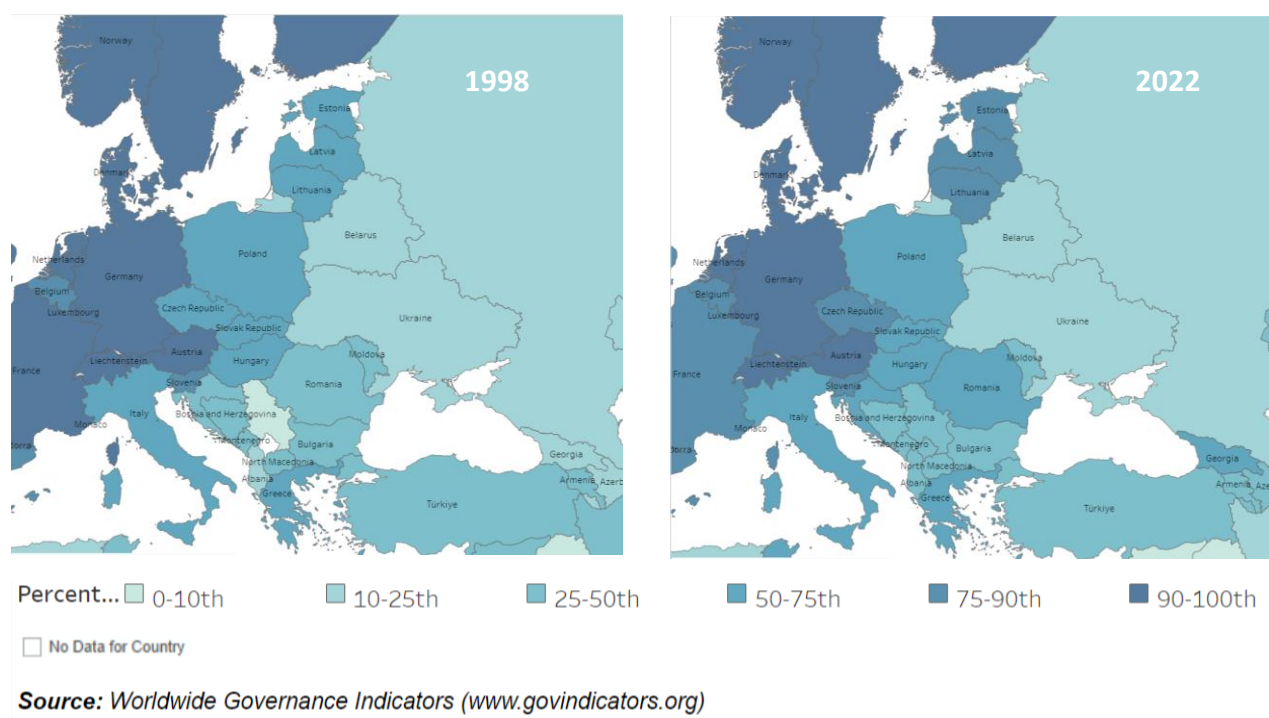
¹⁰ Henry E. Hale, *Patronal Politics: Eurasian Regime Dynamics in Comparative Perspective*, Problems of International Politics (Cambridge: Cambridge University Press, 2015).

¹¹ Dubrovskiy, Vladimir, *Patronalism and Limited Access Social Order the Case of Ukraine*. In: Madlovics, Bálint and Magyar, Bálint, eds. 2023. *Ukraine's Patronal Democracy and the Russian Invasion: The RussiaUkraine War, Volume One*. Budapest–Vienna–New York: CEU Press., Available at SSRN: <https://ssrn.com/abstract=4650822>

However, Ukraine is struggling to break out of its recent historical trajectory, as are other post-Soviet states except for Moldova and Georgia.

Figure 3 shows the RoL indicator for selected European and Eurasian countries during the middle of the accession process of the CEE and Baltic countries in 1998 and today. First, there is a striking contrast between the countries to the east and to the west of the border of the core of the Russian/ Soviet empires. Thirty years after the collapse of the empire, this divide is still evident. This is to be expected, given that these countries were under its influence for more than 300 years. This highlights the persistence of the bad equilibrium and the impact of path dependence. On the other hand, some countries have made significant progress in these 24 years, especially the Baltic States and most notably Georgia. This progress has been achieved through comprehensive reforms, which will be discussed in more detail below.

Figure 3. The RoL indicator for selected European and Eurasian countries in 1998 and 2022



In an environment with an unreliable RoL, economic policy should give priority to simplicity, straightforwardness, and liberalization until the basic legal structures are firmly in place.

The key implication of recognizing that Ukraine's RoL is not merely weak but defunct, and that solving this problem will require a decade of reforms, is that institutions and policies that have been successful in countries with functional RoL and high bureaucratic quality must be adapted to Ukraine with caution. This adaptation should follow a thorough evaluation of their suitability in the Ukrainian context of suboptimal institutions. Tailored, unconventional or innovative approaches are often needed to break out

of the current "bad equilibrium". The establishment of a functioning and reliable RoL in specific sectors is crucial before the effective implementation of more standard policies and institutions.

Ukraine's recent reform history is marked by multiple failures. These failures are largely due to overlooking the institutional context of a defunct RoL in the country. For example, the initial efforts to reform the judiciary in 2014, which were designed along the mainstream principles of judicial independence as recommended by the Venice Commission, actually led to a further erosion of judicial integrity. The underlying assumption was that judges, who have the best knowledge of the misconduct of their colleagues, would punish or remove those who tarnish the reputation of the profession. However, this assumed that most judges were honest and impartial, which was not the case. In reality, increased self-governance only strengthened corrupt networks within the judiciary, allowing them to consolidate control and target honest judges.

Another example of failed reform occurred in the anti-corruption sector in the late 2000s. The Ukrainian authorities, supported by a Millennium Corporation anti-corruption grant, established anti-corruption departments within government agencies. The main focus of this project was the creation of these departments. While they were successfully set up, they did not have a real impact on reducing corruption. This was because they became entangled in the same informal networks whose members they were supposed to prosecute, often led by the formal or informal heads of the agencies themselves. It was clear from the outset that this approach was unlikely to succeed. Moreover, various attempts to counter patronage through codes of conduct have also failed.

The recent example of the Bureau for Economic Security (BES) underscores the need to completely overhaul governmental agencies that have been infiltrated by patronage networks, including eradicating their harmful institutional memory. The Ukrainian Tax Police was notoriously ineffective in prosecuting large-scale tax evasion. This was probably because its officers acted as patrons of such schemes and firms, while at the same time extorting bribes from innocent businesses. The establishment of the BES was aimed at disbanding the tax police, removing responsibility for investigating large-scale economic crimes from other law enforcement agencies, and establishing a unified analytical body for such investigations. Civil society activists and business associations, together with the then Minister of Finance Oleksander Danilyuk, argued for strict restrictions on the employment of former law enforcement officers in the BES. However, their recommendations were not followed. The head of the tax police was appointed as the head of the BES, and he brought his former colleagues with him, staffing the BES with about 60% of the old cadre¹². As a result, although the BES is performing better than the tax police, it still does not meet expectations and needs to be reloaded again. Meanwhile, legislation that further empowers the *nachal'niks* (such as criminalizing smuggling, etc.) is being pushed by the IFIs and passed as if effective law enforcement were already in place.

In contrast, we have witnessed some successful reforms in Ukraine. These reforms were based on the recognition that Ukraine's environment is extremely challenging and requires unconventional solutions. Notable examples include the globally acclaimed ProZorro system for procuring and selling state assets and eData for transparent budget execution. Both tools have brought an unprecedented level of

¹² БЕБ перетворилось на податкову міліцію. Як будуть реформувати Бюро економічної безпеки? «Публікації | Мобільна версія | Бізнес.Цензор.НЕТ (sensor.net) [BES has become the tax police. How will the Bureau of Economic Security be reformed?]

transparency that surpasses even that found in advanced countries. ProZorro, in particular, severely restricts officials' discretion in procuring goods, not only in the government but also in state-owned enterprises. While far from perfect, these initiatives have had a significant impact on the reduction of corruption in government procurement, especially in its most blatant forms. This success stands in stark contrast to the failures of previous mainstream reforms in this area.

The automation of VAT refund administration is another positive development in Ukraine. The electronic system for VAT administration is very restrictive and cumbersome. It is unique compared to those in developed countries but has successfully curbed large-scale evasion. In addition, mandatory kickbacks in this area have been effectively eliminated by the introduction of a transparent, automated queue for VAT refunds. Previously, the fight against evasion was ineffective despite the millions of tax inspections and the extensive documentation requirements for every business transaction. Deliberate delays in VAT refunds were also often exploited for bribery and unfair competition.

In both cases, as in many others, the successful reforms were those that drastically limited officials' discretion in implementing and enforcing the law, simplified and/or streamlined procedures, and increased transparency. In addition, the complete overhaul of certain institutions under the supervision of civil society and international experts proved to be at least partially effective. A prime example is the replacement of the highly corrupt traffic police, a relic of the Soviet era, with the new patrol police.

The 2003-2012 reforms in Georgia are an even more striking example of how policy can produce a qualitative leap when the context of a defunct RoL institutional environment is taken seriously. These reforms were based on three principles applied simultaneously:

- Radical deregulation (such as the regulatory guillotine), unification of customs duties, simplification of taxes, etc., drastically reducing officials' discretion.
- A complete overhaul, or "reloading," of law enforcement and controlling agencies to eradicate their detrimental corporate culture. In some cases, these agencies have been eliminated altogether; and
- Amnesty for past sins.

For example, the Georgian Tax Administration was almost completely reloaded, with about 95 percent of the staff new. This coincided with the introduction of a new, significantly simplified and streamlined tax code that included significant tax cuts. The result was a more than twofold increase in tax revenues as a percentage of GDP¹³. However, too much discretion was retained, especially in the corporate income tax (CIT), which is discretionary by nature. This discretion was later used to persecute political opponents and their media, partially undermining the reform. Subsequently, Georgia also reformed its CIT and introduced a much less discretionary tax on withdrawn capital, similar to the "Estonian CIT" model.

Such drastic measures were necessary to break out of the "bad equilibrium", as shown in Figure 4. Georgia, a country that was in dire straits before the Rose Revolution of 2003 (much worse off than Ukraine is today), within a decade became comparable to most CEE countries in all aspects except political stability and, to some extent, democracy. Despite some shortcomings, Georgian reformers have

¹³ [Tax revenue \(% of GDP\) - Georgia | Data \(worldbank.org\)](#)

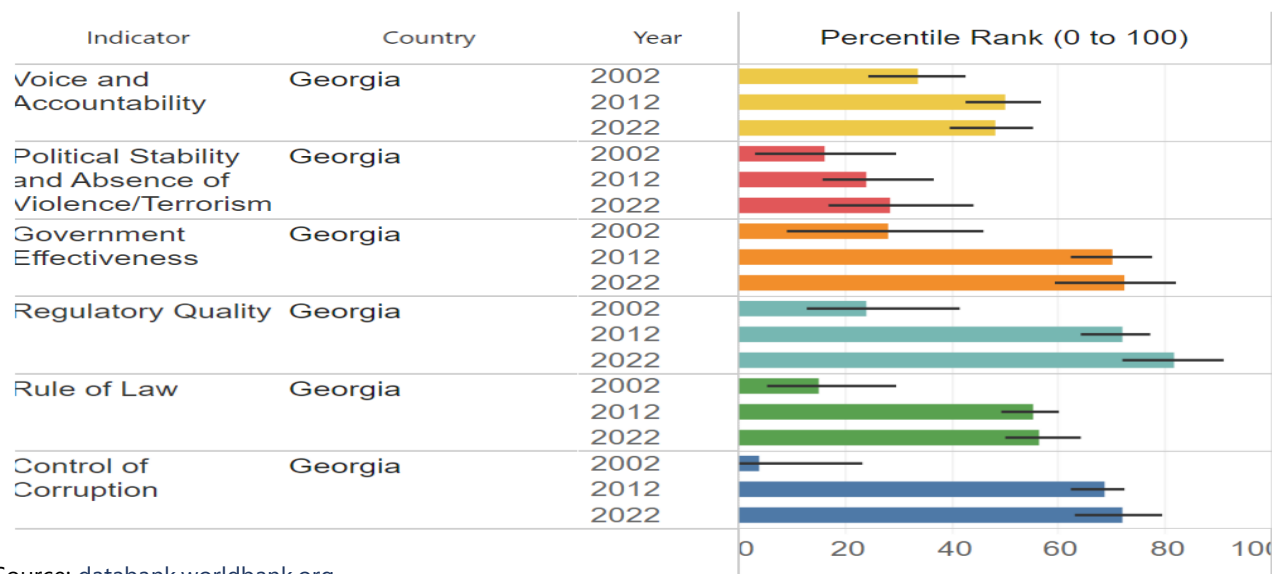
been successful in increasing tax and customs revenues and reducing bribery. As a result, the country has moved from poor to middle-income status. GDP per capita (in current USD) has more than quadrupled.

Notably, these reforms were very popular. However, their main shortcomings, which ultimately led to the electoral failure of the reformers, were that (a) the elites, especially Mikheil Saakashvili, often failed to act as positive role models, with Saakashvili often behaving as if he were above the law, and (b) too little attention was paid to educating the electorate, which was necessary for people to understand the logic behind the reforms and the need to change certain entrenched societal practices, such as nepotism and petty corruption. These negative lessons should be learned alongside the positive ones.

After the Revolution of Dignity, Ukraine, unlike Georgia, did not make such dramatic progress. Nevertheless, among the most important slogans were the demands for the establishment of RoL and the abolition of patronalism. Where progress has indeed been substantial, it has often been as a result of the successful implementation of these approaches, sometimes with the involvement of Georgian experts. Ukraine still needs at least a decade of similarly successful reforms to break free from its imperial institutional legacy and catch up with its Western neighbors in terms of RoL. Only then can it be hoped that mainstream EU policies and institutions will begin to function in Ukraine at least as effectively as they do in other post-communist countries that are now members of the EU. Otherwise, there is a high risk that EU harmonization efforts will repeat the failures of the Petrine reforms due to the above-mentioned adaptation mechanism inherited from the 18th century and reinforced under communism.

Thanks to its long history as part of European civilization, Ukraine has favorable conditions for such a rapid transformation. There is also a strong public demand for the RoL: about two-thirds of the respondents in public opinion polls consistently express their dismay at the lack of respect for the law. For Ukraine's vibrant and influential civil society, RoL is also a top priority. Combined with appropriate approaches, these factors provide a solid foundation for a potential breakthrough. Such a success story could, in turn, be an inspiration to future reformers, civil society activists, and ordinary citizens throughout the post-Soviet region.

Figure 4. The Worldwide Governance Indicators for Georgia before radical reforms (in 2002), at the end (in 2012) and now



Source: databank.worldbank.org