



Ukraine

(post-war) recovery strategy

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Since the onset of the full-fledged Russian invasion in February 2022, numerous reports have been produced with recommendations for Ukraine's post-war recovery and reconstruction. These reports are brimming with insightful ideas on rebuilding Ukraine back better. They also consistently reiterate a set of conventional recommendations on reforms believed to unlock long-term sustainable growth.

Specifically, **these reports emphasize the need for judicial reform, anti-corruption efforts, further privatization, corporate governance reform, European integration** etc. This to-do list, which is consistently found from one report to another, remains entirely valid and well-founded.

However, the mainstream approach to Ukraine's reform overlooks a critical point.

Such recommendations are predicated on the assumption that Ukraine's fundamentals are operational, albeit somewhat frail. This diagnosis often zeroes in on the rule of law in Ukraine, characterizing it as 'weak'. A 'weak' rule of law suggests that while the judicial system and law enforcement generally function effectively, they occasionally falter.

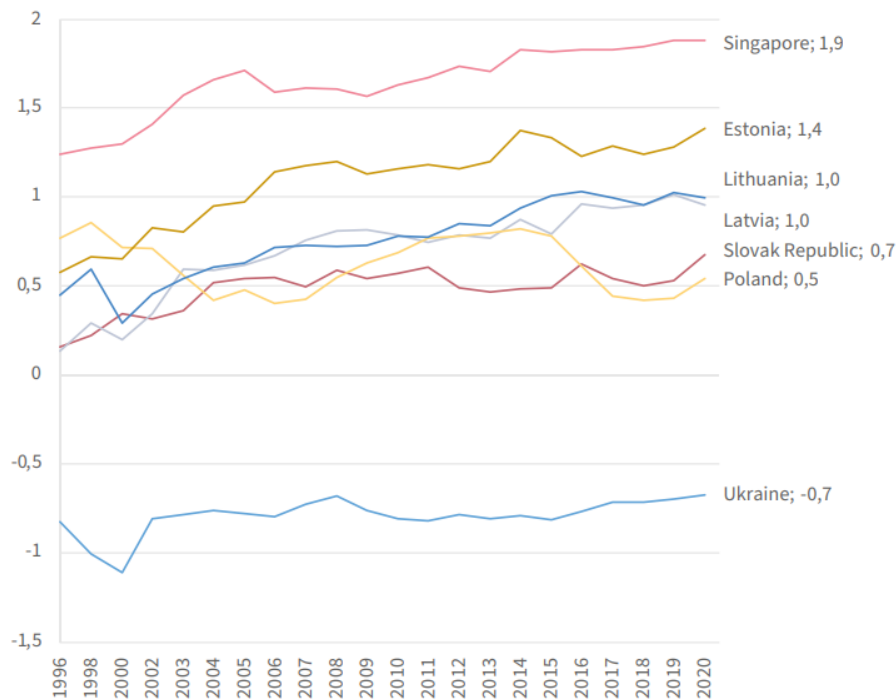
However, this description doesn't accurately represent the reality in Ukraine. In truth, the Ukrainian judicial system and law enforcement predominantly underperform, with only occasional instances of satisfactory operation. This state of affairs underscores that the rule of law in Ukraine is not just weak but fundamentally unreliable.

The World Bank's Rule of Law Index, part of the World Governance Indicators, offers a clear snapshot of the current state of the rule of law in Ukraine. Moreover, this Index illuminates the distinction between a weak rule of law, as observed in Eastern European countries in the 1990s, and the unreliable rule of law that characterizes Ukraine.

Figure 1 reveals that during the 1990s, countries like Poland, the Slovak Republic, and the Baltic states already had functional judicial and law enforcement systems and they had a solid ground to build on further reforms.

Conversely, Ukraine's rule of law has remained relatively stagnant since the dissolution of the Soviet Union. Even by 2020, Ukraine's judicial and law enforcement systems had yet to reach the standards that Eastern European nations had enjoyed 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.

The nuanced distinction between Ukraine's rule of law being not merely 'weak,' but fundamentally unreliable, is pivotal when considering the design of reform strategies and the formulation of successful economic policies.

Undoubtedly, reforming both the judicial system and law enforcement is crucial, a fact reiterated in reform plans, including those from International Financial Institutions (IFIs). The pressing issue is: how do we operate during the extended period when the rule of law is still being established? IFIs imply that a weak rule of law suggests we can leverage existing fundamentals immediately by implementing economic strategies and refining legislation. Assuming the judicial and law enforcement systems primarily operate well, albeit imperfectly, they could still form the foundation for more advanced policies.

But what if the underlying assumption is flawed? What if the rule of law isn't merely weak, but suboptimal and unreliable, functioning correctly only in select cases? What happens when informal relationships and network ties overshadow formal, written rules?

If the premise of a 'weak rule of law' is misguided (and I argue that it is, positing instead that the rule of law is suboptimal and unreliable), then we cannot rely on this foundation to develop and implement sophisticated policies. This includes economic strategies, which could only be implemented once a functional judicial system and effective law enforcement have been established and their efficiency proven.

If we accept the premise that the rule of law is unreliable, it poses a critical question for economic reforms and European integration efforts: how long will it take to establish functional fundamentals? If we believe this can be achieved within the next 2-3 years (or at most 5 years), then the strategy would be to tune conventional policies now and implement them over the short-term period once a reliable judicial system and law enforcement structure are in place. Put it differently, under this scenario the conventional approach to reforms should work well and we just need to be patient until the functional rule of law is established over the next 2-3 years.

If we realistically acknowledge that 2-3 years is an overly optimistic estimate and that building a reliable rule of law system will likely take more than 5 years, our approach to both economic recovery policies and the European integration strategy requires an adjustment toward a clearly non-conventional approach.

Once we recognize that the rule of law may remain non-functional in Ukraine for the next decade (or at least for a period longer than 5 years), we must consider how economic recovery can be achieved in an environment dominated by informal horizontal networks while the rule of law is still under construction.

In this context, **if we acknowledge that the rule of law in Ukraine is not sufficiently robust for implementing sophisticated policies, and if we accept that there will be no quick fix resulting in a functional judicial and law enforcement system, then we must conclude that simplicity in economic policies is the most logical path forward in an environment without reliable foundational structures.**

While sophisticated legislation, or advanced rules of the game, can address specific issues more adeptly than simplified rules, it also leaves more room for varied interpretations. This leads to an increased number of cases where the state and its citizens have differing perspectives on the same situations, necessitating the intervention of the judicial system.

This isn't problematic for societies with robust judicial and law enforcement systems, but for places like Ukraine with a less dependable rule of law, it's a significant challenge. The solution is to prioritize simplification in all areas, reducing the reliance on an unpredictable judicial system. This approach should prevail until a trustworthy rule of law is established and proven.

The simplification strategy starkly contrasts with the approaches outlined by IFIs and other stakeholders in their strategic plans. Furthermore, it might look like it diverges from the European integration strategy, which often introduces more complexity to Ukraine's framework.

In essence, acknowledging the deficiencies in Ukraine's foundational structures necessitates a reevaluation of conventional strategies for both recovery and European integration.

Significantly, advocating for the simplification of rules during the period of the rule of law construction doesn't imply a halt to Ukraine's European integration process.

Central to the European integration challenge is establishing the rule of law fundamentals. Chapters 23 and 24 of the European acquis mandate justice reforms and the safeguarding of basic human rights. They emphasize a functional judiciary, encompassing courts, anti-corruption agencies, and robust political institutions. These are prerequisites for integration. Simply adapting to EU legislation without addressing these foundational requirements won't suffice.

Yet, Ukrainian officials frequently assert that legislative adaptation is Ukraine's primary integration task. This misalignment in priorities must be rectified. The primary focus should be on building a solid foundation, with the adaptation of Ukrainian legislation to the EU acquis as a subsequent, interconnected step. The latter can commence with preparations, but its finalization – both in approval and implementation – should only occur after establishing and verifying the rule of law.

In essence, this call for simplification helps delineate Ukraine's current priorities and sequences the steps required for a seamless and proper European integration, preventing premature and potentially counterproductive actions.

In the realm of economics, tax and customs administration in Ukraine starkly exemplifies the disparity between the complexity imposed by authorities and the simplicity the economy genuinely requires.

In developed nations, where the rule of law is well-entrenched, fiscal discipline hinges on the inevitability of punishment. Entrepreneurs operate within a defined legislative framework without continually seeking permissions (bar some specific activities). If they breach the law, for instance, evade taxes, they face predictable and inevitable consequences. However, in Ukraine, the inefficiencies of law enforcement and the judiciary render this model of inevitability moot. Tax evaders often escape without repercussions.

In response to this institutional void, Ukrainian authorities have devised a tax and customs administration predicated on the presumption of guilt towards the taxpayer or tax agent. This approach essentially transfers the burden of proof to economic agents, aiming to maximize tax collections in a setting where the rule of law is shaky. Interestingly, this practice isn't codified in formal legislation. A perusal of Ukraine's Tax and Customs Codes reveals the incorporation of 'best practices,' emphasizing the 'legality of the taxpayer's decisions'—in essence, the presumption of a taxpayer's innocence.

Yet, the ground reality diverges significantly, saddling entrepreneurs with the responsibility of proof. While the Ministry of Finance believes this strategy enhances tax collection (though

without concrete evidence), it undeniably hampers economic development. A tax and customs administration system built on the presumption of guilt is riddled with discretionary decisions and is consequently susceptible to corruption. More critically, this model fails to shield the national budget from large-scale smuggling or tax evasion facilitated by influential insiders.

The formulation of an economic strategy, one that prioritizes simplification, could assume various shapes and utilize diverse tools. I am not advocating here for any particular solution to achieve sustainable economic growth. However, it is vital to acknowledge and accept that the implementation of advanced economic strategies in an environment devoid of reliable fundamentals is extremely prone to failure. Pursuing a conventional set of recommendations without initially establishing a functional rule of law might result in a futile expenditure of time and resources.

Moreover, attempting to transform the lifestyle of a country that predominantly adheres to informal horizontal networks into one governed by 'written rules,' all while the judicial and law enforcement systems are in disarray, creates opportunities for corruption by imposing additional formal rules and sophistication.

The International Financial Institutions (IFIs) and the European Union will exert critical influence over the formulation of reform strategies and economic policies in Ukraine for the next decade and further on. If they employ their traditional instruments without accommodating the fact that the country lacks the critical fundamentals — fundamentals that have assisted other countries in achieving success through such recommendations — we all run the significant risk of a major failure. Furthermore, there could be a rapid shift towards Euroscepticism within Ukrainian society as Ukrainians might observe the suggested methods failing to yield reasonable results.

Recommendations

1. During the period when the rule of law is still being established and remains suboptimal, prioritizing simplification in economic policy is crucial. This implies that an approach involving less discretion should be favored over one that allows for greater discretionary decision-making.
2. Advanced, result-based metrics should be developed and applied to accurately measure the state of the rule of law in Ukraine. This is essential for properly evaluating the progress of reforms in both the judicial and law enforcement systems, ensuring we can definitively ascertain when the fundamentals become functional.
3. In the process of European Integration, establishing the rule of law should be explicitly prioritized for Ukrainian authorities. Advanced metrics for measuring the actual state of affairs would be highly beneficial in this context. Moreover, the adoption of EU legislation should not substitute the establishment of the rule of law since the authorities are inclined to stick to easy copy/paste of legislation strategy instead of reforming institutions. Ideally, it should be implemented only after a functional rule of law is established and its effectiveness is verified.
4. Remove the presumption of guilt practice from tax and customs administration.