

PD-ABR-092

100333

USAID Strategic Plan for Ukraine

1999 - 2002



USAID
STRATEGIC PLAN FOR UKRAINE
1999-2002

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December 24, 1998

U.S. Assistance Strategy for Ukraine 1999 - 2002

Executive Summary

Ukraine's success in making the transition to a democratic society and market economy cannot be overstated in its importance to U S national interests. A strong, stable, independent, prosperous, and democratic Ukraine will be an important partner in tackling post-Cold War problems such as proliferation, expanding commercial and economic relations, and shaping a more secure and stable Europe. Such a Ukraine will elevate its status as a more equal neighbor to Russia. A weak and destabilized Ukraine, however, would be a debilitated partner of the U S and the West. It could also tempt Russia to interfere or assert itself into the internal affairs of Ukraine. The financial crisis that has engulfed Ukraine and its glacial movement toward reform threaten its ability to develop into a "normal" state.

The U S assistance program has two overarching and mutually supportive objectives, it seeks to (1) help Ukraine realize its potential in building a strong, independent, democratic, and economically viable country by increasing its self-reliance, and (2) further Ukraine's effort to integrate into the global community and forge stronger ties with the West. To succeed in these objectives Ukraine must make the transition to a market economy and democratic society. The U S assistance priorities over the next four years, the period of this strategy document, will help Ukraine to (1) promote economic growth by setting in place an environment conducive to investment, facilitating job creation, transforming important sectors of the economy, and easing the pain of the transition, (2) consolidate the institutions of a functional democracy through civil society and a society based on the rule of law, and (3) improve the quality of life for Ukrainians by addressing, for example, reform in health care delivery.

A state of euphoria greeted Ukraine in 1991 upon its decision to break away from the Soviet Union and become an independent state. The G7 countries anticipated, and expected, a quick and thorough destruction of Ukraine's Soviet past, but expectations were overly ambitious and greatly exceeded what could realistically be done. After seven years, Ukraine, with the support of the donor community, has accomplished much and its transformation to a democratic state may well be irreversible. However, the current economic situation could threaten to overturn progress made in its transition. Despite some progress in economic reform, most observers agree Ukraine has not made the tough, but necessary policy reforms done more successfully than its Central European neighbors (e.g., Poland, the Czech Republic, Hungary). At this point it is clear that Ukraine's political elite does not believe that economic reform, as envisaged by the West, is necessary. The transformation process will take much longer than anticipated and U S assistance will continue to play an important role into the next century.

The G7 countries and the donor community have learned invaluable lessons during this period. First, government in Ukraine is not a monolithic structure, senior officials hold adamant and often divergent views on the shaping of post-communist Ukraine. In

Ukraine where the parliament has significant (if not nearly equal) power relative to the executive branch, political stalemates frequently occur and block change. Moreover, a class of elites who have benefited from turmoil and a chaotic transition has evolved - a group which is reluctant to endorse change that would disadvantage its economic interests. This class has the power to influence politicians at senior levels and with this influence has obstructed progress in the transformation process. Second, the donors have learned that the problems for countries in transition are unique and complex. Lack of political will does not fully account for lack of progress. Western experts hold neither precise nor clear remedies for Ukraine's troubles.

A financial crisis has spread westward from Russia and threatens to undermine Ukraine's economy. Though the financial crisis appears to offer the Government few practicable alternatives other than to pursue reform in earnest, deeply entrenched interests and populist tendencies may counter the Government's pursuit of reform policies over the next several years, especially in the heat of the upcoming presidential election campaign.

In the past, much attention and a significant share of assistance resources were channeled toward the Government's reform efforts. This has had less of an impact than had been hoped. In this uncertain environment, effective approaches for delivering U.S. assistance must be found. Over the period of the strategy, the U.S. assistance program will proceed along three major paths to bolster U.S. assistance objectives. First, empowerment of people, both economic and political, will become a stronger theme. A mix of governmental and extra-governmental support will continue, but the preponderant share of resources will be directed toward grass-roots and empowerment programs dispersed throughout Ukraine, such as strengthening pro-reform, advocacy NGOs, helping progressive local governments evolve into responsive and institutionally capable administrative units, and supporting an entrepreneurial spirit (through such means as teaching business skills). However, we expect to encounter a number of obstacles. This list includes a population that is largely cynical about reform (given the poor results to date) and apathetic toward participation in citizens' groups, local governments that are ineptly managed, irregularly financed from the central government, and often as corrupt or even more so than the national government, and a pernicious national legal environment that impedes entrepreneurship and self-initiative.

A second focus of the assistance program will stress greater involvement of senior U.S. policymakers in the reform policy dialog through bilateral discussions with Ukrainian counterparts, e.g., the Gore-Kuchma Commission, and through U.S. participation in the multilateral funding institutions. In a crisis, opportunities for positive change arise, and the present financial crisis offers such an opportunity. But more effective means must be found to ensure that the donors' collective dialog with the government leads to real change in the most important areas of structural reform (e.g., public administration reform, privatization, and deregulation), not simply compliance with the letter of conditionalities.

A third track will press for reform through technical assistance to implement the conditions of the recently-approved IMF Extended Fund Facility (EFF) and the

conditions of the structural adjustment loans and other loans of the World Bank. The policies sought after under these programs conform to the policy reform framework of the USG, and are essentially the preconditions identified in the Partnership and Cooperation Agreement Ukraine signed with the European Union (EU) in March 1997. By meeting these preconditions Ukraine will advance its efforts in developing a special partnership arrangement with the EU. Moreover, without financial and structural reform, the economy and political system could collapse. U.S. assistance will be applied selectively to crucial reform efforts of the national government and where tangible progress is taking place.

Changes in Program Direction

This strategy does not propose a great departure from the evolving strategy of the past few years¹. There are notable changes, however. First, programs at the local level will gain more prominence. Our experience with local leaders and governments has shown that many want to improve services to their citizens through better infrastructure or adopting a facilitative business environment. As an example, many cities and municipalities are seeking U.S. assistance in privatizing commercial land as a way to generate revenues for local governments and to spark increased investment. Their receptivity is high, their capacity to implement reforms is low. We believe technical assistance can make a difference in those cities and municipalities that embrace reform-oriented ideas and policies.

Second, assistance programs that touch people directly, immediately, and tangibly will become a priority. These include not only local infrastructure activities, such as improvements in public transportation, but also programs that help people take control of their destiny. Major policy reform efforts at the national level have failed to take hold and so the expected benefits of those policies have not trickled down to most Ukrainians. Even in the absence of an enabling economic policy environment, there are market-reform programs that have a high probability of success. The small business initiative is one such program, which will remain a high priority. In agriculture, a new approach will be taken, one that promotes empowerment by working with private farmers and owners of garden plots in selected, progressive regions in Ukraine.

A third change is that the assistance strategy will place greater importance on programs that help develop a civil society in Ukraine. Recent efforts have shown some remarkable results with citizens' groups taking on government and winning. An expansion in our advocacy support programs will try to capitalize on these successes by pressuring the "top" from "below" on national policy changes. The assistance programs will encourage and support indigenous think tanks and NGOs throughout the country to challenge government so that advocates for reform throughout Ukraine keep the reform dialog on the agenda of Government.

¹ However, if one were to compare the assistance program of five years ago with that of today, one would conclude there is considerable change. (The assistance program of five years ago was heavily weighted toward central government-led reforms.) Change in the program has come in increments.

Fourth, policy work at the national level, though vitally important for Ukraine's survival in the short-term and economic growth over the longer term, will have a tighter concentration with most assistance tied in to support "leveraged" reform, that is, the policy conditionalities of the EFF and the World Bank's loans. However, initiatives at the local level or empowerment programs, such as small business, may become stymied by the absence of national policies (or by bad policies). In such cases, we will engage the national government on a selective basis when it appears the chances for success are high and where strong constituencies for change exist.

Other shifts follow. Programs in health care will have a strong strategic coherence with the theme of improving health through a greater reliance on primary and preventive care. Major new initiatives will begin to combat corruption in society, which, among other things, is a major impediment to investment. In the energy sector, U.S. assistance programs will move away from restructuring efforts and begin to pave the way for outright privatization of both generators and distributors of power.

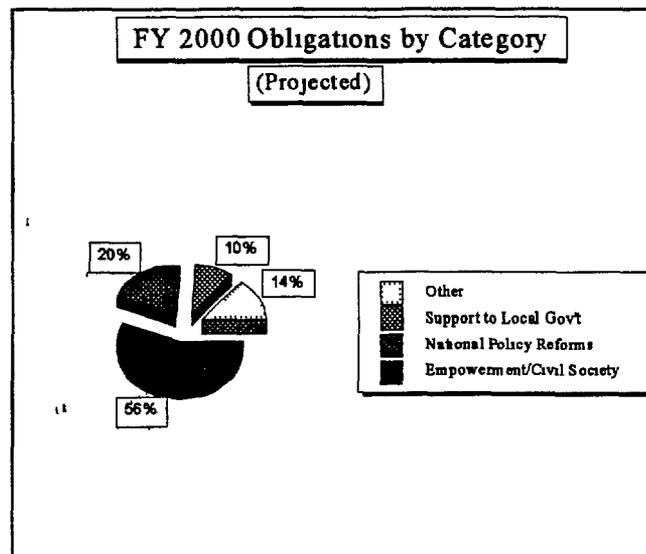
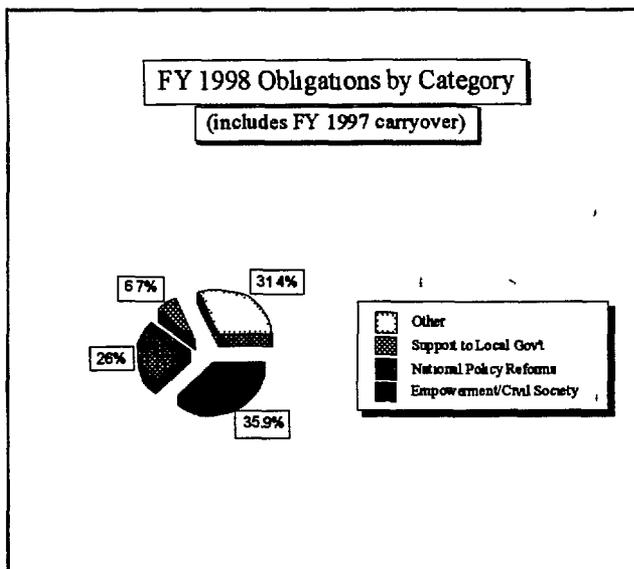
The USG will bring to a close its mass privatization operations, having achieved many of the program's goals, although limited initial support for cash privatization of the largest government-held industries may continue. Restructuring support of the newly privatized companies will begin as a follow-on program.

New special programs will start over the next four years: a regional development initiative in Kharkiv will be undertaken, Poland-Ukraine ties (and ties with other reforming Central European countries) will be strengthened through programs funded by the U.S., the fight against trafficking of women into prostitution abroad will intensify, and programs that address global climate change will commence.

Forecast

The direction Ukraine will take before and after the presidential election in October 1999 is not clear. The U.S. assistance strategy must remain flexible to respond to opportunities and to disengage from failing initiatives. We expect Ukraine will weather its financial crisis, although this is a difficult prognosis to make. Many of the same issues confronting Ukraine's transformation today will be discussed four years from now, only the subtleties will change.

Unless Ukraine abandons its reform effort completely and provided the global economic slump of 1998 improves, we expect Ukraine will eventually begin to experience a gradual rise in GDP during the four-year period of the strategy. Social issues, such as health care and pension reform, will begin to be addressed, but little reform in those sectors will have occurred. Some of the more progressive local governments will have pursued and succeeded in adopting experimental and innovative reforms in land privatization, infrastructure, and agriculture. NGOs will have become more active (some self-sustaining), and more influential in changing public policy.



The USG should set its aims high, but keep its expectations realistic. One of the most valuable contributions the U S assistance program can make over the next four years is to help create the many building blocks of reform through institutional strengthening both inside and outside government, and help advance those national reform efforts the GOU would be willing to pursue (for example, moving from a Soviet accounting system to international accounting standards). This will allow a Ukrainian government with serious reform intentions to consolidate these “building blocks” into a comprehensive reform program, thus shortening the time of the transition. Another valuable contribution will be the wider planting of “seeds” for reform throughout the country. The program will build on the successful practices developed over the past five years at the sub-national levels. Finally, the assistance program will also keep the reform debate alive in Ukraine by supporting advocacy NGOs and reform elements within the Government itself and at the local government level, thereby preserving progress made to date and preventing a retreat back to a Soviet model of governance.

Given the directions outlined above, USG assistance will likely assume the form shown in Graph 2 above. (Last fiscal year’s funding is shown in Graph 1 for comparison.)

Ukraine’s Transition: The “Kuchma Years”

When President Kuchma was elected in 1994 and announced sweeping economic and social reforms as the basis of his agenda, the West greeted him with open arms. Four years later, Ukraine remains bogged down in debate over whether to take many of these necessary steps. Opportunities for reform were lost.

On the one hand, Ukraine has demonstrated it is a strong partner of the West. It willingly gave up the once vast nuclear arsenal it inherited from the Soviet Union, it has begun cooperation with NATO in the form of a special partnership, and in early 1998, it

canceled a lucrative deal to sell a nuclear power plant turbine to Iran at the urging of the US. The European Union and Ukraine have entered into a Partnership Cooperation Agreement that establishes a basis for strengthening the Ukraine-EU relationship (Ukraine seeks an Association Agreement and eventual EU membership). President Kuchma and his Government have announced their desire to have Ukraine accede to the World Trade Organization, although progress has been very slow. In short, the relationship with the West is strong and growing.

The overall pace of structural reforms, on the other hand, has been less impressive and a point of contention between Ukraine and the West. On the positive side, Ukraine has made tremendous progress in monetary stabilization. The hyper-inflation of the early years of independence, as high as 10,000 percent, declined to about 11 percent in 1997. Ukraine successfully launched a new currency, the *hrivnya*, in September 1996, which has until recently remained stable and within a corridor.² The Government has nearly completed privatizing all small, state-owned enterprises, and at least in numbers of enterprises privatized, an overwhelming share of the larger assets has been turned over to the public.³

However, the shallowness of reforms in many sectors has not created conditions for sustained growth, which is now further undermined by a financial crisis. Fiscal policies have improved somewhat recently, but there is general agreement that tax policies and tax administration overburden enterprises and, along with over-regulation in the economy as a whole, discourage investment and development of enterprises within the "official" (namely, tax-paying) economy. (The "unofficial" economy is estimated at 40 to 60 percent of official GDP.) The decline in GDP is tapering off, but nonetheless Ukraine is one of only a handful of countries that has suffered seven consecutive years of economic decline.

The structure of government, in many ways unreformed since Soviet times, may be the single most important impediment to change. It leaves intact many large interest groups with every incentive to delay change and a decision-making process that stifles initiative. Little reform has taken place in reorganizing the Government and reducing its size. The bureaucracy is divided and dysfunctional. Production-oriented ministries remain in place and jealously guard their control (and ownership) of markets. A policy environment that is largely adrift amid unsupportive forces in Government allows bureaucratic politics to obstruct most new reform policies. With an over-regulated economy and crony politics influencing decisions, corruption thrives in Ukraine. Foreign direct investment to date, a measure of a country's investment climate, totals just \$2.2 billion in Ukraine. On a *per capita* basis it is one of the lowest levels in the world. (See Figure 2.)

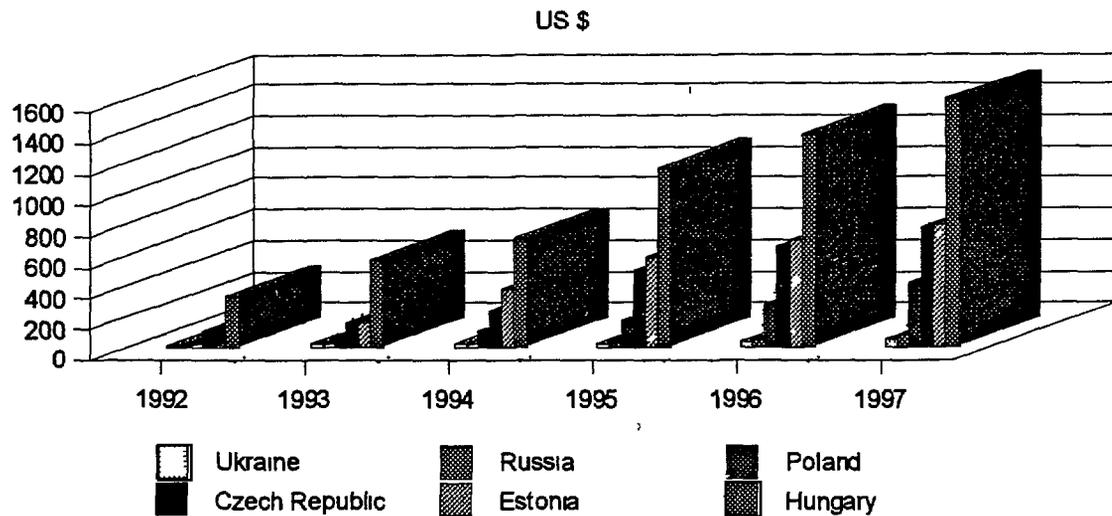
² The recent economic downturn, combined with a lack of progress in implementing structural reforms and uncontrolled government spending, has resulted in a sharp devaluation of the *hrivnya*. Between August 1 and September 30, 1998, the *hrivnya* lost 40 percent of its value.

³ To date approximately 8,300 out of a universe of 9,500 medium- and large-scale enterprises have been privatized. The GOU has recently initiated a cash privatization program for its most lucrative enterprises. Results to date have been disappointing. The Government remains reluctant to give up strategic control in these companies.

For many Ukrainians, the most visible and immediate consequence of the transition has been poverty. The number of poor people has grown to more than 50 percent of the population by official estimates - to about 30% of the population by more reliable estimates⁴. Before independence, poverty was not regarded as an important political or social issue.

Explosions of inflation ignited by attempts to cover budget deficits by printing money eliminated family savings accumulated over many decades -- leaving the elderly and disadvantaged with no cushion to protect them from new economic realities. And

Foreign Direct Investment per Capita



worsening budget deficits froze pensions and other government benefits at far below subsistence levels.

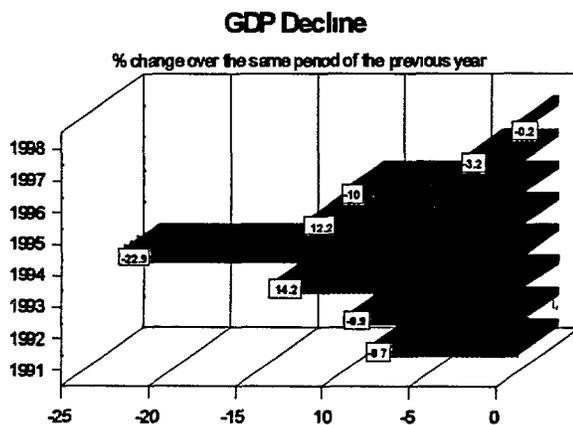
The newly poor resent their status, which many blame on "reforms". Most have turned to political parties calling for a "return to the normalcy" of socialism. These parties are effectively slowing or even blocking reform -- further exacerbating social and economic problems.

Ukraine's Problems

Since independence the quality of life in Ukraine has been on a steep decline. Though statistics must be viewed with caution (e.g., they fail to capture the unofficial economy in full), they paint a grim picture: GDP has fallen by about 55 percent, agricultural production by 60 percent, and industry by 57 percent. Infant mortality has increased.

⁴ The World Bank estimates 80 percent of Ukraine's population has fallen into the poverty ranks. The threshold the Bank uses to define poverty in transitional economies is \$4 per person per day.

from 12.8 per 1,000 births in 1990 to 14.3 in 1996, life expectancy has dropped by an average of more than 2.5 years from 1991 through 1996 years (for men the decline is even more notable, average life expectancy has diminished by more than 3 years from 64.7 years in 1991 to 61.6 years in 1997), and those who have fallen below the poverty line now number between 16 and 26 million persons – one-third to one-half of the population. Official unemployment is growing and the unofficial, but more realistic, reports conclude that 4 out of every 10 Ukrainians are either unemployed or under-employed. One example of measuring this decline in living standards is UNDP's Human Development Index, which examines gross indicators such as real GDP *per capita* (PPP basis), adult literacy, life expectancy, and education enrollment rates. *The 1998 Ukraine Human Development Report* shows Ukraine's index rating slipping once again. Ukraine has fallen from 95th place, as reported in the 1997 report, to 102nd, well below Belarus, and, according to the study, on par with Uzbekistan, and Albania.



GDP

The trend in real (and official) GDP loss has been improving steadily since 1995 with a projected contraction in the economy for 1998 of -0.2%. However, the informal economy is estimated to represent 40 to 60 percent of official GDP, thus the economy's decline since independence is overstated. An over-regulated business environment coupled with a burdensome tax structure greatly encourages businesses to operate outside of the official economy. Eliminating over regulation in the economy, which breeds corruption, and reforming tax policy are two important structural reforms the government must address.

After seven years of independence, Ukraine's democracy is still fragile, though several national-level elections have taken place, including the first elected change of presidents in the NIS. The latest round of parliamentary elections in March 1998 was declared largely free and fair by most international observers, with the Communists winning the greatest number of seats in the Ukrainian Parliament (the 'Rada')

However, the media find themselves under the influence of government. Interest groups tied to political leaders have arguably taken control of most of the larger media organizations. This became most visible during the parliamentary elections and is expected to be more of a problem as presidential political campaigns get underway for the 1999 elections. Media groups that report unfavorable stories have felt pressure, been threatened, and even abused by those directly or indirectly implicated in their reports.

Moreover, a civil society, one in which groups outside of government make their voices known and have influence over policy decisions, is largely underdeveloped, though more than 3,000 active non-governmental organizations (NGOs) exist. The executive branch holds control over the judiciary branch, with court decisions often reflections of the desires of influential politicians and other leaders.

The specifics may be unique, but in general similar problems and underlying causes persist throughout the countries of the former Soviet Union (NIS). All have shared the full brunt of the seventy-four years of Soviet rule and must dismantle former systems and restructure new economic and governing systems - overwhelming and complex tasks. According to studies⁵, Ukraine's uneven experience in reform is similar to the experience of other NIS countries.

Underlying Causes

Clearly, Ukraine's bureaucracy was ill-equipped to govern at the time of independence. Ukraine as a Soviet republic took direction from Moscow, little was decided in Kiev. The Soviet government in Ukraine thus carried out centrally-dictated policies. As a part of the Soviet empire, and earlier as part of the Russian empire, totalitarian government in Ukraine flourished, which has since impeded progress toward developing a civil society and a market economy.

Independent Ukraine has built its current system of government upon the foundation of the old Soviet system. The present system is an eclectic and incoherent mix of organizations inherited from the Soviets and others formed since independence. It is inefficient, largely non-responsive to the needs of the people, corrupt, and ingrained with the philosophy (again a legacy of the past) that government should control, not facilitate and regulate, society and the economy. This forms a barrier to economic growth and the development of a democratic society.

The Government is not responsive to the needs of the people and the present structure does not allow for accountability. Public opinion surveys indicate that an overwhelming majority of Ukrainians feels powerless over its ability to influence change and therefore remains disengaged from public policy issues. In a survey conducted in fall 1998, approximately 87 percent of Ukrainians polled said they do not belong to any civic or political organization. This absence of public pressure on the government has done little to inspire leadership at the top levels in Government. Only recently, when faced with an impending financial crisis, has President Kuchma been engaged in economic reforms.

Decisions involving economic resources are not optimal. Government subsidies, though decreasing, are still passed down to dinosaur industries that have no market for their products. Corruption flourishes in the current environment, the continuing presence of Government in all aspects of the economy has spawned corrupt practices and rent-seeking behavior⁶. Despite recognition by many in government that change in the way Government operates is necessary, the vested interests in the present chaotic situation will cause change to proceed slowly and unevenly.

⁵ See *Nations in Transit 1997*, Freedom House and *Transition Report 1997* EBRD

⁶ Corruption *per se* does not necessarily inhibit investment (foreign or domestic) as long as it is predictable and not too onerous. Southeast Asia was used as an example where corruption and growing investment coexist. However, studies on corruption in the NIS and Ukraine in particular show that corruption or required payoffs are unpredictable and detrimental to the survival of business. A senior World Bank representative recently termed the behavior of rent-seekers in Ukraine as "acid-stripping" of businesses.

A third problem is that even if there were consensus on change, **Ukraine at this stage lacks the capacity** to do so. Few people in and outside government understand the global environment and the realm of possibilities. Many supporters of reform speak the language of market economics, but few comprehend it. Moreover, schools and universities still turn out graduates who are ill-prepared for work in a modern economy. Few teachers and professors understand the requirements of a democratic society and market economy.

Major Events Influencing the Pace of Reform

Over the next four years, two major events will profoundly influence the direction Ukraine takes. The financial crisis is an immediate and mid-term challenge for the Government of Ukraine, which potentially threatens the stability and solvency of the country for at least the next eighteen months and most likely beyond that. In 1999, Ukrainians will return to the polls and elect a president. President Kuchma is a strong contender to retain his position but he faces stiff competition. As the elections draw nearer to the poll date set for October 31, 1999, the Government is less likely to pursue reforms that could require short-term socio-economic sacrifices on the part of the population, even if necessary for longer-term growth, and certainly one could expect it to be totally averse to proposing fundamental reform. Reforms will continue in 1999 and beyond, in our view, but probably only to the extent that they keep the tap open to World Bank and IMF disbursements, or respond to some perceived political advantage.

Financial Crisis

The financial crisis in Ukraine results directly from the structure of the Government's debt, and the spread of the Asian crisis contagion westward to Russia and now Ukraine, and fundamentally from a lack of progress in putting into place structural reforms necessary for a market economy to thrive. Starting in late 1996, the Ukrainian Government began to finance its large deficit through short-term, high-yield treasury bills. At first attractive to non-residents, as the crisis in Southeast Asia worsened and as government failed to restructure its economy, foreign investors grew wary and began leaving the market. Longer-term foreign currency loans or bonds became increasingly difficult to obtain and, for those agreements concluded, interest rates continued to rise. The government quickly built a debt pyramid it could not repay.

On September 4, 1998, the IMF Board approved a three-year, \$2.2 billion Extended Fund Facility aimed at improving the investment climate in Ukraine by introducing a stabilization package and supporting structural reform policy changes. With an immediate release of \$252 million in September, followed by monthly tranche releases (predicated on compliance with conditions), and perhaps as much as \$900 million released through several World Bank Structural Adjustment Loans, the IMF estimated Ukraine would face a total financing gap of about \$1.6 billion by the end of June 1999.⁷

⁷ Ukraine-Request for Extended Arrangement, IMF, Confidential Document, August 14, 1998

To remain solvent, Ukraine must convince the donors and the world's financial institutions that its situation is not as precarious as Russia's and that it is serious about reforming. To backslide on its reform program will result in a cut-off from much-needed donor financing, and signal to investors that the Ukrainian market is still not a viable place for investment. From an outsider's view, Ukraine has no other choice than to implement the tough structural reform policies it has agreed to do. However, our experience in persuading the Government to undertake economic reforms leads us to believe that Ukraine will not aggressively pursue reform and will likely do what is minimally expected in order to meet mandated targets. The EFF does indeed set very ambitious financial targets, but it is somewhat softer on the structural side.

Seemingly, the donors and financial markets will have optimal leverage over the next eighteen months or more to push for more far-reaching reform. However, one concern is whether the IFIs (International Financing Institutions) are feeling pressure to disburse, perhaps prematurely. Many would argue that it is well in the interest of the global community to prevent a financial meltdown in Ukraine similar to Russia's. Reforms do take time to build consensus within a government, and with the many fractious elements in Ukraine's Government, the fear is that the time required to meet structural adjustment loan conditionality may exceed the point of national insolvency. This concern begs the question of whether Ukraine will do less than expected and still reap the funds of the donors. The answer is not clear.

The financial crisis, how the Government responds to this extraordinary situation, and how the G7 countries and multi-lateral donors react, will greatly influence the pace of reform over the period of the strategy.

Presidential Elections

The assistance strategy will also be affected by the presidential elections scheduled for October 1999. The pace and shape of reforms throughout 1999 will be largely influenced by the election campaign, and in 2000 and beyond by the outcome of the elections.

Although President Kuchma and the Speaker of Parliament have claimed that relations have improved between the two branches of power, Kuchma's critics from across the political spectrum are as vocal as ever. Certainly, Kuchma will continue to be vulnerable to criticism that his administration is responsible for the country's economic malaise over the past four years, and one opposition party has already called for his immediate resignation. This popular sentiment may embolden the parliament to oppose any attempts by Kuchma to implement his economic reform programs, as it has already done by rejecting some recent presidential decrees. Whereas some opposition parties may oppose Kuchma's reform efforts for ideological reasons, even reform parties may find it politically expedient to withhold support for Kuchma's decrees. Indeed, certain reforms, such as reducing subsidies, raising the retirement age, or closing down bankrupt enterprises, would be difficult to implement in an election year in any country. Conversely, the president may feel compelled to implement populist measures that are counter to the reform agenda, such as abandoning its strict monetary policy in order to

pay off wage arrears. There are several reasons, therefore, why the period leading up to the presidential elections may be devoid of significant reforms, as was generally the case prior to the March 1998 parliamentary elections.

It is also possible that the current economic crisis will provide the impetus for the government to implement some politically difficult reforms. For example, the Prime Minister's recent drastic actions to collect back taxes from government enterprises may signal an effort to get tough on big businesses or sectors that previously enjoyed political protection.

Another effect of the presidential election campaign in 1999 may be an erosion of political, personal, and press freedoms. The 1998 parliamentary elections witnessed significant abuses of political power by the government in using coercion and manipulation to restrict press freedoms and prevent a fair playing field for all candidates. Given such abuses during the parliamentary elections, such tendencies would likely be even greater in 1999 when the stakes are much higher. If this is the case, it will be a setback for democratic reforms, and will undoubtedly have political reverberations internationally.

Effect of the Presidential Elections Post-1999

Although the possibility of a far-left comeback or a victory by a reform-minded dark horse candidate cannot be ruled out, the most likely outcome of the 1999 presidential elections will be more of the same. Despite the desperate situation in the country, Kuchma's considerable influence over regional governors and much of the national media could give him a considerable advantage in the election campaign. Notwithstanding a Kuchma victory, the current list of leading contenders includes former Parliamentary Speaker Oleksandr Moroz, whose Socialist Party platform more closely resembles the reformed Communist parties that presided over moderate governments in Poland and Hungary than a Marxist/Leninist party. The prospects and opportunities for reform will be different depending on who wins, but the bottom line is that support for reforms will be limited to certain areas that would not undermine the economic interests of the particular political-economic interest groups that supported the victor's campaign.

Conclusion

Given the economic environment and elections, three possible scenarios emerge. First, the crisis in Russia, only now beginning to be felt in Ukraine, will motivate the government into action and strengthen the hands of reformers. Conversely, the backward-looking elements, which still wield considerable power, may cite the Russia example perversely by explaining this is what happens when Western reforms are blindly adopted. A policy of re-nationalization in important sectors, something being given serious consideration in Russia, may appeal to this group. A more likely scenario, and one consistent with past experience, is that Ukraine will muddle through this, barely doing enough to qualify for monthly IMF and World Bank disbursements, yet continue to

implement protectionist policies and worse yet, policies that support the elites and cronies

Approaches

The donor community as a group has concluded that after seven years of providing assistance to Ukraine, its collective approaches have not succeeded in fundamentally changing the policy environment. Studies consistently show that technical advice to governments which do not fully commit themselves to undertaking reform policies show little measurable effect. In the preceding months, the donor community has begun to take stock of its efforts in Ukraine. The World Bank country assistance review in Ukraine, as an example, promises to be a thorough examination of what has worked well and what has not. Without prejudicing the outcome of this evaluation, the Bank will likely conclude that the operating environment for the private sector is no better than it was five years ago. This is a condemning statement not only of the Government's reform and development efforts, but also of the donor community's ability to influence change at the national level.

In discussing in general what approaches U.S. assistance programs should take over the next four years, it is important to consider certain realistic assumptions. First, the financial crisis in Ukraine will continue for at least eighteen months, or longer if Ukraine continues to muddle its way through. Second, the working relationship between the executive and legislative branches will improve only slightly from the gridlock of the last four years, and will likely worsen during the run-up to the presidential elections. There will continue to be no consensus on how far reform should be taken, or what specific reforms should be implemented. A further problem is that the Government's capacity to implement reform will weaken as the fiscal crunch and the public administration reform efforts result in, at least initially, the Government's having many fewer workers with fewer resources at their disposal. This will occur without the necessary structural changes taking place in Government (such as redefining the role of government) that could improve efficiency and cut costs. Third, financial desperation will not be limited solely to the central government, as expenditures are slashed the amount of remittances to local governments will decline precipitously, forcing crises at the local levels. Innovation and assistance to reform-minded groups at the local level will be key to keeping many local governments afloat.

Given an environment in which decision-makers are not expected to adopt deep reform measures before or after the October 1999 elections, the USG advocates an approach that continues to push for top-level, structural reforms with a national impact in this period of crisis (where such efforts prove to be effective), while at the same time place greater emphasis on the longer term by working to prepare the next generation or perhaps the generation after for coming to power. The spill-over effects from Russia have already had a tangible impact on the Ukrainian economy -- the banking system finds itself in a state of crisis and exports to Russia have begun to drop -- and U.S. assistance programs should be directed toward helping Ukraine avoid an economic collapse. There is also hope that the Ukrainian leadership will come to realize that its only path through this

crisis is the one that leads uphill with tough reform policies. Whether the tough decisions are taken we remain hopeful, but not fully convinced.

In general the assistance program will look for more effective ways to effect change in the short and long run, including longer-term efforts to support change from the bottom up. Under each of the priority areas articulated in the section below is a detailed description of what approaches we expect to take over the next four years, but in general they are

Policy Reform Dialog At this point the G-7 countries and the multi-lateral funding institutions hold a tremendous amount of leverage over influencing the shape of Ukraine's economic policies. The two groups should speak with one voice (and consistent strategies) in pushing the government for even greater structural change in the economy as they continue their discussions with the Ukrainian government. The USG should recommend to the World Bank that it lead a consultative group meeting on Ukraine to arrive at agreement on a donors' strategy. USG senior policy-makers should make clear to Ukraine that funding for top-down programs will continue only in response to tangible signs of reform. The U.S. should use its influence at the World Bank and the IMF to press for thorough reviews of conditionality before agreements are made to disburse funds. Both organizations will come under pressure to release funds for Ukraine to help prevent an economic collapse in what could be less-than-desired progress on Ukraine's part. To do so would send a wrong message and result in a loss of credibility of not only the donors themselves, but also the member states. Half-baked reform efforts will mislead Ukraine into believing a hybrid system of reform and a mix of bad economic policies add up in total to achieve the objectives of the conditionalities. Structural reform programs should include enough flexibility to prevent instances where the Government meets the letter of the law of a structural adjustment loan, but contradicts the intent of the reform program by instituting backsliding policies. The Agriculture Sector Adjustment Loan of the World Bank is an example where the letter of the law may have been met, but the spirit was so badly violated that little change or reform will result in the agricultural sector. The USG position must be firm in preventing premature disbursements since the pluses in doing so are short term only.

Selected Support for Effective Government Reform Efforts The general view is that the structural adjustment loans of the World Bank overlaid on top of the EFF make an effective reform program for the immediate financial crisis as well as for the longer term. The U.S. assistance program should continue to help support the enactment, and more important, the actual implementation of these critical reforms unless there are signs of backtracking and/or disbursements under the IMF and Bank programs are suspended. The quarterly review process undertaken now on assistance programs to Ukraine should continue for two purposes. First, keeping the programs under tight review allows greater flexibility in responding to what has worked and what has not. It may also help avoid the "moral hazard" of directing too many resources toward national reform while getting too little.

reform in return. Second, it sharpens the understanding of USG policymakers involved in policy dialog on the complexities and subtleties associated with the assistance program.

Longer-term Approaches An error committed by the USG and other donor countries was the supposition early on that reform could happen rapidly. It hasn't in Ukraine, or anywhere else in the NIS. The USG and other donors must come to the realization that we should be prepared to stay engaged in Ukraine's transition and development for the long haul. This will allow experimentation with new approaches including

Demonstration Activities Commitment to change comes when one has evidence that it leads to something better. One of the weaknesses in Ukraine's transition is that people in general are not aware of the universe of possibilities. They cannot articulate the changes they want, therefore their advocacy policies are ineffective. Demonstration projects would raise the expectations of people to a higher level. For example, a health care facility that provides reliable, relevant, and high quality services for a fee (one not much higher than the unofficial fee patients must pay now to get services) shows people (including those in local government) what is realistic and possible. Greater reliance on partnerships with U.S. organizations will help leverage our assistance dollars further and promote binding ties between the U.S. and Ukrainian organizations.

Pro-Reform NGOs and Think Tanks A number of NGO leaders and think tanks have successfully linked up with pro-reform elements in Government and have had a surprising amount of influence over the direction the Government has taken on certain reforms. The U.S. assistance program will give greater attention to helping make these NGOs and think tanks sustainable and educate them on how to maintain independence (and thus protect their credibility), yet help direct and influence public policy making.

Empowerment of people will become a cornerstone of USG assistance efforts. Getting people to believe in themselves, to rely less on government to guide their daily lives, and to take control of their destiny through economic opportunities and political choices will form the foundation of the assistance program.

Pilot Testing of Reform Initiatives In areas important to the overall transition and where reform has been blocked, the assistance program will begin to develop local pilot efforts in selected progressive *oblasts* and *raions*.

Draw on Lessons Learned from Central Europe, with Attention to the Polish Experience Poland and other Central European states have made the transition to a market economy and democratic society in relatively short periods of time. The reasons for an accelerated transition are many and varied,

but there are valuable lessons that can be applied from their experiences in helping Ukraine move forward. Moreover, a U.S. foreign policy objective is to promote stronger Poland-Ukraine linkages. Through the Poland-America-Ukraine Cooperative Initiative (PAUCI), the U.S. will continue to support assistance to Ukraine using Polish expertise. Although this cooperation is taking place in all sectors and in many areas of the country, PAUCI will at least initially focus on macroeconomic support, local government capacity building, and small business development.

Reforms and Advocacy A stronger connection between proposed reforms and those who will benefit from them needs to be made. For reforms that are important for the overall change process and which have stalled or are under debate, the U.S. assistance program will make a concerted effort to identify groups that benefit from the proposed reform and work with them to make their voices heard.

Greater Support to Reduce the Potential for Corruption Support for anti-corruption measures will play a more prominent role in U.S. assistance programs. One theme that will run through many of our programs will be to reduce the potential for corruption by encouraging transparent measures (for example, public hearings on local budgets), reducing regulation (and thereby reducing the number of potential rent-seekers), and putting into place incentives/disincentives to reduce corruption.

Study Tours Ignorance of how the world market economy and democratic countries operate has constricted understanding of available options. Study tours to the U.S. and Central European countries, particularly Poland, will open the eyes of up-and-coming reformers.

Framework for an Assistance Strategy

There are no simple solutions to Ukraine's difficulties, and no simple formula for effective assistance. Regional trends are important and instructive. A strategy for assistance to Ukraine must take account of the recent financial crisis and political reversal in Russia and the reassessment that has resulted in the U.S. and elsewhere of the disappointing progress in economic and political reform in the former Soviet Union. That reassessment is not over and there are many points of view, it appears, however, that expectations for future economic and political reforms will be scaled back, and that the outside world is bracing itself for a much longer period for positive reform and change. It also appears the donors will place greater emphasis on strengthening domestic institutions and pro-reform constituencies that will, over time, support change from within. What, then, is the appropriate strategy for assisting Ukraine?

For the long-term, the USG can and will encourage the development of constituencies that will press for economic reform and a more civil society from within. We can and will work at a grass roots level to improve the lives of individuals and build a civil

society from below. But the effects will be felt only over an undefined "long term" and local level interventions can, in many cases, be neutralized or even reversed, by the actions and decisions from above. If the state undergoes financial and/or political collapse in the meantime, the long-term picture itself is uncertain.

In the short term, a Russian-style reversal is quite possible. Though Ukraine is not Russia's mirror image, the parallels and connections (e.g., trade) between the two countries are extensive and deep. Ukrainians say when Russia sneezes Ukraine catches cold. Our interpretation is that structural economic reforms in Russia slowed dramatically in 1996 (and were largely incomplete) and did not, as a result, establish the base for sustained growth. Resource revenues and external financing postponed the day of reckoning but did not prevent a collapse from happening.

Ukraine faces similar and perhaps deeper risks. Its immediate financial condition is not as dire. In certain areas (curbing inflation and rationalizing communal services pricing, among others) Ukraine has reformed more than Russia. But in just as many areas, reform has been less. Ukraine lacks natural resource revenues to cover its mistakes. And there may be even less political leadership for reform than in Russia. There appears to be no force in Ukraine, other than donor pressure, strong enough to put in place the structural reforms required setting growth in motion and sustaining it. Without growth, it may only be a matter of time before a Russian-style collapse happens here.

For the short term, therefore, there appears to be few alternatives to more effective donor action to encourage and support the most fundamental economic reforms. However, we are deeply concerned that Ukraine and the donor community have already started down the Russian path. It is deeply disturbing, for example, that international loans are moving forward when Ukraine has yet to offer a majority stake in an attractive state enterprise to a real strategic investor. It is equally troubling that our own efforts in policy reform dialog are failing to effect fundamental reforms in key sectors. No strategy for long-term assistance to Ukraine is viable without a more effective mechanism between donors and the Government to assure fundamental economic change. This strategy, therefore, proposes a multi-track approach:

- X reduced expectations about what can reasonably be accomplished -- but not below levels required to prevent a collapse,
- X a tougher position on conditionalities for international loans combined with continued technical assistance to support implementation of structural reforms, but only where reform is clearly moving forward,
- X focused assistance on programs, such as small business development, that can empower people economically and awaken them from political apathy,
- X and, a long-term effort to establish and strengthen individuals and institutions that will support the development of civil society from within.

Scenario Planning

The assistance strategy assumes Ukraine will follow the middle road reform will take place, but only in small increments. Support for national reform efforts will in most cases track closely with the policy reform loans of the World Bank and the IMF. We could expect some progress in privatization of the more lucrative firms, implementing deregulatory measures, and passing some legal reforms, such as a law on bankruptcy. It also assumes Ukraine will follow fiscal austerity measures and, in addition to maintaining compliance with IMF spending targets, will survive its present financial crisis.

However, several very real possibilities come into view. One such possibility is that despite a valiant effort, Ukraine may lose its insolvency battle, causing its economy to unravel. Assistance programs will likely shift course by addressing immediate humanitarian needs. Depending on needs assistance funds could be used to import food, heating fuel, medicines, and other emergency commodities. Balance of payments support may be another consideration. The goal of the assistance program will shift to one of protecting national survival.

If reforms stagnate and Ukraine falls out of compliance with the IFI loan programs, the U.S. will need to reassess its strategy carefully. One possible approach in response to an outward rejection of reforms is to withdraw completely from central government policy reform programs. The emphasis of the assistance strategy will move toward encouraging reforms in the regions and supporting grass-roots movements.

Implementation Considerations

A strategy of placing greater emphasis on sub-national groups (NGOs, local governments, etc) carries with it an amount of risk. A majority of Ukrainians by most studies avoids belonging to political or policy groups, which accounts partly for little pressure being exerted on the Government. This wariness of joining groups is a legacy carried over from Soviet times and is directly attributable to the poor economic situation. Many feel they have little influence over the direction society moves in, let alone their own personal lives. A recent nationwide poll in Ukraine contains some disturbing information on what Ukrainians think. By far most Ukrainians polled believe mafia and criminal elements control and dictate government policies. About 92 percent consider the economic situation "very bad", a plurality favors a return to pre-*Perestroika* times, and an increasing majority prefers deeper relations with the CIS and Russia and distrusts the West.⁸

These beliefs and attitudes will prove difficult to overcome. Yet in order for our efforts at the grassroots level to have impact we will need to identify and work with young leaders who are committed to improving the lives of Ukrainians. This is necessarily a long-term prospect and one whose impact is difficult to measure, at least in the shorter term.

⁸ See *Ukrainian Society, 1994 - 1998*, Democratic Initiatives Foundation

To date the U S assistance program has more than 1,000 ongoing or completed activities in about 395 villages, towns, and cities throughout Ukraine. More seeds for change need to be planted, however, and we need to do so using more cost-effective means to reach more and more people. Short regional strategies and programs will be developed in four or five oblasts and regions in Ukraine over the next four years to identify gaps in our programs and to encourage greater harmony between and among our activities. In Lviv, where the U S has worked very closely with the city and oblast administrations to develop a regional initiative, we now see these two governments organizing conferences with U S assistance to spread the lessons learned in development to more than 30 smaller cities in the Lviv region. In Kharkiv we will soon begin to develop an initiative designed to meet the specific developmental and investment needs of the oblast. We foresee applying the lessons learned from these two initiatives to an additional two or three oblasts or regions to have greater impact.

One possibility is the Donetsk coal basin, known as the Donbass region, which is situated in eastern Ukraine. One-tenth of Ukraine's population lives there, it accounts for one-fifth of national GDP and one-third of all exports. Many who live there have become disillusioned not only with economic reforms, but more important with the unmet expectations of an independent Ukraine. Whereas in 1991 an overwhelming majority of more than 95 percent of Donbass residents voted for independence, seven years later 75 percent (according to a recent poll) would like to see reintegration into a larger Russia.

Greater concentration of activities in selected regions, nurturing up-and-coming leaders supportive of reform, and putting into place activities that help people deal with the problems that "stalled" reform has created are means to help mitigate the risks of a strategy designed to drive reform predominantly from the people or "demand" side.

Customer Service Plan

The members of USAID/Kiev Strategic Objective Teams, commit our collective efforts and team resources to efforts to achieve sustainable development in Ukraine, and to do this in such a way that fully engages the Ukrainian population and local governments in this effort in those areas where this effort is concentrated. To this end we work with and through our Implementing Partners to serve our immediate customers and related institutions working with these customers so that they may in turn effectively answer the needs of our ultimate customers, the citizens of Ukraine. To the maximum extent possible we will solicit customer input (through surveys, polls, focus groups, conferences, etc) in designing activities to support and encourage citizen participation in political and economic decision-making. Measures to monitor the impact of our activities will reflect customer input.

We will conduct periodic visits to sites where our Implementing Partners provide technical assistance and training to our customers, and our Strategic Objectives Team will also participate in the implementation process itself. Where feasible, we will employ participatory evaluations when assessing achievements. We will respond promptly to inquiries regarding the purpose, activities and achievements of our programs from all interested parties, including local and other government officials, media and others, and seek popular and media support for our activities. We will process USAID documentation and vouchers of Implementing Partners promptly to facilitate the work of our Implementing Partners in serving our customers.

We will manage programs for efficiency and impact, focusing on coordination across the portfolio, as well as within the broader USAID/Kiev program and with other donors. Administration of the program will be efficient and responsive to documentation and analytical needs as they arise.

Strategic Objective 1.1

Increased Transfer of State-Owned Assets to the Private Sector

1 Introduction

After four years of consistent USAID support for privatization, the vast majority of state-owned enterprises in Ukraine have been privatized. The importance of this accomplishment cannot be overemphasized: significant private ownership of enterprises and land is an absolutely essential prerequisite for a successful transition to a market economy. Private ownership of resources is the primary means of empowering the Ukrainian people to make decisions, participate and become stakeholders in the economic arena—actions that will make a difference in the lives of all those who become property owners. On a national scale, private ownership and control of enterprises will lead to increased efficiency and competitiveness, and will ultimately serve as the engine for Ukraine's economic recovery. As the private sector continues to grow, incomes will increase, and small and medium private enterprises will absorb workers displaced from old state enterprises.

Ukraine has made great progress in the area of privatization, with constant assistance and pressure from the international donor agencies and financial institutions, but a significant amount of work remains to be done. Although USAID is closing down assistance under the rubric of Strategic Objective 1.1, selected ongoing and future activities in the area of privatization will be transferred to SOs in other sectors, as explained below.

2 Progress to Date

U.S. assistance to transfer state-owned assets to the private sector has taken the form of programs in (1) small-scale privatization, (2) mass privatization, and (3) land privatization.

Small-Scale Privatization Over 45 thousand small enterprises have been privatized—15.5 thousand of these with direct USAID assistance—in over 70 cities in 23 oblasts throughout Ukraine. As a result, over 90 percent of all small and medium enterprises in Ukraine are privately owned, providing employment to more than 660,000 people. Activities have also focused on the privatization of unfinished construction sites (UCS), which have provided a fresh start (location, land, and building) for new start-up enterprises. By the end of 1998, over 5,000 unfinished construction sites will have been privatized—resulting in the creation of over 3,000 new jobs so far in the new firms, the transfer of unproductive state-owned resources to productive employment by new private owners, and additional revenue for the budgets of the local governments that sold the property.

Mass Privatization With USAID assistance, a transparent certificate privatization process was carried out. Over 90 percent of privatization property certificates (PPCs) were collected by the public, and as a result of investment in PPC auctions and preferential sales—an estimated 35 percent of Ukraine's citizens are now shareholders through the mass privatization program. By

the end of 1998, more than 8,700 medium and large enterprises (out of a universe of approximately 10,000) will have been privatized (e.g., at least 70% privately owned) through mass auctions. Of these, nearly five thousand will be 100 percent privately owned.

Land Privatization There has been considerable success working at the level of oblast and municipal government to privatize agricultural and enterprise land. Neither effort is self-sustaining yet and neither has yet reached the stage of nationwide impact. But initial results are promising. Ownership of agricultural land has been transferred from the state to collective agricultural enterprises and some 6.5 million land shares issued to individual collective members. Physical titles have been issued to 155,300 people including 10,300 since July, 1997 through USAID-supported programs. Privatization of land under enterprises started only in October, 1997 but enterprise land sales offices are now operating in 24 cities and more than 1,500 privatizations will be complete by the end of FY1999. The agricultural and enterprise land programs are discussed in more detail under SOs 1.3a and 1.3b respectively.

3 Remaining Issues

Quality of Privatization Despite the successes in rapidly privatizing the vast majority of formerly state-owned enterprises in Ukraine, many problems continue to constrain the complete transfer to private hands of these resources. The quality of privatization to date remains an issue, with a large percentage of large privatized firms sold to employees (44%) and management (20%) within the enterprise, and with the state retaining a controlling share of many partially privatized firms. In the agriculture and energy sectors, state control over private holding companies give enterprises monopoly power, which has proved to be a constraint to further reform and development of private sector activity in these sectors. Shareholders' rights and corporate governance are still concepts not very well understood in this developing market. The confluence of these factors results in an environment in which privatized enterprises are not forced to restructure—and hence the many positive economic benefits (and some negative consequences) from privatization have yet to be widely felt.

Strategic Enterprises Many of the “blue-chip” companies in Ukraine continue to operate under state ownership. According to the GOU, there are approximately 1,000 of these strategic enterprises (other private sources place the estimate closer to 100). Powerful interests and continuing statist attitudes have managed to protect these companies from being privatized. These enterprises are more attractive to outside investors for a good reason, and insiders including technical ministries are guarding them carefully against privatization in order to protect their own interests. The privatization of these enterprises is a key to completing the successful transfer of property to private hands.

Land Ownership Within the Rada and some parts of the state bureaucracy, there is strong entrenched opposition to land privatization, in particular for agricultural land. Considerable work will be required to bring about the full privatization of agricultural land and the surplus land associated with privatized enterprises.

Other Enterprise Assets Social assets of former state enterprises—including kindergartens, apartments, medical clinics—are not normally part of the financial responsibility of an efficient private enterprise in a market economy. Pilot work has been carried out in privatizing these assets under the small-scale privatization program, but there is potential for future resistance as local governments do not want to be burdened with the additional responsibility for providing these services once the assets are divested from the privatized firms.

4 Program Approaches in the Future

Since the strategic objective—increased transfer of state-owned assets to private hands—has largely been achieved on the whole, assistance under SO 1.1 is in the process of being closed down. Ongoing and future activities will be transferred to relevant SOs as indicated below.

SO1.3(a) A More Market-Responsive Agricultural Sector Despite progress in privatizing farms, grain elevators, and input supply companies—Khliv Ukrainy and other state holding companies maintain a restrictive hold on the agricultural sector, with monopoly control resulting in price-setting behavior that does not permit the operation of a market for agricultural products. USAID will continue into the first year of the strategy to focus on the privatization of grain elevators, and over the period of the strategy on land titling at the rayon level, in order to get land titles into the hands of individuals as quickly as possible.

SO1.3(b) More Competitive and Efficient Privatized Enterprises Support to complete the privatization of unfinished construction sites is discussed under SO1.3(b) below. Assistance to privatized enterprises will include a variety of activities to encourage widespread firm restructuring and continued support for enterprise ownership of associated lands, and (under SO1.4) the strengthening of corporate governance and shareholders' rights.

SO1.5 Economically Sustainable and Environmentally Sound Energy Sector Continued support for privatization in the energy sector will take the form of efforts to help with privatization and demonopolization of energy distribution and production companies.

Strategic Objective 1.2

Increased Soundness of Fiscal Policies and Fiscal Management Practices

1. Statement of the Strategic Objective

In order to make a successful transition to a market economy, the Government of Ukraine must shrink the size and scope of the public sector while encouraging the growth of the private sector. This requires continued reforms in macroeconomic policies and, in particular, improvements in fiscal policy and public financial management.

Since 1995, the National Bank of Ukraine has pursued a responsible monetary policy, with inflation held to acceptable levels and exchange rates for the national currency, the hryvnia, kept reasonably stable. However, given the impact of the global financial crisis and the default and devaluation in Russia in mid-1998, it is clear that the Government of Ukraine (GOU) needs to make corresponding reforms in its fiscal policies.

Thus far the pace of fiscal reform has been slow, and the GOU has often been unable to meet the fiscal criteria for receipt of IMF loans. Tax revenues fall short of expectations, and heavy-handed measures to increase revenue collections tend instead to encourage the movement of economic activity into barter operations and the informal “shadow” sector. Budgets plan for unrealistic levels of expenditures, including continued subsidies to unprofitable state-owned enterprises, and the result is mounting payment arrears in the budget sector and still larger tax and inter-enterprise arrears in the state-owned enterprise sector.

The persistence of these problems, compounded by the global financial crisis, has closed off most sources of deficit financing for Ukraine. Moreover, payments on outstanding debt are severely overburdening the current budget. This increases the urgent need for fiscal reforms, both to minimize budget deficits and to qualify for longer-term, lower-cost IMF and World Bank loans. Further USAID assistance to promote compliance with loan conditionality will be essential for Ukraine’s continued receipt of this much-needed funding.

USAID will consider this objective achieved when Ukraine meets the following criteria: (a) the tax system is sufficiently fair, simple and transparent to encourage greater taxpayer compliance and revenue collection is increased without placing an undue burden on economic growth, (b) public expenditures meet government priorities at a level that can generally be sustained by reliably estimated revenues, (c) the process of budget preparation, adoption and execution is well-informed, accurate, transparent and responsible, and (d) fiscal policy makes a positive contribution to macroeconomic stability and growth in GDP and personal income.

2 Problem Analysis

Problems with the tax system have been one of the factors serving to push economic activity into the informal sector and barter trade. Modernizing the tax laws to broaden the base, lower the

marginal rates and facilitate compliance, and incorporating these laws into a single, consistent tax code, should promote economic growth within the official economy and reduce reliance on barter. This in turn should increase revenue collections and ease the strains on the budget. These developments will also create a more favorable environment for private investment, as strategic investors are more likely to see a return on their capital in a more stable fiscal environment.

Taxes and government expenditures are both considered to be too high, and the resulting fiscal deficit cannot be sustained. The GOU traditionally has sought to reduce the deficit by increasing the rates and number of taxes, rather than by reducing expenditures. There is concern that in an attempt to meet IMF conditionality on deficit reduction, the GOU will continue to pursue this approach, although such an approach discourages private sector growth, particularly within the formal economy, and is thus counterproductive.

In recent years, the GOU has relied more on short-term borrowing to cover the deficit, both sales of treasury bills and external borrowing from commercial sources. The need to service and roll over this increasingly expensive debt is the major contributor to the current financial crisis as debt service costs rise to crippling and unsustainable levels.

Despite some improvements, the Ministry of Finance still lacks the ability to develop realistic budgets in a systematic way. Budget planning and implementation continue to be plagued by unrealistic projections of revenues and an overly generous approach to expenditure responsibilities. In particular, there is little capacity for setting priorities and conducting program analysis to determine how best to meet those priorities with the limited resources available.

3 Results Framework Narrative

Transition Hypothesis

In a market economy, an efficient fiscal system plays the vital role of providing sufficient revenues to support necessary public expenditures without hampering the growth of the private sector. Reforming both fiscal policy and fiscal management practices in Ukraine will help the Government of Ukraine to better define the size and scope of the public sector and the essential needs for public provision of goods and services. It will also encourage private sector economic growth by limiting the resources consumed by government and establishing a fair and stable tax environment.

Critical Assumptions

- (1) GOU continues to support budget and tax reform policies and implementation
- (2) NBU continues responsible monetary policy
- (3) Privatization is carried out so as to yield planned revenues
- (4) No further exogenous shocks from world financial system distort budget revenues or expenditures

Causal Linkages

Achievement of Strategic Objective and Individual Results

Achievement of the Strategic Objective will be measured by the fiscal deficit as a percentage of GDP, as compared to the IMF target. The Strategic Objective will be considered to be on track if the fiscal deficit does not exceed the limit agreed to in the IMF program, according to the IMF definition. For 1998, the IMF target was 2.3 percent of GDP.

Success at the strategic objective level will depend on achievement of the following principal intermediate results, considered necessary and sufficient to the broader objective:

IR 1.2.1 Reform Budgeting and Financial Management Practices in the Ministry of Finance

Improving the budget process to ensure realistic and transparent budgets that comply with IMF targets and World Bank loan conditions is a key component in the creation of a fiscal environment compatible with a market economy. This involves revenues that are reasonably estimated, expenditure plans that are developed within these revenue constraints, spending priorities that clearly correspond to policy directives, Parliamentary deliberations on the budget that are responsible and well-informed, and budgets executed as adopted. In order to help the GOU continue with reforms to the budgeting and financial management process, assistance should be directed at (a) improving budget preparation and execution, including the development of budget classification and budget system laws, (b) building capacity for program analysis to promote the efficient use of public resources, (c) improving macroeconomic analysis and revenue forecasting, and (d) reforming the system of intergovernmental finance to allocate budget transfers on a formula basis.

IR 1.2.2 Create a Market-Oriented Tax System That Encourages Growth

To promote development of the private sector, Ukraine must restructure the tax system to encourage economic activity and taxpayer compliance and to ensure fair and consistent application of the laws. This involves (a) modernizing the tax laws to reduce the burden on private enterprise and incorporating them in a single, consistent tax code, (b) formalizing the "shadow" economy to improve equity and increase the tax base, and (c) introducing more sophisticated and less coercive tax administration techniques. Ultimately, it is expected that a more equitable and efficient tax system will result in greater revenue collections, without requiring an increase in tax rates.

IR 1.2.3 Parliament Acts Affirmatively on Fiscal Reform Legislation

Implementation of fiscal reforms, such as the tax code and budget system law, requires adoption of the necessary legislation by the Parliament (Verkhovna Rada). For Parliament to take responsible and well-informed action on fiscal reform legislation, support is needed in the form of (a) training to increase the understanding and appreciation of fiscal policy and macroeconomic

issues among members and staff of the Verkhovna Rada, particularly the Budget Committee and the Banking and Finance (Tax) Committee, and (b) analysis of pending fiscal legislation, providing mainly through the Fiscal Analysis Office established in the Verkhovna Rada

Additional linkages with IRs from other SOs

IR 1 4 1 1 1 Modern, Standardized Accounting System Developed (critical to IR 1 2 2 1)

Widespread application of internationally-accepted accounting standards would enhance the ability of businesses to understand and comply with new tax laws, as well as to obtain loans and investment. In order for these accounting standards to be widely adopted, businesses must be permitted to prepare their tax returns on this basis, and the State Tax Administration (STA) must be capable of performing audits of returns prepared in this way. Assistance is needed to provide training to STA officials in international accounting standards and their application to tax returns and tax auditing, in order to enable effective tax collection without impeding vital accounting reforms.

IR 2 3 1 and 2 3 2 Improved Management and Legal Sustainability of Local Governments (critical to IR 1 2 1 3)

Since the Law on Local Government was passed in 1997, the focus has turned to legislation that will enable full implementation of the provisions of this law and of the Constitution relating to local government. Increasing local governments' authority to institute local taxes and duties and to manage their budgets independently should help make them more accountable and reforms to the intergovernmental finance system more viable. Assistance is needed (a) to define more precisely the revenue and expenditure assignments for different levels of government, (b) to develop alternative approaches to formula-based intergovernmental transfers, and (c) to strengthen the tax base of local governments, both legislatively and administratively, particularly through the development of a Western-style property tax.

4 Program Approaches and Progress to Date

Overview

The USAID fiscal reform program for Ukraine is aimed at establishing sound fiscal policies and management practices that support both the growth of a market economy and the necessary redefinition of the size and scope of government activity within a market economy. The program currently focuses primarily on (1) improving tax law, policy, and administration, (2) developing analytic techniques and procedures for budget preparation, adoption and implementation, and (3) formulating macroeconomic policy and analysis. In addition, as a vital adjunct to these efforts, USAID is providing assistance for the functional review and restructuring of the Ministry of Finance, Ministry of Economy and State Tax Administration in connection with the public administration reform initiative led by the World Bank.

In all areas of activity, emphasis is placed on working with counterparts to ensure that skills are transferred and work products are appropriate to the Ukrainian situation. Counterparts are located in the Ministry of Finance, State Tax Administration, Ministry of Economy, and the budget and tax committees of the Rada. Increasingly advisors are also working with local offices of these entities and with local governments.

Intergovernmental finance is an important issue for Ukraine, as the GOU has begun to recognize that much of the expenditure overrun and payment arrears problems originate at the local level. This issue has received significant attention in the past year and will constitute a larger part of the fiscal reform program in future years. Activity has focused on development of formula-based transfers from central to local governments, improving local government finance legislation, building local government finance databases, and development of additional revenue sources for local governments, including the property tax.

Work with non-governmental institutions is also becoming a larger part of the fiscal reform program. Budget and economic analysis techniques are being taught through a pioneering program at the International Center for Policy Studies in Kiev. Assistance in restructuring the Ministry of Finance and Economy is being provided through the CASE Institute in Warsaw, as part of the Poland-Ukraine Cooperation Initiative. If they are successful, these efforts -- which also serve to build NGO capacity -- will be expanded.

Over the period of this strategy (1999 to 2002), the mission expects to begin to phase out work under this strategic objective. By the end of this period, it is expected that the main necessary reforms to the tax code and the budget process will be in place. Furthermore, the institutional capacity for analysis in both the Verkhovna Rada and the Ministry of Finance, and the programs for training STA officials at the National Tax Training Center, should be self-sustaining by 2002. However, continued assistance at a more modest level is likely to be needed for full implementation of tax and budget laws and procedures.

Budget Policy and Budgetary Management Process

Macroeconomic Forecasting USAID has assisted in establishing a macroeconomic monitoring group, under a Deputy Minister of Economy, to compile key economic indicators and provide analysis to aid top GOU officials with economic policy-making. This activity includes developing and supporting a macroeconomic model to assess impact of policy decisions on the economy. In the longer term, assistance is targeted at ensuring that top GOU officials make informed policy decisions on the basis of reliable data and macroeconomic analysis prepared by specially trained staff, so that the GOU's capacity for macroeconomic forecasting and policy formulation is improved and provides a reliable framework for the development of realistic budgets.

Budget preparation process USAID and U.S. Treasury advisors have assisted the Budget Department of the Ministry of Finance in implementing a budget classification based on IMF GFS standards, budget procedures requiring ministries to submit detailed spending requests within a budget ceiling, and monthly spending allocations to aid in expenditure control and meeting IMF

deficit targets Support has been provided for computerization of the budget preparation process to enable swift compilation of budgets and budget revisions and promote on-time budget adoption and compliance with IMF conditions A relational database for budget information has been developed for MOF use, along with time series for key budget data going back to 1992

Budget System Law A comprehensive budget system law that defines an orderly realistic, and effective process for preparing, adopting, implementing, and revising budgets has been drafted by a team including USAID, U S Treasury and IMF advisors and representatives from the Ministry of Finance and the Verkhovna Rada After substantial delays, the draft law has been approved by the Cabinet of Ministers and is awaiting action by the Rada

Treasury USAID has provided significant assistance, mainly in the area of training assessments, to the World Bank/IMF project to establish a Treasury Department in the Ministry of Finance that will control state budget implementation and account for all state budget expenditures

Intergovernmental Finance System Restructuring An intergovernmental fiscal model has been developed for analyzing alternative financing arrangements between central and regional governments, staff of both Ministry of Finance and Verkhovna Rada trained to use and maintain this model Work proceeding on legislation to reform intergovernmental finance New budget preparation systems for oblast and rayon level governments implemented and computerized by Ministry of Finance, these systems and their related databases were linked with local government level budgets, to form a comprehensive picture of expenditure needs and funding flows across levels of government Organized workshop on formula-based approach to distribution of state budget subsidies to lower level budgets

Reform of Tax Code and Administration

Tax Code In 1997, Value-Added Tax (VAT) and Enterprise Profits Tax (EPT) sections of tax code were enacted, with improvements made in 1998 to meet IMF conditions for the EFF In the longer term, USAID assistance is targeted at developing tax analysis capacity and ensuring that major tax laws (for the value-added, enterprise profits, personal income and excise taxes and for tax administration) are reformed and incorporated into a single consistent tax code.

Tax Administration The STA has implemented the VAT and EPT laws within a very tight time frame, and has succeeded in issuing taxpayer identification numbers (TINs) and preparing tax forms and instructional materials Over 21 million TINs had been issued to enterprises and individuals by 1997, this is seen as an important step toward ensuring that taxpayers are voluntarily complying with their tax obligations Computerized taxpayer databases are under development, initially in Kyiv, and will be extended throughout the country

Training Study tours to the U S and Belgium resulted in the State Tax Authority's (STA) adoption of a detailed work plan for improving administration of new VAT and EPT laws Training has been carried out in several pilot rayons for conducting joint VAT/EPT audits and auditing on the basis of International Accounting Standards (IAS) The National Tax Training

Center, established with joint USAID/US Treasury support, develops courses in all areas of tax administration. This Center, which is already self-supporting, is expected to ensure that, over time, Ukraine's 60,000 tax officials are trained in new tax laws and more efficient techniques of tax administration.

Parliamentary Support for Fiscal Reform Legislation

Analytic Capability The main progress in the Verkhovna Rada has taken place through the Fiscal Analysis Office (FAO), which was established as an official arm of the Parliament. Under the leadership of a Ukrainian economist, the FAO has trained its local staff, assembled databases for collection of fiscal information, and is providing objective and quantitative analysis of tax and budget legislation. The FAO publishes monthly and quarterly analyses of budget execution and other fiscal topics and informs the Rada of economic issues posed by legislative proposals. This analysis has been used by leading members of the Rada in debates on proposed tax laws. In the longer-term, the FAO is expected to develop the capacity to provide analyses of all major tax and expenditure legislation.

Informed Deliberations Assistance provided to the Verkhovna Rada through the FAO has led to more informed deliberations within the Budget Committee on a number of issues, including intergovernmental finance. It should be noted, however, that FAO staff do not engage or assist in formulating political positions for individual Rada members or groups; they provide objective analysis on which members may or may not base their political decisions. In addition, USAID and the U.S. Treasury may support study tours to provide Rada members and staff with information on how other legislatures, such as the U.S. Congress, approach deliberations on complex issues. There is a need for the Verkhovna to have better procedures in this area, particularly in the handling of proposed amendments to tax legislation, where adoption of ad hoc changes in tax laws without full consideration of the consequences can have negative and unanticipated consequences.

Anticipated Developments over the Strategy Period

Over the period of this strategy (1999 to 2002), the mission expects that funding levels for fiscal reform will phase down slowly and a greater portion of the effort will be directed at lower-level bodies of government. Assuming the tax code is passed, tax administration will become still more key, and continued support will be provided in the implementation of Tax Modernization efforts under the World Bank loan and in the application of organizational and procedural reforms at the district level. In the budget area, aside from further improvements in the budget preparation process, increased attention will be placed on program analysis and a move toward program based budgeting. With respect to intergovernmental finance, activities involving direct work with local governments are likely to increase as the broader intergovernmental functional and funds transfer arrangements are sorted out. Particular emphasis will be placed on development of local government revenue sources, especially the property tax, which requires major efforts to develop the necessary infrastructure and techniques for proper administration. Assuming that the overall restructuring of the Ministry of Finance is accomplished in 1999, further effects to reorganize and

strengthen the Ministry of Finance, including extensive training, are likely to be subsumed under the specialized program areas listed above, e.g., improving the operations of the Budget Department. Finally, in the area of fiscal analysis capability for the Verkhovna Rada, the current Fiscal Analysis Office is expected to become a permanent arm of the Rada, with the expatriate advisors phased out over time and all activities shifted to Ukrainian professionals hired by the Rada.

5 Development Partners

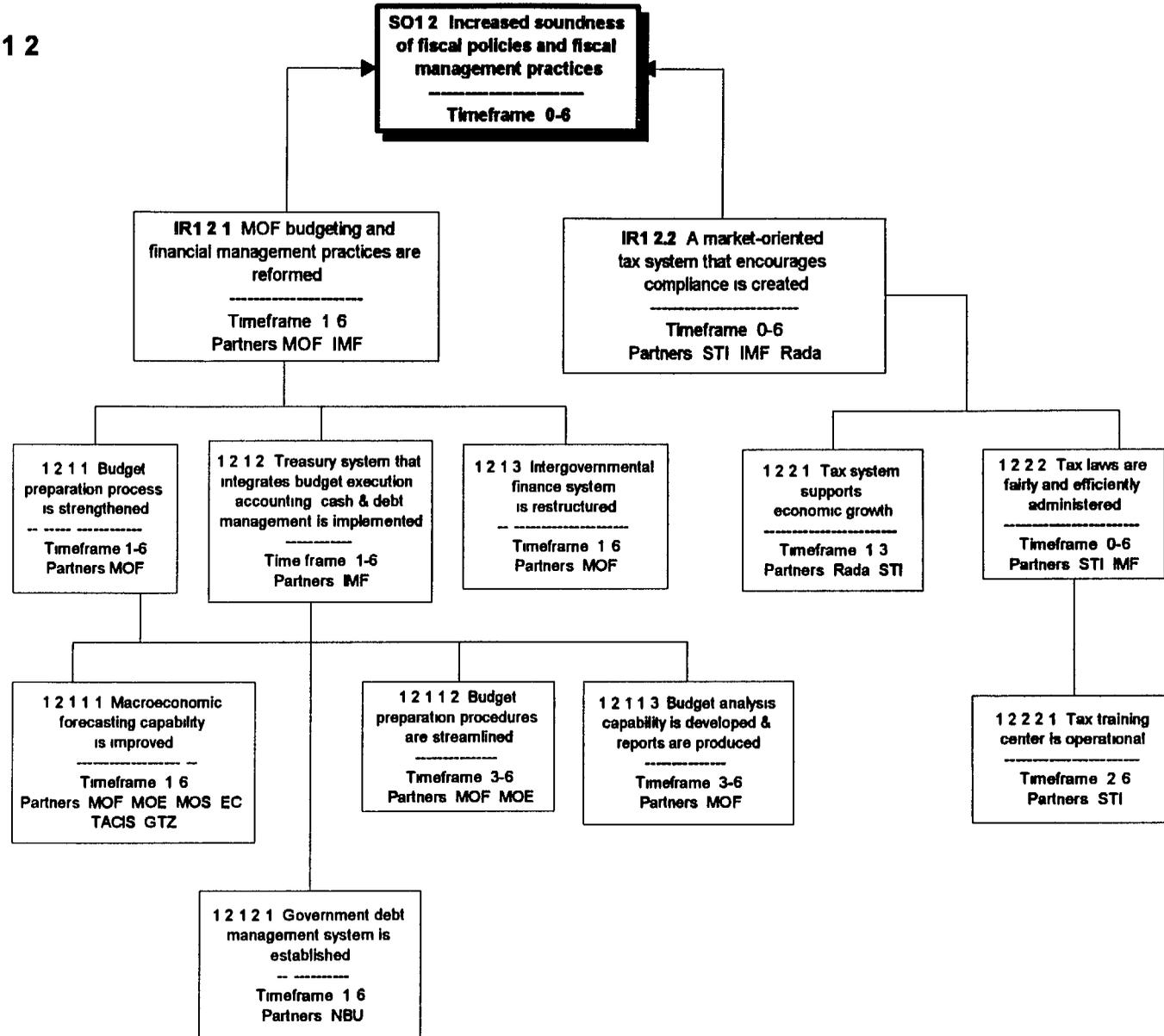
USAID fiscal reform programs are closely coordinated with both the International Monetary Fund (IMF) and World Bank to ensure that technical assistance is provided in support of the fulfillment of loan conditions. Currently USAID is providing technical assistance to the State Tax Administration on a pending World Bank loan for modernization and computerization (now in pre-appraisal stage), to the Ministries of Finance and Economy on the proposed Public Administration Reform Structural Adjustment Loan, and to various entities on a Local Government Finance loan. USAID technical assistance in tax administration, budget process, intergovernmental finance and administrative reform are also directed toward helping the GOU meet the IMF conditions for continued receipt of “tranches” of the EFF. In all these areas, USAID’s work is also coordinated with other U.S. Government-funded organizations, mainly the U.S. Treasury, and with other public and private donors and non-governmental organizations. In particular, joint work related to fiscal reform is being carried out with EC-Tacis, the Canadian International Development Agency, British Know-How Fund, the Polish CASE Foundation, and the Ukrainian International Center for Policy Studies.

6 Sustainability

All USAID resources in this sector are targeting activities that increase the institutional capacity of the Ministry of Finance, State Tax Administration, the Ministry of Economy and the Verkhovna Rada to develop effective fiscal policies and to design and administer efficient budget and tax systems that are conducive to the development of a market economy. Training programs and transfer of knowledge through long-term advisors working in these entities give GOU officials the understanding and practical experience they need to implement fiscal reforms and manage them on a continuing basis and to enable members and staff of the Verkhovna Rada to consider and adopt the necessary enabling legislation.

The Fiscal Analysis Office (FAO) in the Verkhovna Rada is designated as an analytic arm of the Parliament, similar to the U.S. Congressional Budget Office/Joint Tax Committee. As the FAO has gained analytic capacity, demand for its services within the VR have increased. Longer-term plans are being developed to have the Rada gradually assume responsibility for funding and managing the FAO, the transfer is expected to be completed by 2002.

Ukraine SO 1 2



Critical assumptions

- 1 GOU supports budget and tax reform policies
- 2 NBU continues restrictive monetary policy
- 3 Privatization continues as projected
- 4 Budget outcomes are not distorted by unexpected exogenous shocks

Strategic Objective 1.3

Accelerated Development and Growth of Private Enterprise

Strategic Sub-Objective 1.3(a)

A More Market Responsive Agricultural Sector

1 Statement of the Strategic Sub-Objective

This sub-objective contributes to the emergence of a competitive market economy in which the majority of economic resources is privately owned and managed by promoting a more private sector- oriented agricultural sector in which privately-owned farms produce and sell their output in privately organized markets and purchase their inputs and obtain credit from private sector suppliers

USAID will consider this objective met when

- (1) Sustainable nation-wide agricultural policy reforms are implemented
- (2) Private farmers in selected regions enjoy opportunities to increase their production and marketing of agricultural commodities

2 Problem Analysis

US assistance to agriculture and agro-industries in Ukraine has been premised on the expectation that fundamental policy reform would take place relatively quickly, resulting in an expanding open market, private sector-driven agricultural economy. Programs were designed to spearhead key policy changes nation-wide through activities that would demonstrate the effectiveness of open markets and related private input supply, processing and marketing institutions, and private land ownership and farm management.

Since 1996, however, the prospects for fundamental policy reform at the national level have worsened. The pace of reform has been slow and uncertain, and the Government of the Ukraine has undertaken policy measures that resulted in a more adverse environment for private sector-led agricultural development. These measures included restrictions on private marketing of grain, and an initiative by the Government to supply agricultural inputs, fertilizer, and machinery. Opposition to private land ownership and private farming has remained strong in Parliament and in many parts of the Government.

While there is little potential for fundamental reform emanating from the level of the national government in the near future, USAID believes that regional and local governments may be more amenable to allowing greater private sector participation in the agricultural sector through initiatives that focus on particular regions.

The agricultural sector, including input and processing industries, contributes to roughly half of gross domestic product. However, agriculture and the agro-industrial complex that supports it, have experienced a disastrous decline since 1990. Production is barely half, input use one-fifth, and incomes and employment in agriculture and the agro-industrial complex, as in the rest of the economy, have fallen drastically.

Revival of the Ukrainian economy and growth in household incomes depends on a dynamic agriculture sector. This revival will depend not only on significant changes in the policy and legal environment, but on the creation of viable private agricultural structures and institutions.

In order for private farmers and agro-industrialists to expand production and marketing, they must overcome several constraints created by state control of the sector.

First, farmers have inadequate access to the most basic factor of production required in agriculture - land. The organization of agricultural production into collective farms, now collective agricultural enterprises, offered little scope for private determination of the best uses of agricultural land in relation to consumption requirements and market opportunities. While significant progress has been achieved in privatizing the collective farms and promoting land titling, much more needs to be done.

Second, the organization of agricultural production into collective structures meant that administrative mechanisms for the supply of inputs and marketing of output focused on these large-scale entities. With the allocation of inputs and distribution of output determined administratively, there was little need for markets with prices providing information on scarcity or opportunity. Collective agricultural enterprises are still tied to state marketing systems because of their reliance on state-provided inputs and support systems. Private farmers lack access to markets and inputs. USAID has made some progress in addressing this need through the support of commodity exchanges and market information systems, but many impediments remain though.

Third, the state remains the main, but a limited, source of lending to agriculture, with its role limited to financing centrally-determined investments. There was no need for loans based on land or the value of the crop in the Soviet system, and there was no need to collateralize land. Therefore, the viability of private farming hinges on the development and strengthening of competitive credit markets that allocate scarce capital. These structures and procedures need to be developed if private farmers are to succeed.

3 Results Framework

Critical Assumptions

Essential to USAID's achievement of the strategic objective through the intermediate results are the following critical assumptions:

(1) Policy reform will be a gradual process, with a long-term horizon required to strengthen the

position of reform advocates both within and outside of government

(2) Other donors will continue to provide pressure for reform, complementing USAID's efforts

(3) Local and Oblast level governments will continue to demonstrate a flexible attitude towards USAID- and other donor- supported regional agricultural development initiatives, thereby providing the "laboratories" required to demonstrate the benefits of reform to national-level authorities

Causal Linkages

Achievement of the Strategic Objective will be measured by

- Private sector contribution to agricultural production

Necessary and sufficient for the achievement of this strategic objective are two key intermediate results *IR 1 3a 1 Improved policy, legal, and regulatory environment facing the private agricultural sector in selected regions*, and *IR 1 3a 2 Increased private marketing of agricultural commodities in selected regions*. These intermediate results and their supporting approaches are presented in Figure 1 3a 1

IR 1 3a 1 Improved policy, legal, and regulatory environment facing the private agricultural sector

USAID believes that while fundamental agricultural policy reform will be a slow and uncertain process, significant progress can be achieved during the period of the proposed strategy as a result of three lower level results. First, essential for better agricultural policies is improved capacity for agricultural policy analysis that demonstrates to policy makers why good policies produce desirable outcomes while bad policies do not. Second, agricultural policies will be more enabling for private sector producers if the private sector enjoys access to the policy deliberation process and can effectively lobby its interests as a promoter of agricultural growth. Third, government at all levels, must learn from and be persuaded by the positive lessons provided by regional agricultural development initiatives that harness the energies of private farmers and private agro-industry. These lessons, or "best practices" will be derived from the results of USAID's programs in selected regions, described next under IR 1 3a 2

IR 1 3a 2 Increased private marketing of agricultural commodities in selected regions

Enlarging the dynamic role of private farmers and agri-businesses contributes first to directly improving agricultural performance and the incomes of producers. It also reinforces USAID's efforts in promoting nation-wide policy reforms by engaging the lobbying energies of the private sector as well as of local and regional governments whose regions benefit from private sector-based agricultural development. USAID will work to achieve this intermediate result through approaches and activities that concentrate on three or more geographic regions (Lviv, Odessa, Poltava, Kiev). Increased private marketing of agricultural commodities in these regions will

result from activities that (1) promote further farm restructuring and land titling to increase private farmer access to land, (2) increase private farmers' access to agricultural inputs through competitive markets, (3) improve private farmers' access to information about market opportunities and issues, (4) increase their access to credit, (5) improve the marketing infrastructure that will enable farmers to sell their commodities outside of state-dominated channels, and (6) provide direct support to leveraged private sector agro-industry

4 Progress to Date

USAID activities have achieved significant results since 1993, but these achievements have fallen short of the fundamental agricultural reform anticipated

First, land ownership has been transferred from the state to the collective agricultural enterprises (CAEs), an estimated 65 million land shares have been issued for CAE land. Actual land titles have been issued to 8,000 people through USAID supported activities. Further, the number of private farmers rose from under 2,000 in 1992 to 36,000 in 1997, accounting for over 900,000 hectares

Second, the USAID-supported process of mass privatization resulted in over 4,000 agro-industrial enterprises being officially privatized, with the long-delayed process of privatization of grain elevators now underway

Third, a private sector is active in input supply and agricultural marketing and processing. Private US "agribusiness partnerships" have expanded the provision of inputs, processing facilities, and marketing outlets. Private independent commodity exchanges, with functioning spot and forward contract mechanisms, are operating at a limited level. USAID also established the Commodity Exchanges Information System to provide weekly information on Ukrainian and world prices. Price information is disseminated to over 1100 direct recipients, including newsletters, new agencies, Oblast administrations, agricultural producers, processors, and distributors

Fourth, private industries and commodity exchanges have established, with USAID support, independent associations to defend their interests and lobby for policy change

Fifth, a framework has been established, through the Inter-Ministerial Commission on Agrarian Reform (IMCAR), under which the Government of Ukraine and donors are beginning to jointly consider policy changes in agriculture and the agro-industrial sectors

5 Program Approaches

Policy, Legal, and Regulatory Approaches To improve the policy, legal, and regulatory environment facing private farming and agri-business, USAID will adopt approaches that strengthen capacity for policy analysis and reform, facilitate advocacy for policy reform by private professional and trade associations, and work with interested local government and oblast officials to create the space necessary for the regional agricultural initiatives to operate effectively. IT will

also articulate the progress attained back to national agricultural policy decision-makers

USAID, working with other donors, have supported the development of a Ukrainian policy analysis capacity in the Inter-Ministerial Commission on Agrarian Reform (IMCAR) and of the secretariat, an Agricultural Policy Unit in the Ministry of Agro-Industrial Complex, and the Institute of Agrarian Economy. USAID will continue to support Ukrainian "ownership" of agricultural policy analysis and dissemination. USAID will continue to provide assistance to the National Private Farmers Association, the National Commodity Exchange Association, the League of Entrepreneurs, and the Ukrainian Cooperative Foundation so that these organizations may acquire a more effective voice in articulating and advocating a unified policy reform agenda.

Local authorities often have some leeway in interpreting and implementing national laws and decrees. The proposed program will solicit both national and local support or agreement, through Memoranda of Understanding (MOUs). MOUs would include agreements regarding actions to be taken, but also agreements that would guarantee open marketing, land privatization, and private sector input supply and processing in the selected areas. Efforts would be made to develop community support for and understanding of private farming and private agro-industry.

Approaches to Increasing Private Marketing USAID will address the constraints on private sector agriculture by focusing its activities on expanding the base of private farmers, and improving marketing, input supply, credit, and extension services.

Farm restructuring and agricultural land privatization - land titling and private farm formation - will be central to this approach. USAID will build on its experience in this area, aided by the greater interest in land reform at the regional, local, and farm level than at higher levels of government. The program will also support private farmers through the provision of land from the land fund. At present there are approximately 35,000 such farmers, averaging 28 hectares, and farming over 1 million hectares (2 percent of sown area). Private household plots will also be an important element of the regional focus. Households already supply over 50 percent of total farm output, especially of potatoes, vegetables, fruit, milk, meat and eggs. Much of this is for family consumption but a significant amount is marketed.

A major focus of USAID's agricultural sector involvement to date has been the provision of agricultural inputs (seeds, chemical, equipment) through the creation of private dealerships (either indigenous or in partnership with US firms), promotion of trade and the development of cooperatives. This emphasis will continue, but in closer collaboration with the farm restructuring and titling activities to ensure that farms coming out of the restructuring process have available to them the input supply alternatives essential to viable private farming operations.

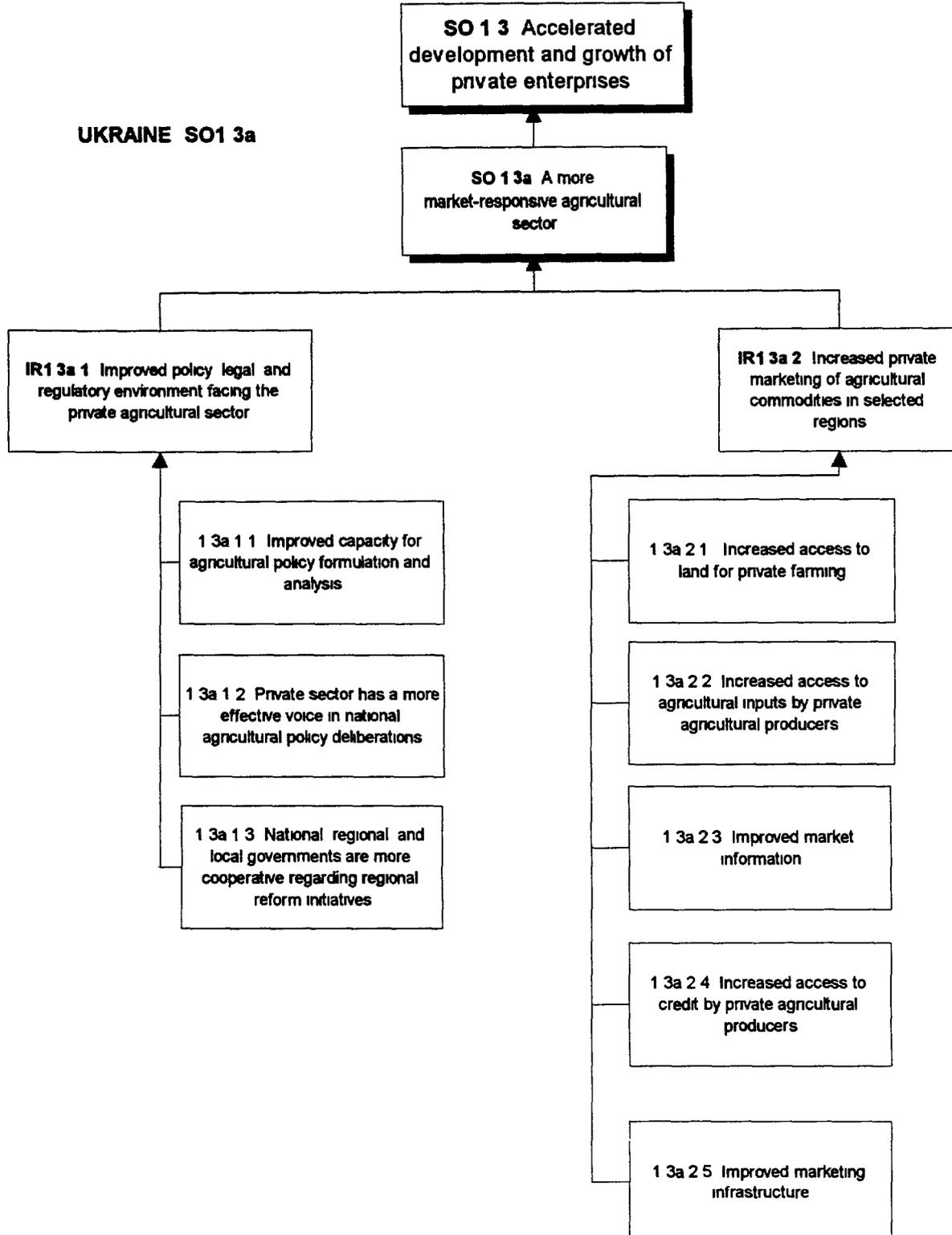
Given the absence of the traditional sources of credit to private farmers - the banking sector and collateralized land - USAID will explore a range of alternative institutional approaches to address the credit constraint in these concentrated regions, including credit unions, cooperatives, and suppliers credit.

USAID will address the constraints faced by private farmers, restructured farms, and plot holders in dealing with elements of the agricultural production-marketing-processing chain through approaches that reflect the diversified nature of their production. USAID will also work to strengthen cooperatives and farmers associations in providing direct links between individual farmers and markets, and to encourage private farmers, restructured farms and plot holders to trade on open markets.

6 Development Partners

The World Bank, EU/TACIS, the British Know-How Fund and USAID cooperate closely in their policy reform and project activities, and are jointly funding internal Ukrainian agricultural policy analysis through IMCAR.

The World Bank has the largest agriculture program in Ukraine, and has released the final \$150 million under an Agriculture Sector Adjustment Loan (SECAL). The World Bank is not planning additional policy-related sector adjustment loans because of the same policy reform problems that have faced USAID's efforts. However, the World Bank is planning to include policy related issues in various projects that are under development. These include Land Title Registration, Rural Credit, Agri-business, and a new Rural Development project that may include co-financing of farm restructuring. The World Bank is linking many of these projects to existing USAID initiatives, enhancing the impact and sustainability of USAID's program activities.



Strategic Sub-Objective 1 3(b)

Privatized Enterprises are More Competitive and Efficient

1 Statement of the Strategic Objective

Privatization of state enterprises in Ukraine has reached the final stage. The auctioning of small-scale enterprises is essentially complete, and over 9,000 medium and large enterprises have been privatized. The fate of these privatized enterprises is important for the economic recovery of Ukraine. Some privatized enterprises will undergo the necessary restructuring in order to compete successfully, others will not. For the majority of these privatized enterprises, whether or not they restructure and survive depends on many environmental factors.

In order to encourage privatized enterprises to become more competitive and efficient through restructuring, assistance efforts must concentrate on both the demand and the supply sides of the problem. Why are the majority of privatized enterprises currently not restructuring? Outside ownership is very diluted, with 36% of shares owned by a broad group of outsiders, including the state. The majority of shares of privatized enterprises are held by employees (44%) and management (20%) - a group that has a collective interest in opposing the changes to labor and social asset portfolio which would accompany restructuring, and generally lacks the skills necessary to pursue restructuring. USAID can help motivate these enterprises to restructure (i.e., create a *demand* for restructuring) by promoting an environment that (1) increases the control of outside ownership in the firms, (2) strengthens shareholders' rights and (3) offers viable alternatives to enterprise collapse (i.e., bankruptcy, increased financing through capital markets). With greater outsider interest in the profitability of an enterprise, management will be forced to restructure in order to become more competitive and efficient.

For those firms that are ready to restructure, we need to ensure that there is sufficient capacity in the economy to *supply* the skills and financial resources necessary—and that the legal and regulatory framework is supportive—to help these enterprises to go through the process of restructuring. Privatized enterprises in Ukraine are particularly unprepared for the changes needed to survive in a market economy - managers and employees lacking basic skills in marketing, modern accounting, and management and most have only experienced life under the previous system of state control and production quota systems. These old mentalities must be changed in order for the enterprises to move forward.

USAID will consider this strategic objective achieved when the economic environment both encourages and supports efforts by privatized enterprises to undergo restructuring in order to become more efficient and competitive. More specifically, an environment that encourages restructuring will involve (1) greater outside ownership and control over these privatized enterprises, to stimulate the demand for restructuring, as well as (2) an improved financial sector to allow the prospects of additional investment for restructured firms to motivate privatized enterprises to undergo restructuring. A supportive environment will satisfy this demand for restructuring by (1) making business skills and training accessible, and (2) implementing laws to

reduce or eliminate the numerous legal and regulatory constraints to growth and restructuring

2 Problem Analysis

Privatized enterprises are burdened by many problems inherited from the old Soviet system, in addition to the old mentality and skill set of the work force. Perhaps the biggest obstacle to enterprise restructuring on a macro-political level is the need for these large enterprises to downsize their labor force. In order to become more efficient, most of these privatized firms will have to shed considerable numbers of redundant employees that were originally hired under the old system, in which employment was considered a right. In addition, many enterprises also inherited social assets (schools, medical clinics, apartment buildings) from their old state-owned predecessors, in most cases, these firms will no longer be able to maintain these assets and also remain competitive. The causal linkage between restructuring and shedding labor and social assets—not only on the enterprise level, but also for the national and local governments—has complicated the role of reformers in the political sphere.

An excessively burdensome tax and regulatory system are additional problems preventing the development of privatized enterprises. Secondary problems stem from the underdeveloped financial system: heavy reliance on barter trade and the lack of investment/credit have made it difficult for firms to attract the capital needed to grow. Other problems include enterprises' inability to own and collateralize their associated land, and the non-compliance of Ukrainian firms with International Accounting Standards (IAS)—both of these factors tend to limit the attractiveness of Ukrainian firms to foreign and domestic investors.

Enterprises in Ukraine continue to benefit from direct and indirect subsidies. Until this system of support comes to an end, and a hard budget constraint is imposed, many privatized enterprises will continue to consume, rather than add value in the economy of Ukraine. Steps taken elsewhere in the USAID program to improve tax collection, adjust utility tariffs and provide social services through more efficient means must be complemented by steps to increase the competitiveness of Ukrainian enterprises.

3 Results Framework

Transition Hypothesis

Competitive privatized enterprises can be a key engine to Ukraine's long-term economic growth. The restructuring of privatized enterprises depends on a conducive policy, legal, and regulatory environment, widespread access to modern business skills and practices, and increased access to credit. In addition, the growth of the medium and large enterprise sector depends on development of SMEs, since SME demand for intermediate goods produced by privatized enterprises will stimulate increased production and growth of medium and large enterprises.

Critical Assumptions

(1) Economy and Financial Sector Remain Stable

Macroeconomic stability is necessary for private sector growth, since it is a prerequisite for business planning, forecasting, and access to capital on predictable terms. It is assumed that (a) the national currency, the Hryvnia, will remain relatively stable, (b) inflation remains at a moderate level, and (c) no further exogenous shocks from financial crises in Russia and other emerging markets significantly affect Ukrainian financial markets.

(2) Government is Committed to Reform in Support of Privatized Enterprise Restructuring

GOU commitment to reform is a necessary condition for the growth of privatized enterprises. Most of the measures to change the structure of ownership—currently seen as the main barrier to enterprise restructuring—depend on the GOU to (a) sell residual state shares in enterprises that have already been privatized, preferably in large blocks; (b) sell strategic enterprises through internationally accepted tender procedures and offer controlling interest rather than minority packages to potential investors; and (c) remain committed to protecting shareholder rights.

It is also assumed that the GOU will proceed with privatization of land under enterprises and the development of land markets in Ukraine, including the sale of unfinished construction sites. Despite some opposition within the Rada to private land ownership, the growing interest at the local levels of government to engage in privatization along with enterprise demand for private ownership of associated lands creates a powerful constituency—and hence we believe this assumption to be realistic.

A further requirement is GOU commitment to end most forms of direct and indirect subsidies, and to significantly reform the role of the state in providing social and housing services through medium and large enterprises.

(3) IMF and World Bank Loan Conditions Are Satisfied

Many of the conditions on World Bank and IMF assistance demand reform in the area of regulation and taxation of private enterprises, reform of the Bankruptcy Law, and Land Title Registration. Continued GOU support for reforms in conjunction with IFI conditionality is essential to the overall success of this strategic objective.

Causal Linkages

Achievement of Strategic Objective and Individual Results

Achievement of the Strategic Objective will be measured by growth in industrial production. Since the majority of privatized enterprises are industrial, this indicator is a proxy for health of the privatized medium and larger enterprises. As privatized enterprises undergo necessary operational and financial restructuring, over the longer term, many of them will become more efficient and competitive, and overall output for this sector will begin to recover. Increases in industrial production levels can also be achieved through legitimate policy reforms, such as steps

to encourage new investment (domestic and foreign), and reduction of trade barriers

Success at the strategic objective level will depend on achievement of the following principal intermediate results, considered necessary and sufficient to the broader objective

IR 1 3(b) 1 Improved Access to Market-Driven Business Skills and Information

Business centers currently provide skills and information directly to small and medium enterprises through consulting services, but these centers have recently begun to address the growing need for service to large, privatized enterprises. While initially these centers serve as a means of using USAID funds to increase local capacity to operate a business according to modern market principles, ultimately they will become independent and self-financing as they build up their clientele and can recover costs through the charging of fees.

The Enterprises Restructuring Project, which started in 1998, will provide a package of training and self-help materials designed for managers of medium and larger enterprises. Working through Ukrainian financial intermediaries, this project will build their capacity to restructure enterprises. Not only will this meet the immediate needs of enterprises, but will serve as the basis for a broader set of restructuring "tools" provided by business service providers in Ukraine. Commercial distribution of a similar set of materials in Russia was very successful.

The final measure of successful restructuring takes place in the enterprises by measuring the number of restructuring plans being implemented in activities funded by USAID and other donors. Since donors have generally taken a demonstration effect approach to restructuring, this group of enterprises is intended to serve as successful examples of restructuring.

Conversion to International Accounting Standards is an essential step for Ukrainian enterprises to access capital markets, attract foreign direct investment and accurately measure performance of the enterprises. This transition occurs both at the policy level, as promoted and adopted by standard-setting bodies, and within the enterprises on a case-by-case basis. SEC disclosure regulations will require reporting based on IAS starting in 1999.

IR 1 3(b) 2 Enterprises Have the Ability to Own Land and Premises

Privatization of enterprises in Ukraine did not include the privatization of the land underneath them. While this is still a very political issue, local officials are beginning to support enterprise land privatization. This asset is important to enterprises for capitalization, collateralization and investment purposes. As the real estate and financial markets grow, secondary sales and mortgage lending are expected to expand, bringing benefits to these industries and residual benefits to local governments through taxation and fees. Enterprises will have the ability to more rationally use land as an asset.

Unfinished construction sites in Ukraine are opportunities for new business start ups and growth of existing businesses into new premises. A continuation of the process of selling these premises

will make use of an existing, but unfinished and abandoned asset. Each privatization of an unfinished construction site represents a new business and new jobs.

IR 1.3(b).3 Privatized Enterprises Face Fewer Financial Constraints to Growth

Without sufficient access to finance on reasonable terms, privatized enterprises will not be able to grow and develop. It is generally understood that the banking system will not be capable of serving as a significant source of business loans in the near future, so successful development of privatized enterprises is strongly dependent on reforms in the banking system and in capital markets (see SO 1.4). Implementation of the new Law on Leasing and the Law on Collateral has the potential to substantially increase the financing opportunities for all private firms, and the ability to divest social assets will free many privatized enterprises of responsibilities that they are not able to afford.

A clear symptom of the current financial situation facing Ukrainian enterprises is the amount of wage and interenterprise arrears carried by most firms. Barter accounts for 70% of trade, according to some sources. Employees in privatized firms, although certainly in a better situation than civil servants and pensioners, are often not paid on a regular basis, or are paid in commodities. Therefore, a decrease in both of these indicators, as reported by enterprise managers, will signify greater financial stability of the enterprises.

In the interim until these reforms are carried out, funds from the international financial institutions (IFIs) can help fill the gaps in financing that the domestic banking system is incapable of addressing—but these measures are small, relative to the financing needs of the economy. Programs such as the West NIS Enterprise Fund help to address this temporary shortcoming in the domestic financial market by making debt and equity investments in private enterprises. Encouraging foreign investment is also critical to success at the IR level, since the domestic supply of capital is not sufficient to meet Ukraine's demands. Efforts to reform the legal, regulatory, and tax environment will help significantly to eliminate the barriers that currently prevent foreign investors from being attracted to Ukraine.

Additional linkages with IRs from other SOs

IR 1.2.2.1 Tax System Supports Economic Growth

IR 1.4.1 Market-Oriented Private Banking Sector Developed

IR 1.4.2 Transparent and Open Securities System Developed

IR 1.4.3 Market Supportive Legal System Created

4 Program Approaches and Progress to Date

Overview

The USAID program to support the development of privatized enterprises concentrates on providing essential business skills, removing external constraints and creating an enabling environment for private sector growth. The principal focus of USAID's program to support privatized enterprise development to date has been in the area of reducing financial constraints to growth by means of promoting private ownership of urban land under enterprises and land markets in Ukraine. Access to credit is the most critical ingredient for growth of all private enterprise, and USAID has targeted this problem directly through the West NIS Enterprise Fund and indirectly through collateral law and banking reform, and through support to tax system reforms that will facilitate the flow of private investment. Training and certification efforts under the accounting reform activities and the new training program under the enterprise restructuring program ensure access to business skills and information. The legal and regulatory environment has been another important limiting factor preventing these privatized enterprises from restructuring, and the USAID program has provided support to organizations within the GOU to promote reforms to the business legal and regulatory environment. The following are specific activities within the 1 3b portfolio

Unfinished Construction Site Privatization - To date, over 5,000 unfinished construction sites have been privatized - over 1,000 with direct assistance from this activity - creating over 3,000 new jobs, even while most sites are still in the process of completion. Each privatization represents a business opportunity, unhampered by old technologies and redundant labor. The objective for 1999 is to privatize an additional 5,000 sites, with direct assistance through the project ending in 2000.

Enterprise Land Privatization and Real Estate Profession Development - The ability for enterprises to privately own their associated land has important implications for the enterprises' access to finance. Offering its associated privately-owned land as collateral, an enterprise would have better access to credit on more favorable terms. Local support for these programs is very strong, and will continue without significant legislative action at the national level. By the end of FY1999, at least 1,500 land privatizations will have been completed. Enterprise land sales offices have been opened in 24 cities. Privatizations to date have generated over \$2.0 million in revenue for municipal budgets—which constitutes a major financial incentive for local governments to continue supporting the transfer of enterprise lands to private hands. In the near future, privatization and secondary sales of enterprise lands will continue, as will the training courses and seminars for real estate professionals. The revenue generating potential of the program will be coordinated with municipal development projects funded by USAID and other donors. Pending achievement of objectives in 1999, the project will be extended into 2000 with a significant redesign focussing on creation of a real estate service market through establishment of a fee structure. Standard setting and certification assistance for real estate professionals will continue through a separate mechanism (Eastern Europe Real Property Fund) on a modest basis into 1999.

Enterprise Restructuring The new Enterprise Restructuring Project will transfer business skills to two groups in Ukraine. The first group represents professionals working in financial intermediaries. These individuals will receive formal and hands-on training in fundamental

business concepts and practices, as well as analyzing enterprises, developing and implementing restructuring plans. In addition, financial intermediaries will receive assistance in investment portfolio management and business strategy, to help them focus their investment resources. Enterprise managers are the second group targeted for business skills transfer. Managers of the demonstration restructuring enterprises will be fully engaged in the restructuring process, complimented by formal training as needed. A much larger group of enterprise managers will have access to training courses and a "toolkit" specifically designed to transfer restructuring skills. A policy and analysis component of the project will identify top priorities for policy reform and suggest solutions, working closely with other USAID projects and other donors. The project is planned to continue until early 2001, based on successful implementation and significant transfer to local professionals.

It is important to note that USAID's efforts to promote and support enterprise restructuring in Ukraine are based, in part, upon a current longitudinal study which is looking at the impact of privatization (i.e. change in ownership structure) on the performance of the enterprise. Initial data analysis conducted by the London Business School has shown that those enterprises with more consolidated and significant outside ownership are more likely to take restructuring steps. The study should be funded through 2000.

Management Accounting - The Accounting Reform Project, which has provided training to accountants and auditors in International Accounting Standards and which assisted in the formation of the Ukrainian Federation of Professional Accountants and Auditors (UFPAA), has helped to improve the management of enterprises and to make their accounts more transparent to investors. Support to UFPAA will continue as it works with government agencies to establish a legal basis for converting Ukraine's accounting system to International Accounting Standards, with the goal of submitting an accounting law to the Rada by February 1999. Institutional development in UFPAA will include extension of its certification and training programs based on IAS. At the enterprise level, a program to convert Ukraine's small, medium and large enterprises will result in 30 additional pilot conversions by mid-1999. This activity will continue through the period of the strategy in order to increase the capacity of Ukrainian accountants to provide better financial information to enterprise managers and to attract greater foreign and local investment. Opportunities will be sought in the last half of the period to shift from a TA-intensive approach to promoting partnerships between UFPAA and similar professional organizations in the region and US. Opportunities will also be sought to establish IAS as the basis for tax accounting and audit.

West NIS Enterprise Fund The W/NIS EF continues a program of debt and equity investments in medium and large enterprises in Ukraine, for a total of over \$23 million in completed transactions. While the average deal size of the Fund has increased, a significant mortgage remains. Budget planning for this mortgage represents an increasing percentage of the Mission's budget for business development in the face of decreasing resources.

5 Development Partners

As mentioned previously, IFI lending conditionalities including numerous elements of legal and

regulatory reform USAID participates fully in providing technical assistance to meet several conditionalities Regarding enterprise restructuring, USAID recently initiated a donor coordination group for assistance to privatized enterprises In addition, we have coordinated closely with the World Bank regarding the pending Private Sector Development loan

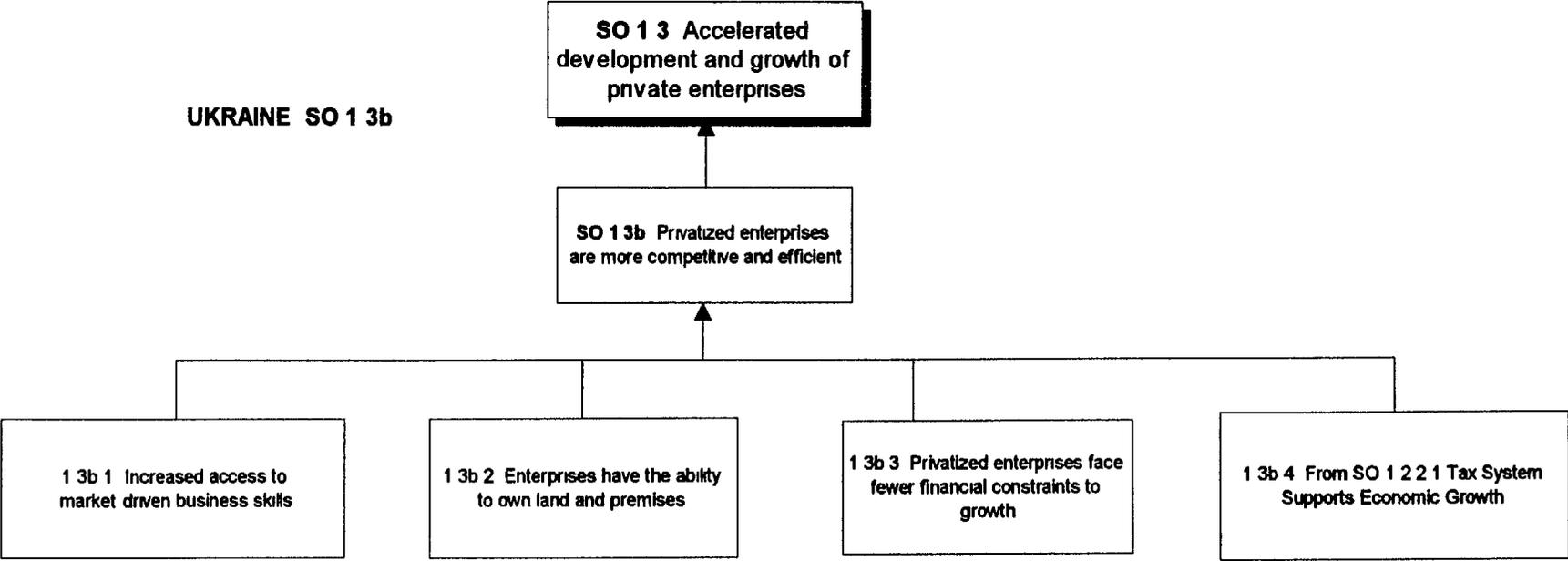
6 Sustainability

Sustainability of privatized enterprise development depends to a great extent upon GOU support for reforms to the relevant policy, legal, and regulatory environment, since efforts to promote business skills and access to finance will be less effective in the long run if the excessive tax and regulatory burden is not reduced and the ownership and bankruptcy laws do not promote financial restructuring Official resistance to privatized enterprise restructuring exists for different reasons at all levels of government local and oblast governments do not want to be saddled with the financial burden of divested social assets from these large enterprises, and the national government cannot politically tolerate significant (albeit temporary) increases in unemployment that are likely to accompany restructuring If this attitude toward large, privatized enterprise restructuring does not become more favorable, the prospects for creating the *demand* for restructuring are questionable

Business and professional skills transfer activities supported under this SO are designed to be sustainable Work with UFPAA has already created an association of professional committed to accounting reform Under the enterprise restructuring activity, investment intermediaries are motivated to build their capacity to restructure enterprises through the potential increase in the value of their investment

Sustainable access to sources of finance is similarly dependent on continued reform by the GOU Some of the current measures to fill the gaps not addressed by the underdeveloped banking system are not sustainable The expectations are that as the GOU takes the necessary steps to fix the financial sector, IFI funds can decrease as the Ukrainian banks begin to finance the bulk of the credit needs of privatized enterprises

UKRAINE SO 1 3b



Strategic Sub-Objective 1.3 (c)

Expanded Role of Small and Medium Enterprises (SMEs) in National Economy

1 Statement of the Strategic Objective

Small and medium enterprise (SME) development is an essential element of Ukraine's transition to a market economy. SME development can make a positive difference in peoples' lives through its impact on the labor market, in the long term, SMEs are likely to become the largest source of employment for the people of Ukraine. In Western Europe, for example, approximately 50 to 70 percent of the workforce is employed by small and medium enterprises. According to official figures, only about 10 percent of the labor force in Ukraine is employed by SMEs, in Russia, the figure is 20 percent, in Eastern Europe, SME employment is between 45 and 50 percent of the labor force. Of course, a large part of SME activity in Ukraine currently exists in the informal (e.g., shadow) economy, so the actual figures for SME employment are probably higher than the official figures. Creating an environment that encourages SME growth will also promote the move from the shadow economy to the formal sector, which leads to additional benefits to the state in the form of increased revenues from greater tax compliance.

In the near future, SMEs will play the critical role of absorbing the large numbers of unemployed workers who were dislocated by the restructuring of larger, privatized state enterprises. By creating jobs at nearly no cost to the government, supporting the development of small business can serve as a means to create an efficient and very cost-effective social safety net. Furthermore, SMEs are an important source of innovation—this will be particularly important as new technologies overtake those set in place under the old Soviet system of production—and have the potential to play a symbiotic role with the large enterprise sector, contributing quality inputs to industrial production as in Western Europe. The experience of a number of the Northern Tier countries in Eastern Europe, and Poland in particular, points the way to how SMEs can serve as a key engine for economic growth in post-Soviet economies. However, the lack of practical and historical experience in free market, industrial economies by countries in the NIS poses additional problems to creating the conditions for SME growth. These problems will take longer to overcome in the NIS countries than it took for Eastern European countries which were within the Soviet orbit, but had different histories.

Small and medium private enterprises will flourish when constraints preventing their growth are reduced or removed. USAID will consider this objective achieved when the high tax and regulatory burden on private enterprise is reduced, the weak financial system is improved to permit greater access for SMEs to credit and investment, and the level of business skills is improved.

2 Problem Analysis

Excessively burdensome tax and regulatory systems are the main problems preventing the

development of small and medium enterprises. Secondary problems stem from the underdeveloped financial system, heavy reliance on barter trade, and the lack of investment/credit, which have made it difficult for SMEs to attract the capital needed to grow. Other problems include enterprises' inability to own and collateralize their associated land, and the noncompliance of Ukrainian firms with International Accounting Standards (IAS)—both of these factors tend to limit the attractiveness of Ukrainian firms to foreign and domestic investors. A shortage of business skills and inexperience in dealing with market-based economies is another significant constraint which has limited the ability of Ukrainian entrepreneurs to develop competitive businesses.

But the prospects for pro-SME reform in Ukraine are good. The Government of Ukraine (GOU) generally looks on SME development as a win-win situation. Even among those in the government who oppose other reforms, development of small enterprises represents a political "good" which both provides jobs and increases tax revenues, while resulting in very few negative side effects. While they may balk at specific deregulation aspects or some other important steps in private sector development, a mandate to push such changes through the system is often easy to establish under the flag of small enterprise development. A very powerful and persuasive argument in favor of reforms to support SME development is that these changes are not costly to the government, either in terms of finance or political capital (i.e., impact on voters is only positive or neutral, but not negative). Finally, the February 1998 mandate from the President that empowered the State Entrepreneurship Development Committee to challenge all legislation and regulations unfavorable to business development is seen as a means to pave the way for reforms to the enabling environment through the removal of constraints to SME growth.

3 Results Framework

Transition Hypothesis

Competitive small and medium enterprises will be one of the primary engines to Ukraine's long-term economic growth and will play a leading role in the creation of jobs. Transformation of the small and medium enterprise sector depends on a conducive policy, legal, and regulatory environment, widespread adoption of modern business skills and practices, and increased access to credit by micro, small, and medium enterprises.

Critical Assumptions

(1) Economy and Financial Sector Remain Stable

Economic stability is a prerequisite for private sector growth, and a prerequisite for business planning, forecasting, and access to capital on predictable terms. It is assumed that (a) the national currency, the Hryvna, will remain relatively stable, (b) inflation remains at a moderate level, and (c) no further exogenous shocks from financial crises in Russia and other emerging markets significantly affect Ukrainian financial markets.

(2) Government Is Committed to Reform in Support of SME Development

Since SME development is generally considered to be good for the vast majority of the citizens of Ukraine, public participation in the legislative process is also assumed. In an attempt to act in the interest of its constituents, the GOU will continue to support enabling legislation to create an environment that does not excessively constrain the growth and development of small and medium enterprises.

(3) IMF and World Bank Loan Conditions Are Satisfied

Many of the conditions on World Bank and IMF assistance demand reform in the area of regulation and taxation of private enterprises. If these conditions are not met, Ukraine risks losing their financial support and the corresponding effect on the Ukrainian economy would be extremely negative.

Causal Linkages

Achievement of Strategic Objective and Individual Results

Achievement of the Strategic Objective will be measured by (a) the percentage of GDP produced by SMEs and (b) the percentage of the total workforce employed by the SMEs. These two figures capture the increasing contribution of SMEs to the economic recovery on a national scale by measuring the extent to which small and medium enterprises have directly affected the lives of the citizens by providing both income and jobs. Note that the official figures will tend to increase as either the SME sector increases in size, or as it becomes increasingly formalized (moves from shadow to formal sector), in either case, an increase in the figures is a positive sign.

Success at the strategic objective level will depend on achievement of the following principal intermediate results, considered necessary and sufficient to the broader objective:

IR 1.3(c) 1 Improved Access to Market-Driven Business Skills and Information

Enhancement of business skills is an essential prerequisite for the successful development of the small and medium enterprises in any economy, but these skills play an even more significant role when the entire economy is in transition to a market system. Many of the marketing, accounting, and business planning skills necessary to operate a small business in a market economy were almost completely lacking in the previous system, in which fulfilling the state plans—rather than seeking to maximize profits—was the main objective of most firms.

Business centers and small business incubators provide skills and information directly to small and medium enterprises through training and consulting services. While initially these centers serve as a means of using USAID funds to increase local capacity to operate a small business according to modern market principles, ultimately they should become independent and self-financing as they build up their clientele and can recover costs through the charging of fees. On the other hand, similar centers elsewhere have often found themselves moving to support larger and wealthier

businesses if financial support for smaller businesses, which are less able to afford business services, diminishes. Thus, alternative sources of subsidies to target the small business market must be found to replace the existing donor subsidies. A new project will be developed and put in place by USAID to move the business skills development area into a new phase for USAID's SME development program in Ukraine. It will seek to unite a number of activities under an umbrella project that will provide broader support to a greater array of business service providers.

The Accounting Reform Project, which has provided training to accountants and auditors in International Accounting Standards (IAS) and which assisted in the formation of the Ukrainian Federation of Professional Accountants and Auditors (UFPAA) has helped to improve the management of enterprises and to make their accounts more transparent to investors. This activity will continue through the period of the strategy in order to increase the capacity of Ukrainian accountants to provide better financial information to enterprise managers and to attract greater foreign and local investment. Opportunities will be sought in the last half of the period to shift from a TA-intensive approach to promoting partnerships between UFPAA and similar professional organizations in the region and U.S. Opportunities will also be sought to establish IAS as the basis for accounting and audit. Since the majority of Ukrainian accountants are women, these activities also increase the status of women in enterprise management and finance.

IR 1.3(c) 3 Improved Access to Finance

Without sufficient access to finance on reasonable terms, small and medium enterprises will not be able to grow and develop. A two-year-old program funded by the German Government and based on a successful EBRD credit program in Russia, has provided a new source of credit to small and microenterprises through selected banks, primarily in Kiev. The EBRD has plans, supported by USAID and the European Union, to expand this program to other parts of Ukraine. However, successful development of SMEs is strongly dependent on reforms in the banking system and in capital markets. Implementation of the new Law on Leasing will also substantially increase the financing opportunities for SMEs, and the auctioning of unfinished construction sites (UCS) will serve as a means for new businesses to acquire land and capital, and to make productive use of otherwise unemployed resources.

In the interim until these reforms are carried out, funds from the international financial institutions (IFIs) can help fill the gaps in financing that the domestic banking system is incapable of addressing—but these measures are small, relative to the financing needs of the economy. Programs such as the West NIS Enterprise Fund and Eurasia Foundation help to address the credit needs of small businesses. New SME finance initiatives in FY98 and FY99 have included USAID technical assistance in support of an EBRD microcredit line, an NGO-led microfinance activity, and an activity by the IFC to develop leasing as a financing alternative.

Additional linkages with IRs from other SOs

IR 1.2.2.1 Tax System Supports Economic Growth

- IR 1 4 1 Market-Oriented Private Banking Sector Developed
- IR 1 4 3 Market Supportive Legal System Created

4 Program Approaches and Progress to Date

Overview

The USAID program to support the development of small and medium enterprises concentrates on removing constraints and creating and enabling environment for private sector growth. Improving access to business skills has been the principal focus to date of USAID's program to support SME development. The legal and regulatory environment has been the most critical factor limiting the development of SMEs, and the USAID program has begun to provide support to agencies in the GOU to promote reforms to this environment. Finally, access to credit is another important ingredient for growth of small and medium private enterprises. USAID has targeted this problem directly through support for the West NIS Enterprise Funds and recent microenterprise credit initiatives.

Business Skills Development

Business Service Centers In order to ensure that small and medium enterprises have access to business skills, USAID has funded the creation of twelve business service centers (BSCs) to date throughout Ukraine, with four more to be created in 1999. The primary goal for these business centers was to transfer skills and information about operating a business in a market economy. During the four years of its existence the program has succeeded in reaching thousands of clients in SMEs throughout the country. Under the NewBizNet activity, 15,283 clients had received services as of May 31, 1998. The four IFC business centers in smaller cities in Ukraine have trained over 2,000 managers and staff from SMEs, and have provided business toolkits and other information services to over 200 local businesses.

The long-term measure of impact from such business centers is not the number of clients that can be trained while the centers are still receiving USAID funding, rather, the sustainability of these business service centers is the real issue that determines whether these services will continue to be provided and contribute to SME development after USAID is no longer funding their activity. Sustainability of these business centers has been a goal since their creation, and has been achieved to a substantial extent for some of the centers which were created earlier. The business centers charge clients fees for services to partially cover costs, and by June 30, 1998, the business service centers generated a total of well over a million dollars in revenue. On an individual basis, two of the business centers should be covering their own costs from the fees and dues that they charge their clients by December 1998, and by the close of this strategy period in 2002, it is expected that most of the business centers will have achieved complete financial self-reliance as the centers evolve into independent consulting and accounting firms, receiving revenues from both client fees and targeted subsidies from local sources.

A new project in business skills development is expected to begin during FY99 and will merge a number of the activities in this area into one project which will provide technical assistance, training and directed subsidies to a vast array of business service providers in Ukraine. The objective of this project will be to provide broader support to develop the business consulting industry in Ukraine with less emphasis on the creation of new institutions and more focus on assisting existing and new business service providers to improve their product and service mix as well as to improve their management and financial capabilities. Support to business centers will be continued under this new project, but will be more targeted. This new project recognizes that other business service providers have been established in Ukraine, including some private consulting firms which are spin-offs of business centers created by various donors. Assistance to accounting firms, market research firms, small business training institutions and other types of business service providers may be included in this new project. The new project will also develop methods to link the various business service providers through electronic and other types of networks in order both to increase internal and external trade for Ukrainian SMEs and also to establish closer linkages among business service providers.

This new direction in business skills development will end the first phase of USAID's program in establishing business skills development and begin phase two to assist in the development of a broader number and types of business service providers. Lessons learned in Poland by a similar USAID project there which has been operating for the past year, as well as lessons learned by other SME development projects in the region will be analyzed for applicability to Ukraine during the project design process.

An assessment of business training needs conducted in early 1998 revealed that the training needs of businesses in Ukraine are extensive and more basic than MBA-level skills, indicating that measures to address the need for business skill development should not be limited to only a few locations or institutions. A new project in Business Management Education will work with 30 educational institutions throughout Ukraine to develop their business management curriculum and improve their capacity to deliver practical business education courses for young people and adults to improve the understanding of business operation in market economies.

Business Incubators Small business incubators in Kiev, Kharkiv, and Lviv were created to assist Ukrainian client entrepreneurs to improve the capacity of small businesses in the technology and light manufacturing sectors, to leverage USAID funds through partnerships, and to help organize support to sustain the incubators. The business incubators are to provide quality, demand-driven services to clients in the cities and surrounding oblasts, with the goal of revitalizing the local economy by developing successful small businesses and creating new jobs. Although they work in cooperation with existing USAID-supported business centers in these cities, these business incubators have sought to differentiate their services from the business centers. The business incubators operated by Loyola College in Kiev and Kharkiv have concentrated on training a smaller number of businesses in longer and more intensive courses and concentrated on innovative technologies. The business incubator operated by Counterpart in Lviv is a more traditional incubator and has focused on a shorter training courses of a week or less and has used these training courses to qualify potential clients for the small loans available through their project. The

number of rentals of incubator space in Lviv and Kharkiv has been very limited to date. It is hoped that as awareness of these services increases, the number of clients renting space and applying for loans will grow. Since the cost/benefit ratio of the incubator approach appears to be much higher than other approaches, we do not anticipate funding new incubators during the strategy period. It is possible that small incubators might be funded by Eurasia provided that local communities provide viable financial support and usable space for such incubators. However, this will also depend upon Eurasia's willingness to fund such incubators.

Other Efforts to Transfer Business Skills USAID has also provided modest support to business schools in Lviv, Kiev, and Donetsk, and—under the accounting reform program—trained over 1,000 Ukrainian accountants and auditors in IAS accounting, reporting, and managerial accounting. Work under The Alliance consortium (IESC, CDC, ACDI/VOCA, and MBA Enterprise Corps) in FY98 resulted in 253 business volunteer projects providing training and consulting services to 350 Ukrainian companies. It is anticipated that these programs will continue through the strategy period, but with a decrease in firm-level assistance and an increase in activities which will assist in the development of Ukrainian organizations to provide these services on a long-term, sustainable basis. Movement in this direction has already taken place and will accelerate during this strategy period.

Reform of the Legal, Regulatory, and Policy Environment

Assistance to the Key Reformers in the Government of Ukraine, the Parliament and Regional/Local Governments USAID's assistance to reform the legal, regulatory and policy environment for SMEs in Ukraine has largely been concentrated on the Inter-Agency Commission on Economic Reform (IACER) under Vice Prime Minister Tyhypko and the State Committee for Entrepreneurship Development (SCED) — formerly under Yuri Yekhanurov and now under Oleksandra Kuzhel. Support to IACER and SCED has consisted of the following activities:

- training in policy and regulatory reform analysis,
- technical assistance from American and Ukrainian policy reform experts and Ukrainian attorneys to review and analyze laws and regulations,
- advisors from Poland on strategic planning and business association development,
- study tours to Poland and Russia,
- office equipment and furniture,
- funding to hold a national workshop on business association development in March 1998,
- financial and technical support to hold an international conference in November 1998 (as a result of the Gore-Kuchma Talks) on SME Development with international speakers and roundtable discussions on key topics, presentations by existing SME support programs, and an interactive information fair with participation by various SME support programs available in Ukraine.

Further discussion of the first two activities above may be found under SO1.4

New Directions of Policy Reform Assistance With the recent election of a number of pro-SME

business development candidates to Parliament (including Yuri Yekhanurov, the former head of SCED), USAID will be providing similar support to the Sub-Committee for Entrepreneurship in Parliament chaired by Yekhanurov (under the Committee on Economic Development) and other progressive Parliamentarians. At the same time, similar support activities will be provided to progressive regional (oblast) and municipal authorities. As a first step in assisting local governments to help them develop a local strategy conducive to SME development, USAID is working with the oblast and municipal governments of Lviv, Donetsk and Kharkiv. (See also SO1 4) It is believed that much can be done at the local level to improve the environment for business development. For example, since many laws and regulations are enforced at the local level, it is hoped that local governments can be effective agents in changing the behavior of local enforcement officials to make their actions more transparent and to eliminate corruption. Other local government programs will be added later, based upon the results of the pilot work. A Policy Reform Coordinator position has been added to the NewBizNet Project to coordinate much of this new focus. Although the NewBizNet Project will end in September 1999, this work is expected to continue under the follow-on project.

Demographic Survey of both Formal and Informal Activities in the SME Sector USAID will undertake a new activity in FY99 to develop an accurate baseline of information on the SME sector in Ukraine. There is currently no reliable comprehensive information on the SME sector in Ukraine. Data on formal, registered businesses is available, but there is no accurate picture of the extent of informal SME activity. The survey to be undertaken will sample a number of regions of Ukraine and include both formal and informal SME activities. This will provide more accurate baseline data for policy planning purposes and through periodic surveys to update the information, will allow government to measure the impact of changing government policies and SME support programs in Ukraine. Experts in informal sector surveys have been obtained through the Implementing Policy Change IQC in Washington and will conduct this survey over nine months from November 1998 through July 1999, in close collaboration with SCED. Training will be provided to local Ukrainian institutions on how to conduct the study in order that they might conduct the updates in the future on an annual or bi-annual basis. The methodology for this survey was developed under the GEMINI Project of the Global Bureau of USAID in the early 1990s and was used extensively in Africa and some countries in Asia. This is the first time this methodology has been employed in the ENI Region and may prove useful for replication in other countries in the region.

Support to Business Associations Business associations are currently relatively underdeveloped and small, but with USAID support it is expected that they will become increasingly important advocates for SME policy/regulatory reform. Over the long term, the private sector must become the principal advocate for policy/regulatory reform and institutions must be developed to influence the direction of policy and legal changes on the national, regional and local levels. Thus, during this strategy period, support to reformers in government will be increasingly balanced by support to private sector organizations that can effectively represent the interests of the private sector as well as to governmental institutions that provide vehicles for voicing those interests. The NewBizNet Project has provided training and seminars for eleven regional membership-based business associations in Ukraine over the past year to improve their services to members, increase

their membership base, and develop their capacity to lobby government for the interests of their members. More focused technical assistance and financial support for selected business associations will be provided in the next year. One example of subsector-based associations is the Ukrainian Real Estate Professional Associations. USAID has helped to create regional associations of realtors in Lviv, Odessa, Kharkiv, and Odessa. Nine more small realtor associations are beginning to incorporate in other cities, with memberships ranging from 3 to 24 firms. USAID also conducted a national workshop on business association development in March 1998 which resulted in the creation of a coordinating committee of participating business associations. Alliances among business associations can be an effective means of influencing the direction of government policy. USAID will seek to maximize opportunities for these kinds of alliances through regional and national seminars and workshops.

Improved Access to Finance

Prior to FY98, USAID's activities in finance for SMEs was limited to the West NIS Enterprise Fund's Small Business Loan Fund, the Eurasia Foundation's Small Enterprise Lending Program, and credit union support. This was complemented by activities to improve the efficiency of the banking sector. (See also SO1.4) In FY98, USAID initiated new activities to provide finance to microenterprises, both through a project to provide microcredit through banks (with initial loans to average \$5,000) and a second to provide microfinance through a local NGO (with initial loans to average \$1,000 — \$2,000). The program utilizing banks will commence in late 1998. The NGO-led MicroFinance Activity (NGO-MFA) was expected to begin in early 1999, but has been delayed due to unanticipated legal problems which prohibit an NGO from providing loans and charging interest. (Only banks and credit unions are currently permitted to provide credit and charge interest.) Ways to overcome this obstacle are currently being investigated and it is hoped that the NGO-MFA will now commence in mid 1999. It is important that this legal obstacle be overcome in order to be able to provide the extensive national coverage envisioned by this loan program. Very small, experimental NGO-led microloan programs are already underway in a few cities in Ukraine, but are not addressing this legal problem head-on. However, in order to implement a large program that reflects the state of the art of large NGO-led microfinance programs could provide microfinance to literally thousands of microenterprises in Ukraine, a way must be found to overcome this legal obstacle. It is anticipated that during the period of this strategy, this legal obstacle will be addressed and Ukrainian microenterprises will have access to substantially increased credit resources. The success of the various approaches to credit through banks, credit unions and NGOs, will be analyzed and reviewed during the period of this strategy and USAID is expected to continue to support those approaches found to be the most effective.

The current status of the various programs in SME finance are described below.

EBRD Ukraine Microcredit Program USAID will provide \$2 million to the EBRD over two years to cover technical assistance to banks to implement the EBRD Ukraine Microcredit Program (UMP). This program is based on a successful EBRD microcredit program in Russia and will extend an existing German-funded microcredit program from Kiev and Donetsk to other regions of Ukraine. Technical assistance is in place and the program will commence in December.

1998 If this program is found to be successful, it is anticipated that further funding may be provided during the course of this strategy period

NGO-led MicroFinance Activity USAID is vigorously investigating ways to overcome the legal obstacle mentioned above in the next few months. Assuming that this obstacle is overcome, USAID expects to fund a four year program providing technical assistance and operational support to create and develop a NGO-led MicroFinance program through the establishment of a Ukrainian NGO specifically designed to implement a nationwide program. (Existing NGOs in Ukraine do not have the capability to implement such an extensive program. USAID envisions using a model similar to that employed by ACCION in Latin American countries.) Again, this approach will be reviewed and analyzed to determine its effectiveness during the period of this strategy.

West NIS Enterprise Fund This fund, which was established by Congress to provide funds for the development of the private sector in Ukraine, established a Small Business Loan Fund which provides direct loans from \$10,000 to \$100,000 to SMEs for equipment purchases. As of November 1998, the SBLF had provided 52 loans to SMEs averaging \$46,000. The SBLF has offices in Kiev with branch offices in Kharkiv and Lviv (located in the NewBizNet centers in those cities). It is not anticipated that their loan activities will increase in the near term, due to the spillover into Ukraine of the recent financial crisis in Russia. The Enterprise Fund is currently considering a co-sharing arrangement to provide loan funds to the EBRD UMP and has indicated an interest in providing loan capital for the NGO-led MFA after the pilot phase of that activity. Other enterprise funds established by the U.S. Government in Poland and Bulgaria have supported similar microfinance programs in those countries and have been critical to their creation and development. USAID is encouraging the West NIS Enterprise Fund to support similar microfinance initiatives in Ukraine.

Eurasia Foundation The Eurasia Foundation Small Enterprise Lending Program also provides equipment loans from \$10,000 to \$100,000 to SMEs through banks in Ukraine. As of November, 1998, Eurasia had provided 15 loans averaging \$49,773 through 2 banks. Problems with the first bank utilized for the program caused Eurasia to put this program on hold for some months in late 1997 and early 1998. It is now lending again through a new bank with better results. It is not anticipated that this program will grow substantially during this strategy period.

Credit Unions A significant part of USAID's portfolio on helping SMEs to gain access to sources of finance, the program to create and ensure the sustainability of credit unions has succeeded in setting up 8 model credit unions in various regions of Ukraine, and has trained more than 800 credit union managers, board members, and initiative group representatives. This project has also assisted the Ukrainian National Associations of Savings and Credit Unions (UNASCU) to improve its services to member credit unions and to develop new legislation that more appropriately reflects credit union activity in Ukraine. The grantee, the World Council of Credit Unions, has received a one-year no-cost extension to take their activities through September 1999. It is anticipated that they will submit a new proposal in early 1999 to continue and expand their activities in the following years. USAID is currently assessing the effectiveness

of their program in Ukraine. It is expected that USAID will fund further activities to develop credit unions in Ukraine during this strategy period, either through WOCCU or another grantee/contractor.

5. Development Partners

Other development partners are active in promoting growth of SMEs, through such means as the provision of loan funds to support microenterprise development, technical assistance programs and by placing conditionality on loans that require the GOU to continue to work toward creating a positive enabling environment for SMEs. The governments of Germany, Canada, and Great Britain as well as the European Union, United Nations Development Program and the World Bank are all providing funds for programs to promote the development of SMEs. Representatives of USAID and these agencies meet on a regular basis to coordinate their assistance programs for SME development.

6. Sustainability

Sustainability of SME development in general depends to a great extent upon GOU support for reforms to the relevant policy, legal, and regulatory environment, since efforts to promote business skills and access to finance will be less effective in the long run if the excessive tax and regulatory burden is not reduced. Assuming that the positive attitude in the GOU toward SME development continues to translate into actual reforms that benefit small and medium enterprises, the outlook for sustainability is very good.

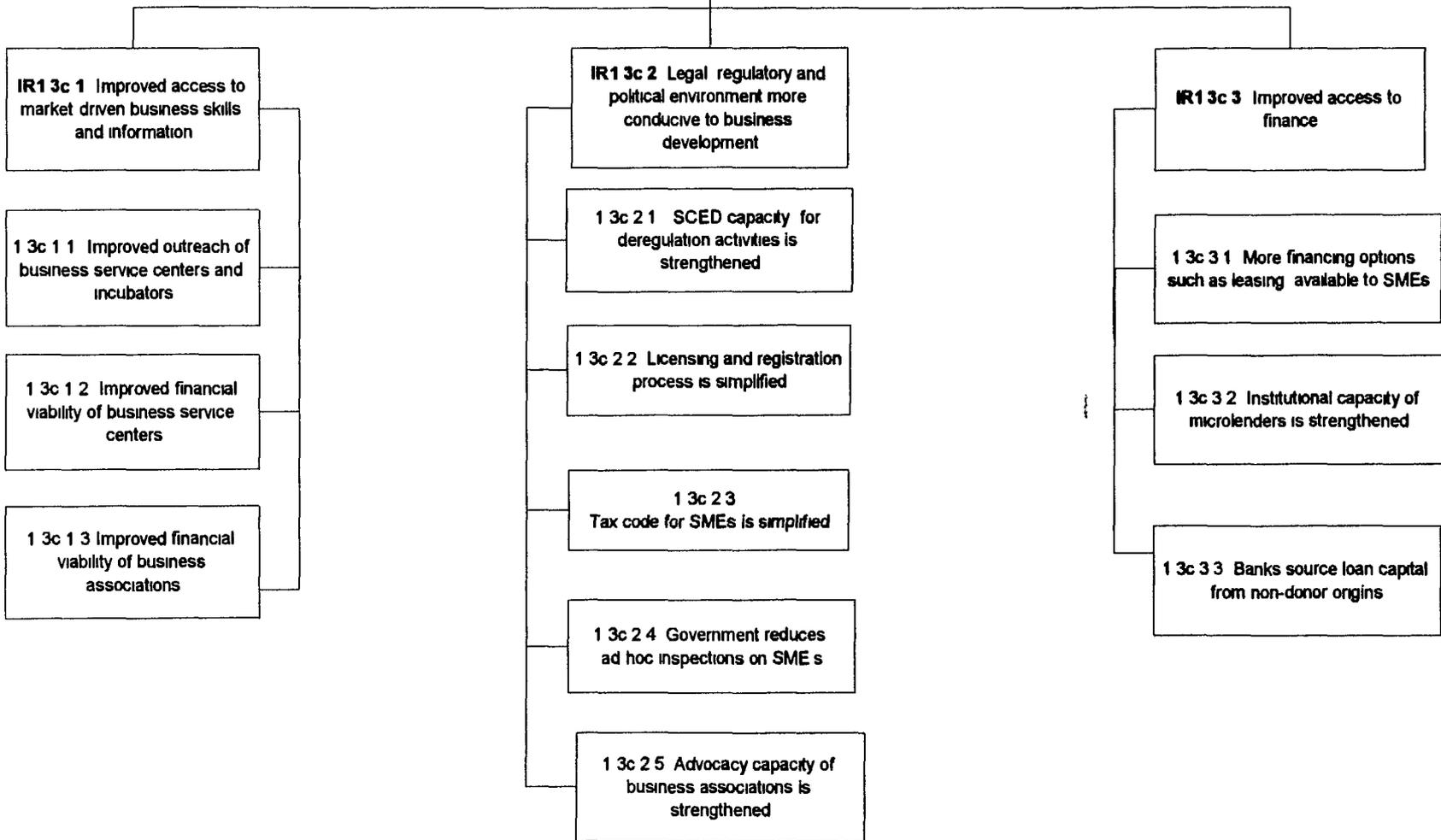
USAID assistance to ensure access to modern business skills has focused on capacity building within Ukrainian institutions, including business centers, professional associations, and business incubators. In nearly all of these cases, the institutions were intended to be self-financing after a few years, through fees and dues charged to clients that use their services, as well as targeted subsidies provided by local governments or institutions. No longer dependent on USAID funds by the end of this strategy period, most of these activities are expected to be self-sustaining and will continue to operate well after USAID has closed down support to this strategic objective.

Sustainable access to sources of finance is similarly dependent on continued reform by the GOU. Some of the current measures to fill the gaps not addressed by the underdeveloped banking system are not sustainable. The expectations are that as the GOU takes the necessary steps to improve the financial sector, donor funds can decrease as the Ukrainian banks, credit unions and other local NGOs begin to finance the bulk of the credit needs of micro, small and medium enterprises.

UKRAINE SO1 3c

SO 1 3 Accelerated development and growth of private enterprises

SO 1 3c Expanded role of small and medium enterprises (SMEs) in national economy



Strategic Objective 1.4

A More Competitive and Market-Responsive Private Financial Sector

1 Statement of the Strategic Objective

At the start of the decade, the financial system of Ukraine was not organized to mobilize savings or to allocate funds to the most efficient investors, but rather to function as a mechanistic intermediary for implementing the Central Plan. In that environment there were no concepts or concern for capital adequacy, risk management, solvency or service to the population because the system bureaucratically allocated capital and credit without reference to market principles.

The task is now to transform the financial sector from a mechanistic, bookkeeping system to a service-oriented sector based on market principles -- capable of providing financial support to consumers and to small and large businesses. The government's role in the transformation is to develop an infrastructure that promotes safe, sound and responsive financial services and to provide the legal and regulatory framework that will allow the sector to operate effectively and responsibly. Such a system critically depends upon several factors:

- First, an economic environment of growth and private initiative, supported by government stabilization policies that promote efficient resource allocation
- Second, a legal environment that specifies transparent "rules of the game"
- Third, government regulatory authorities who are able to implement the "rules of the game" in an evenhanded way
- Fourth, a culture and incentive structure that encourage financial market players to carefully analyze the risks of their activities and conduct their business in a manner consistent with western "best practice"
- Fifth, a constant upgrading of human capital to provide the sector with the needed management and decision-making capacity

During the past six years, USAID's technical assistance has been developed with these objectives in mind. Emphasis was placed on developing the fundamentals of the financial infrastructure, on upgrading human capital, and on strengthening the legal, policy and institutional environment. This thrust will continue over the medium-term (1999 - 2002).

Currently the development of the Ukrainian financial sector occurs against a backdrop of turmoil in international financial markets. Of particular importance is the difficult situation in Russia, which, because of the close trade and financial ties between the two countries, has had adverse consequences for Ukraine. Compounding this situation, badly askew macroeconomic policies have dampened private sector development and resulted in highly restrictive monetary policies.

leading to liquidity problems for banks. While USAID's basic objectives, and thus the underlying program, will not change, particular care will have to be taken in this environment to ensure that efforts do not destabilize an already fragile financial system.

Special mention should be made of one principle which directs the assistance program -- the careful attention to the sequencing of technical assistance. Although there are a myriad of needs, it is critical to focus the work on fundamentals. USAID's program concentrates on the building blocks of a functional financial system -- government regulatory authority, accurate accounting and reporting, payments mechanisms, training of basic skills.

USAID will have achieved its objective of a more competitive and market responsive private financial sector when

(1) The fundamental financial infrastructure is developed that will both increase public confidence in the banking sector, create a level playing field in which all banks can compete, and strengthen the Central Bank's supervisory authority.

(2) Institutions and practices are established for an open, transparent and safe equity market that will provide savings vehicles for homeowners and businesses, and, in turn, supply capital to the industry, commerce and the Government.

(3) A market-oriented legal and regulatory infrastructure is in place that provides both the financial institutions and the entities they serve with an effective and transparent framework in which to operate.

2 Problem Analysis

The sad events in several Asian countries and most recently in Russia dramatize all too clearly the critical role of the financial sector in economic growth and stability. Ukraine, like other transitional countries, started very much from the beginning in developing institutional mechanisms to support financial sector markets. Equally important, there was no experience from the former system in developing a business culture based upon market norms.

Under the former Communist system, financial markets had a very limited and sharply circumscribed role. Banks were no more than funnels for centrally determined investment plans. In this system, neither risk management nor prudential lending standards were a concern. Nor did impartial, transparent corporate securities markets have a role in a socio-economic system in which all productive enterprises were owned by the state. Thus, western standards of transparency and arms-length involvement in transactions are not currently fundamental elements of financial sector practice.

The most important tasks in building a market based banking system in Ukraine are a) to foster public confidence in the banking system, and b) to improve the banking sector's capacity to promote economic development through the market-based allocation of financial resources.

Similar challenges confront the corporate securities market which has had even less time to develop than the banking system -- public share ownership only began when Ukraine started its privatization program in 1995

Clearly impeding the development of a market-oriented financial sector is the lack of Ukrainian experience in market principles and parliamentary processes, which are fundamental to the development of a legal and regulatory framework that promotes sound financial practices and serves both the financial institutions and their customers

Banking After six years of independence the contours of a market-based banking system are beginning to form. Nonetheless, many fundamentals of the former centrally-planned Communist economy do not die easily. Some prevalent practices of the Ukrainian banking system, such as lending to insiders and related parties, as well as the continuing (albeit much reduced) directed lending by the banks at the government's behest, are anathema to the development of a market-based banking system. It is still also the case that building blocks of the supporting financial infrastructure -- the government's regulatory apparatus and the legal underpinnings -- are quite undeveloped.

Moreover, because the fundamental infrastructure is weak, and at the same time Ukraine is rapidly integrating into international financial markets, there is increasingly a danger of a systemic banking crisis, impacting good banks as well as bad banks. As we have seen in many countries, this could adversely impact the economy and jeopardize Ukraine's fragile economic recovery.

Corporate Securities The financial crisis in the region makes development of an open, transparent and safe corporate securities market in Ukraine more important than ever if domestic business is to grow, employ resources and people effectively, and help Ukraine avoid the collapse other countries have suffered. A lesson the countries most affected by the regional and global financial crisis have learned is that highly leveraged economies and companies are the most vulnerable. Capital markets are also important to facilitate changes in ownership following mass privatization and to facilitate restructuring that new owners bring. They are important as a channel for direct and indirect foreign investment. In the longer term, the institutions and practices of a developed market for savings and investment in corporate equity are essential to mobilize domestic capital, including the all important future pension systems of Ukraine, for private domestic investment.

Ukraine has experienced progress, but major challenges remain. Corporate governance abuses remain widespread. Investors, small or large, cannot trust the re-registration process to assure their transactions will be settled expeditiously - a depository is badly needed. Standards need to be raised to weed out less responsible traders and custodians. Only two of the five basic laws required to govern the market effectively are in place. Among those missing are laws to protect against corporate governance abuses and to assure the safety of collective investments (mutual funds, pension funds, etc.). Finally, there is still a very mixed understanding within the Government of the importance of impartial market oversight and the difference between regulation of the market and control.

Market Supportive Legal System A successful market economy requires a legal framework to support basic economic freedoms, the guarantee of private property rights, and the means to enforce these rights. At independence, Ukraine had a legal system that only had the most superficial correspondence to one needed for a functioning market economy. Basic laws and organizations simply did not exist. The basis for reforming this situation has begun -- a modern Constitution was adopted, existing legislation has been updated, a series of new laws has been introduced. However, several critical pieces of legislation have yet to be enacted, most prominent among them is the Civil Code. Following the Civil Code is a myriad of secondary legislation that will provide both the framework and the tools needed by the financial institutions and their clients to conduct business.

In addition to inadequate legislation, a major weakness in the current legal environment is that of effective application and enforcement of law. There is a broad perception, particularly prevalent in the international community, of instability in the legal infrastructure. It is clear that the laws on the books do not necessarily shape state or private behavior. There is a definite lack of predictability in the legal system, as well as a control mentality and excessive regulation.

3 Results Framework

USAID's proposed strategy for achieving the objective of a more competitive and market responsive private financial sector rests on a series of interdependent results that will combine to achieve progress (or causal linkages). The strategy also rests on a set of critical assumptions that represent conditions, outside of USAID's control, that will affect the achievement of results. Figure 1.4.1 presents the overall results framework.

Critical Assumptions

Essential to USAID's achievement of the strategic objective through the intermediate results are the following critical assumptions:

(1) The Government of Ukraine will demonstrate the lessons that it has learned from the recent financial crisis by adhering to the conditions established under its access to the International Monetary Fund's Extended Fund Facility. The Government must also respect the autonomy of the Central Bank and its ability to implement policies which will ensure continuing price stability. The Government must reduce the need for a restrictive monetary policy, a by-product of the past years of cumulative large fiscal debts, by finally cutting its expenditures to realistic levels while at the same time reforming its tax policies and administration to boost revenues. This is needed to correct the government's by now substantial cumulative fiscal imbalance. This will be particularly difficult given the presidential elections in 1999 and the temptation for the Government to pressure the NBU to relax monetary policies to pay off wage arrears and shore up political support.

(2) Privatization of state enterprises and enterprise restructuring will proceed, providing the additional impetus for financial sector transactions, be it increased supply of tradable shares on the

securities market or increased demand for banking services

Causal Linkages

Achievement of the Strategic Objective will be measured by

- Increased private sector investment intermediated through the banking system
- Increased securities market investment

As illustrated in Figure 1 4 1, it is USAID's hypothesis that the success of the strategic objective of a more competitive and market-responsive private financial sector will depend upon the achievement of three intermediate results, considered necessary and sufficient to the broader objective

IR 1 4 1 - Market-oriented private banking sector developed, IR 1 4 2 Transparent and open securities system established, and IR 1 4 3 Market supportive legal system created

These key intermediate results are the product of lower level results, described in greater below In addition, the overall program objectives will be facilitated and reinforced by the results of Strategic Objective 1 2 (Improved Fiscal Policies and Fiscal Management Practices) which will rationalize the government's fiscal structure, reduce its need for accommodating monetary policies by the Central Bank, and improve the Government's debt management practices and the derived market for government securities, and Strategic Objective 1 3 (Accelerated Development and Growth of Private Enterprises), which will contribute to the growth in the demand by private enterprises for financial intermediation through both the banking sector and capital markets, as well as of increased demand for improved corporate governance through the adoption of international accounting standards

IR 1 4 1 Market-oriented Private Banking Sector Developed

A market-oriented private banking sector is the cornerstone of a market-based financial system The development of a banking system is crucial for the establishment of payment systems, which facilitate economic growth and act as an efficient allocator of society's savings to the most productive uses USAID's strategy will continue to focus on the development of a sound financial infrastructure, thus promoting confidence in the banking system USAID's approaches will emphasize technical assistance to support infrastructure development, training of both regulators at the National Bank of Ukraine and private bankers, and continued support for strengthening the policy, legal and regulatory environment

IR 1 4 2 Transparent and Open Securities System Established

A well-functioning securities market is essential to Ukraine's transformation to a market economy The development of a secondary market for securities is critical for success in privatization and enterprise restructuring, improvements in corporate governance, and the creation of mechanisms that are conducive to international strategic investment While basic

institutions and regulatory function have been established, much more needs to be done. USAID will continue to develop the capital markets infrastructure and capacity for prudential regulation through technical assistance and training. USAID will work to further empower the Securities Commission to exercise its proper role in ensuring fairness and orderliness in capital markets. Attention will increasingly be paid towards strengthening the capacity and professionalism of self-regulating organizations (SROs) of market participants, and the organization and development of trading systems.

IR 1.4.3 Market Supportive Legal Systems Created

The primary underpinnings of a commercial law system include structures for property ownership and transfer, for market entry and exit, and for market competition. The foundations of a market-oriented legal system need to be broadened and strengthened. The lack of supportive legislation in some areas coupled with conflicting and ambiguous laws in others negatively impact fluid and transparent market forces and open the door for irregular administrative, if not extralegal, behavior. USAID will continue to work in specific areas of legislative development that are most critically needed by the financial sector and the entities they serve. Specific attention will also be placed on building indigenous capacity in the areas of drafting, training, and information dissemination and building a constituency for effective legislation and enforcement.

4 Progress to Date

USAID has provided strong support for the development of the Ukrainian fixed-income market, encompassing banking and government securities. USAID has provided critical support to the National Bank of Ukraine's regulatory authority and capacity. The program put into place regulations that include classifying and provisioning for bad loans, setting higher minimum capital requirements, and lending to one borrower and related parties. It has trained supervisors in both western-based inspection techniques and off-site risk analysis. The program is also training supervisors in rehabilitation techniques for problem banks.

In collaboration with other donors, USAID has helped convert the banking system to international accounting standards. An initial pilot program of banks tested the new chart of accounts. Subsequently IAS was introduced throughout the banking system in January 1998. Since that time USAID has been working with the commercial banks to deepen the usage of IAS-based financial reporting and to develop back office functions such as internal auditing.

Work continues on the creation of a self-sustaining banking school. To date, over 3,000 bankers from all over Ukraine have received short-term training. A second USAID program works with the leading Ukrainian business school, the International Management Institute (IMI), in implementing a one-year intensive training course leading to an MBA in banking. Seventy banking professionals have received MBAs under this program, thirty two are currently enrolled. A number of graduates are currently team teaching with foreign advisors at the banking school.

During 1996 and 1997, USAID's activities led to the formation of the Securities and Stock Market State Commission and its authorization to regulate the corporate securities market. USAID provided assistance to the SSMSC in conducting enforcement activities and surveillance inspections, analyses of disclosure filings and financial statements, and conducted training/education programs covering all areas of securities markets, especially corporate governance. USAID also spearheaded legislative coalition-building and assistance in the drafting of laws and regulations in the areas of securities and the stock exchange, business association, joint stock companies, and self-regulatory organizations.

USAID also supported the formation of a broker-dealer organization which, in turn, established an organized over-the-counter securities trading system (PFTS). By the end of November 1998, PFTS membership reached 299 in 21 cities, and the total volume of trades amounted to nearly 5,500 with a value of \$289 million. USAID provided technical assistance and training in Depository and Custody issues.

USAID activities also created trade associations for registrars and depositories (PARD), for investment funds (UAIB), and for accountants and auditors (UFPAA). By the end of November 1998, PARD membership surpassed 270 in all principal cities. USAID enabled the UFPAA to adopt guidelines and instructions for 4 international accounting standards.

USAID assistance contributed to the amendment to the Law of Ukraine on Pledges to provide for a State Pledge Registry of movable property. The amendment was passed in October 1997, regulations were approved in July 1998, implementation is scheduled for March 1999.

An extensive training program in bankruptcy and financial restructuring for judges of the Highest Arbitration Court and other legal and financial professionals has been completed. A modern bankruptcy law has been drafted and has passed its second reading in the Parliament.

5 Program Approaches

Banking Sector

Policy, Legal and Regulatory Strengthening. USAID will support the National Bank of Ukraine's Legal and Bank Supervision Departments in the development of more comprehensive banking laws, as well as further refinement of the NBU regulatory structures. It will also work with the Licensing Department to develop guidelines, including the regulation of foreign banks.

Infrastructure Development. USAID will continue activities that strengthen the National Bank of Ukraine's bank supervision functions, including developing the NBU's on-site supervision capacity, working with NBU supervisors on badly-needed bank rehabilitation plans, establishing and incorporating methodologies for the deepening in the banks of international accounting standards, working with individual banks on developing financial reporting to efficiently utilize IAS-based accounting.

Human Capital Formation USAID intends to support, first, the creation of a self-sustaining banking school that will provide Ukrainian bankers with exposure to Western banking fundamentals, and second, an intensive masters-level program in banking at the leading Ukrainian business school. USAID will also support a specialized program in fundamentals of western accounting standards to support the recent introduction of IAS. As assistance in this area winds down over the next two years, specific attention will be placed on measures ensuring the sustainability of the training programs and the institutions that implement them.

Capital markets development

Policy, Legal and Regulatory Strengthening USAID's strategy for the next four years will aim to establish the institutions and practices for open, transparent and safe equity investment. It will combine partnerships between USAID and private institutions in the market (ultimately leading to independent partnerships between those institutions and similar ones in the region and United States) with continued support to the Corporate Governance Task Force and Ukraine's Securities Commission as long as they continue to move effectively in the direction of openness, transparency, and impartiality. The emphasis in working with the Commission will be to establish the missing key laws and implementing procedures, strengthen the delegation of self-regulatory authority to private parties, and improve enforcement particularly of shareholder rights and corporate governance.

Infrastructure Development Partnerships will be strengthened with private market institutions including the PFTS, a privately-owned central depository, the Ukrainian Association of Registrars (PARD), and an anticipated association of collective investment firms such as mutual or pension funds. The nature of the partnerships will vary between organizations and over time but will be characterized by the development of democratic governance by and for members, professional standards and practices of self-regulation, expanded advisory services to members, a gradual transition from TA-intensive support to grant relationships between USAID and the private partner, and support for exchanges and establishment of ongoing, independent links between these private groups in Ukraine and successful counterparts in the U.S. and the region. Development of a central depository will represent the only "hard" activity during the period and should be complete during the year 2000. Here too, however, as the success of the PFTS has shown, successful institution-building will be the key and will depend largely, in turn, on establishing predictable and consistent, open and democratic governance by members and users.

Human Capital Formation Through partnerships between USAID and private market institutions, USAID will develop professional standards and practices of self-regulation, membership advisory services.

Legal systems development

To ensure that an effective legislative framework is in place USAID's program will focus on providing assistance to promote sound legislative drafting, as well as the effective implementation

of laws once enacted. In addition to the basic laws and regulations needed for banking and capital markets development, establishment of supportive legislation in the areas of collateral law, bankruptcy/financial restructuring, regulatory reform, and effective enforcement will be addressed. Special attention will also be focused on passage of the Civil Code and development of the secondary legislation needed to effectively implement and enforce it.

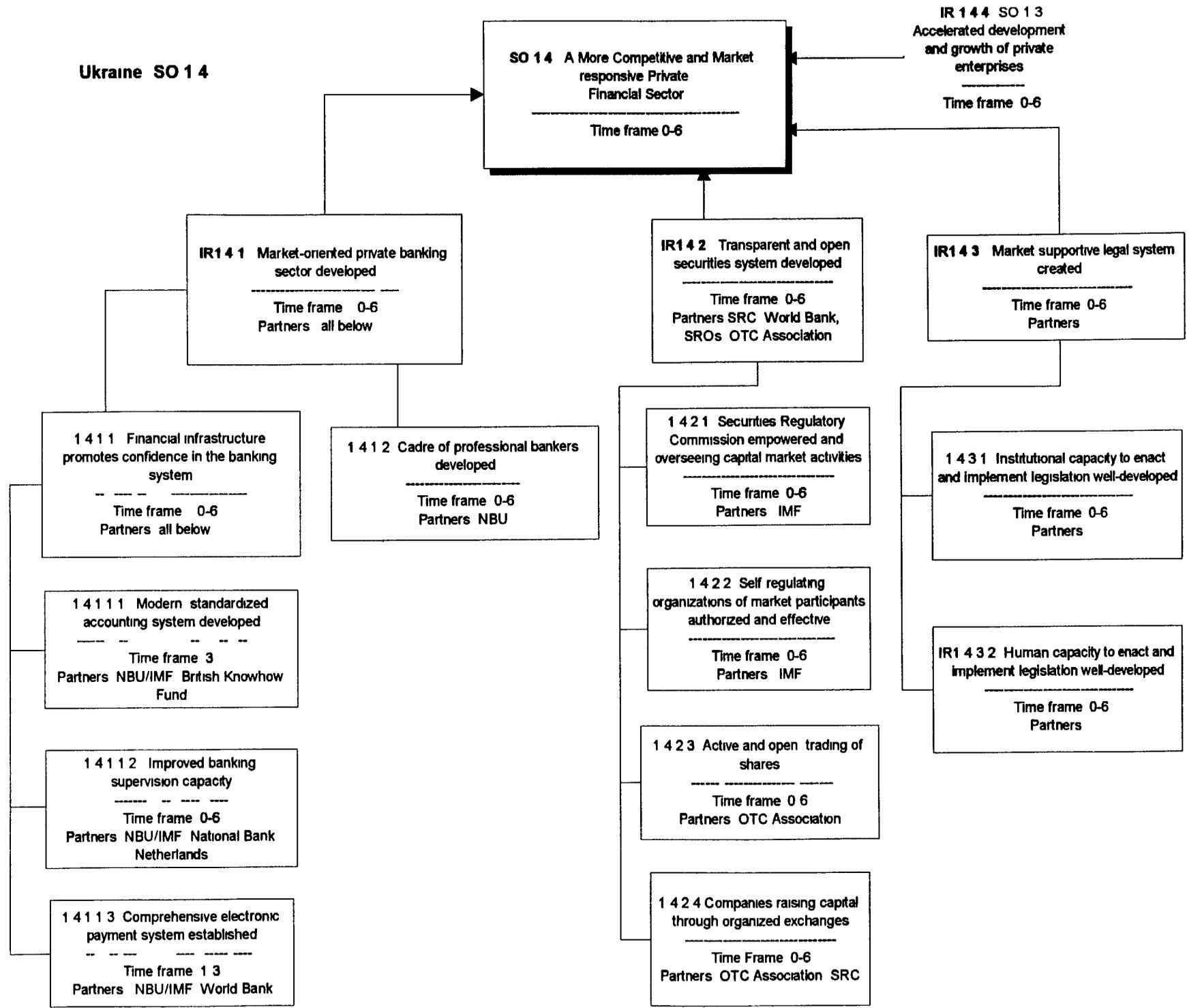
Reforms in collateral law will provide the financial sector with a collateral registry, the lack of which is currently one of the most important bottlenecks preventing sound credit analyses. A new bankruptcy law will provide for the effective financial restructuring of troubled enterprises, strengthening both their financial and productive positions. Sensible regulatory reform at both the national and local level will make the rules of the game more transparent and provide more efficient and effective systems for conducting business. Underlying all these reforms will be accessible and transparent mechanisms for enforcement, free from undue control by government organizations or powerful individuals.

In implementing these legal reform programs there are three key premises that will be followed: 1) legislative drafting must be Ukrainian led, 2) assistance must also be directed to build an understanding of, and constituency for, the objectives of the law, and 3) once enacted, mechanisms must be in place to fully implement the law as intended. To do this USAID takes a more comprehensive approach to address capacity building, working through indigenous NGOs in the areas of drafting, training, and information dissemination.

6 Development Partners

USAID's work in the banking sector is supportive of both the World Bank *Financial Sector Adjustment Loan* and the IMF *Extended Financing Facility* (twenty-five of whose conditions concern the banking sector). Upgrading NBU bank supervision, developing NBU capacity to deal with problem banks, passage of banking laws, deepening the conversion to international accounting standards are all examples of USAID activities that feature prominently in both FSAL and the EFF. Joint programs exist with EU-TACIS and the British Know How Fund in bank accounting, with EU-TACIS in problem bank restructuring, and with the Swiss government in bank training.

USAID's efforts in strengthening the capital markets are reinforced by the World Bank's activities through its *Enterprise Development and Adjustment Loan II*. The World Bank has demonstrated strong support for USAID-promoted reforms such as (1) the adoption of a two-tier regulatory program utilizing self-regulatory organizations in addition to government oversight, (2) the replacement of an oligopolistic state-owned registrar with a competitive registrar industry (and subsequent industry-wide depository), and (3) the rapid adoption of International Accounting Standards within the corporate disclosure program of the Securities Commission and the implementation of these standards in the accounting profession through the Ukrainian Federation of Professional Accountants and Auditors (UFPAA). In addition, the European Union's EU-TACIS program has initiated corporate disclosure and custodian development programs that also support the achievement of USAID's objective.



Strategic Objective 1.5

A More Economically Sustainable and Environmentally Sound Energy Sector

1 Statement of the Strategic Objective

This objective contributes to the emergence of a competitive market economy in which the majority of economic resources is privately owned and managed by promoting greater efficiency in energy production and use, restructuring energy companies into economically viable, market-based entities, improving the environmental performance of energy systems, and preserving the energy resource base

USAID will consider this objective met when

- (1) The legal and regulatory environment surrounding the development of the energy sector is developed and provides an enabling environment for strategic private investment
- (2) The energy sector has become a competitive, financially sustainable energy production and delivery system
- (3) Ukraine reverses the decline in domestic fuel production and is able to reduce dependence on imported natural gas and coal from Russia
- (4) Improved efficiency in energy utilization is achieved

2 Problem Analysis

The energy sector is one of the key parts of the Ukrainian economy, accounting for half of total imports and perhaps 20 percent of total output. It provides critical inputs into an energy-intensive industrial sector. Energy is also an important consumption good for Ukrainian households.

As a legacy from the centrally-planned economy, the energy sector has been highly inefficient and a net drain on the economy. Energy production has been cut in half since independence and the physical infrastructure has deteriorated greatly. The sector has accumulated very large debts - more than \$1.7 billion since independence, which have been financed by credits from foreign donors and additional foreign aid. Well over half of all hard currency is used to maintain import fuel. Energy consumption has been highly subsidized, but suppliers still have been unable to collect payment in cash from customers and have lacked the legal authority to cut off service. In this environment where little of the cost of energy is borne by industry, government and communal consumers, consumption patterns are frequently wasteful.

Since 1995, progress in the reform of the energy sector has been significant and in some respects is greater than anywhere else in the region. Ukraine began the process of power sector restructuring to address critical financial and managerial problems and to develop a financially sustainable power sector. Critical first steps were the break-up of energy production and distribution monopolies and the establishment of regulatory institutions. The industry now consists of four thermal, one nuclear, and two hydroelectric generating companies (GENCOs), and 27 local distribution companies (LECs).

Deeper reform is required, however. The policy, legal and regulatory environment needs to be strengthened and extended to other aspects of the energy markets, including coal, oil and gas. Suppliers must be empowered to collect energy tariffs. For efficiency and financial reasons, privatization and restructuring of energy companies with significant involvement of international strategic investors is essential. Strategic investments are necessary to supply the needed capital, technology, and management expertise, and to put the energy sector on a sound commercial footing. The ability of strategic investors to withstand political pressure is essential to achieve the final objective. In addition, incentives must be developed that encourage more efficient use of energy, not only to reduce Ukraine's dependency on imported fuels, but to put the sector on a more sustainable foundation to meet future energy needs. Other reasons to promote energy efficiency in Ukraine include environmental and macroeconomic benefits, as well as the issue of global climate change (GCC).

3 Critical Assumptions and Causal Linkages

Critical Assumptions

Essential to USAID's achievement of the strategic objective are the following critical assumptions

- (1) The Government of Ukraine will uphold its commitments under the IMF Extended Fund Facility to intensify reforms aimed at commercializing the supply of energy, separating non-monopoly elements from activities with natural monopoly characteristics, and increasing payment discipline among customers - - all within the context of the Financial Recovery Plan (FRP) for the electric energy sector. In addition, also under the EFF conditionalities, the government will remain committed to develop further a competitive gas market and appropriate regulatory framework
- (2) The Government of Ukraine will uphold its commitment to work with the World Bank to reform the coal sector with budgetary subsidies redirected to finance mine restructuring and/or phase-outs over time, with most nonviable mines closed out over the medium term
- (3) The Government of Ukraine will adopt new policies toward a tender-based, transparent and cost-effective fuel procurement process
- (4) Ukraine will progress with economic restructuring of industry, complete fuel and energy tariff reform, so that prices reflect the full economic cost of supply for all main categories of energy users', ensure metering of all energy supplies, and enforce energy supply contracts so that users pay for what they take

Causal Linkages

Achievement of the strategic objective will be measured by the reduction of subsidies to the energy sector. The absence of explicit and implicit subsidies is a good indicator of the

sustainability of the energy sector. Our work in three intermediate results will contribute to the sustainability of the energy sector, but cannot guarantee it because we are not working on all aspects of energy. These are *IR 1 5 1 - Improved regulatory environment for the energy sector, IR 1 5 2 - Development of a competitive, financially sustainable energy production and delivery system, and IR 1 5 3 - More efficient and effective utilization of energy*

IR 1 5 1 Improved Policy, Legal and Regulatory Environment for the Energy Sector

Four years ago the Ukraine electric power industry embarked on an ambitious market reform program by strengthening mechanisms that facilitate the operation of the wholesale market, and instituting the regulations required for non-competitive components. Since 1995, the National Electricity Regulatory Commission (NERC) has functioned as an effective price and market regulator for the power industry. In 1998, the President of Ukraine assigned NERC the function of regulating the operations of the emerging oil and gas sector markets. Electricity, oil and gas regulation is a new function that Ukraine did not engage in under the soviet command economy planning system. Thus the focus of the assistance will be on the development of regulatory frameworks and commissions, operational implementation, market development, and regulatory policy analysis. NERC also has the right to review district heating tariffs, a function where USAID may also provide assistance. The ability of NERC to function free of interference from other ministries is a major objective of our assistance.

NERC has a major role to play in the power sector by supporting the wholesale market operation and observing market members' operations. In particular, the focus of assistance will be in the following areas: (1) market-based tariff policy, (2) compliance with licenses, (3) independent audit of market bidding and funds distribution documentation, (4) transparency of market operation, (5) strategic investments' protection, (6) environmental protection, and (7) public participation.

NERC has a new role to play in restructuring and regulating the operation of the oil and gas industries. For the past five years, the Government of Ukraine has avoided restructuring this major sector of the economy. As a result, an enormous debt was accumulated payable to Russia and Turkmenistan. At this juncture, assistance will be focused on the following areas: (1) creating the necessary technical expertise to govern the operation of the newly-created oil and gas market, (2) establishing a market-based tariff mechanism, (3) awarding licenses to all market players as well as independent energy suppliers, and (4) supporting investment activities.

The existing power wholesale market operation is constrained by insufficient collections and ineffective fuel supply. Appropriate measures need to be implemented to revise the energy market algorithm and ensure a fair, non-discriminatory operation of a Market Funds Administrator. USAID assistance will be directed at the wholesale market operators to bring about the necessary improvements. These improvements are critical to achieving the financial recovery plan (FRP) which began in April, 1998. The plan contains 23 separate actions aimed at improving the wholesale market operation through key reform areas: (1) cost reduction, (2) retail tariffs, (3) payment discipline, (4) collection of arrears, and (5) privatization. USAID assistance will be directed at the wholesale market operators to bring about the necessary improvements.

Coalbed methane (CBM), or natural gas contained in coal seams, represents a significant, albeit greatly underdeveloped, energy resource in Ukraine. By some estimates, Ukraine may have methane resources total 12.0 trillion m³, slightly greater than those of the United States, the world leader in commercially-produced CBM. Until recently, methane has been largely viewed in the Ukrainian coal industry as just a mining safety hazard, responsible for many deaths resulting from in-mine explosions. Despite the interest in establishing CBM commercial development projects, foreign investors have been reluctant to invest badly needed capital in Ukrainian methane projects because of the lack of reliable gas markets for payment, the tax burden on gas exploration, production and sales, and a complicated licensing and permit process for CBM development. USAID will provide assistance to the Alternative Fuels Center to promote needed legislative and regulatory changes, such as amendments to the profits tax legislation, the Law on Alternative Fuels, introduction of a tax credits system, introduction of a special CBM geological regulation, etc. These changes could make CBM in Ukraine economically attractive for foreign and domestic investors.

IR 1.5.2 Development of a Competitive, Financially Sustainable Energy Production and Delivery System

Electric generating and distribution companies have to become commercially viable and competitive in order to achieve the strategic objective. Those companies have to develop and adopt policies to (1) reduce costs for electricity production and transport, and (2) establish procedures to serve customers trouble-free and collect from them in full. Currently, the macroeconomic crisis in the Ukrainian economy and the associated socio-political instability have had a negative impact on power pool operation, which means that production does not occur at the lowest possible cost and the generating and distribution companies do not get paid. As a result of central and municipal government pressure not to cut off power to non-paying customers, companies are unable to purchase sufficient fuel to operate 24 hours a day and the overall economy suffers losses. USAID has worked intensively with several distribution companies with limited results on cash collection. Different approaches will be tried at various points in the energy complex.

Initial efforts to privatize electric distribution companies were not successful. USAID and other donors are working with the Government of Ukraine to develop a program for successful privatization of the power sector with the non-discriminatory participation of strategic investors. The assistance will be rendered to the Ministry of Energy, which is an advocate for strategic investments to the power industry. In addition, necessary pre-privatization activities need to be implemented within the power utilities to provide documentation to interested investors (master and business development plan, restatement of accounts in IAS format, annual reports, etc.) These activities are based on the belief that only a privatized energy sector can be economically sustainable.

The power industry suffers from non-transparent fuel procurement practices. In most cases, power utilities obtain poor quality coal at high costs as part of the electricity-coal offset.

mechanism. The existing practice does not stimulate coal mines to compete on the basis of quality and cost. In addition, power companies suffer from utilization of poor quality coal (increased maintenance needs plus purchases of mazout for co-firing), and the cost of electricity remains quite high, which constrains them from bidding effectively in the wholesale electricity market. USAID will assist the Government of Ukraine to introduce market-oriented, tender-based procurement practices of fuel (coal, mazout) by the State Reserve Committee, the Ministry of Energy and the generating companies and requiring similar approaches by independent energy supplies which pay for electricity with fuel.

IR 1.5.3 More Efficient and Effective Utilization of Energy

USAID implemented a comprehensive, multi-year program to improve energy efficiency during the last four years. The Program is focusing both on the national level, through the Energy Conservation and Energy Efficiency Work Group under the USAID funded Program to Promote Sustainable Development, and on the local level through implementation of industrial and municipal-based energy management projects. An array of regulatory, legal, institutional, tax, and import policy barriers inhibit the adoption of energy efficiency. Without further policy reforms, energy efficiency efforts cannot succeed. USAID will attempt to overcome these barriers by working with government agencies and ministries that are involved in energy efficiency. Counterparts include the State Committee on Energy Conservation, the Ministries of Energy, Economy, and Industrial Policy, and the Parliament Commission on Energy Complex. The major approach will be to identify "realistic" policy options that can be adopted quickly.

USAID realizes the importance of combining national policy reforms with local initiatives, particularly in urban areas. USAID will provide assistance to new municipal energy efficiency initiatives by local communities that can reduce energy waste, improve city heat supply services, and enhance environmental quality.

One of the major barriers is the lack of locally produced energy efficient equipment. Many of the products are not domestically manufactured and the high duties and certification barriers prevent imports. The Ukrainian government is increasingly reluctant to permit imports that detract from other goals such as expanding domestic manufacturing production and maintaining domestic employment. Ukraine's economic ability to expand imports is severely limited. USAID will work with private sector producers of energy efficiency equipment. Special attention will be given to activities that enhance domestic capacity to manufacture reliable metering systems, which is the first step to better energy management. Few meters are available on the local markets, and most models are of poor quality that makes reading inaccurate. USAID will promote technology transfer to manufacture modern reliable metering systems through joint ventures and partnership programs with relevant U.S. manufacturing companies and utilities.

District heating in Ukraine is estimated to be about 65% of total heat production which compares to less than 40% in Western Europe. Ukraine's district heating infrastructure was designed to maximize delivery of heat with minimum controls which is the least efficient approach possible. The infrastructure is old and inefficient, resulting in significant losses through production,

transmission, distribution and consumption. Ownership of district heating companies mostly lies with municipalities, with no private sector involvement in the ownership and operation of the infrastructure. Modernization needs be undertaken both at production and end-use. USAID will focus its activities on introducing decentralized management of heat supply to adapt heat supply to customer's needs, and facilitating the introduction of tariffs based on actual heat consumption, which will provide the motivation customers. These activities will improve the financial and operational performance of district heating companies, making possible private sector involvement, improved billing and revenue collection, and a more commercial attitude to customers. USAID may provide assistance to improve the efficiency of heat production and transmission if there is progress on reducing consumption. The accumulative effect of these activities will help achieve significant energy savings that will "make projects pay for themselves" and associated environmental benefits from reduced carbon dioxide emissions.

4 Progress to Date

Since 1995, the Ukraine electric power industry has undergone far reaching reforms. The totally integrated power system was broken up into 35 generation, distribution, and transmission companies. A regulatory mechanism has been established, and commercialization of wholesale markets has been achieved. The World Bank proposed a Financial Recovery Plan (FRP) in 1997 that would enable the power sector to become solvent and self-sustaining. USAID played an active role in supporting the Government of Ukraine's adoption and implementation of the FRP. To date, 18 of 26 of the Plan's covenants have been met, and one other has been partially met.

USAID has been the lead provider of technical assistance to the National Energy Regulatory Commission which is providing fair, transparent, and predictable governance over the electric generation and supply market. NERC is now recognized as a solid institution in the issuance of licenses, regulation of producer-consumer relationships, and formulation of market-based tariffs.

USAID provided assistance to selected coal mines in the development of marketing strategies and business development plans. The western-standard business plan for Krasnolimansaya coal mine has been submitted to EBRD and the World Bank for consideration. Also in the coal sector, USAID played a lead role in promoting health and safety awareness and practices regarding coal bed methane. USAID is promoting the development of CBM as a commercially-viable alternative source of energy. To that end, USAID has identified the key legislative and regulatory issues affecting commercial exploitation of coal bed methane (which has been treated in the past as a hazardous by-product of coal mining with no commercial value). USAID collaborated with the Government of Ukraine in the creation of the Alternative Fuel Center to coordinate CBM activities, including information dissemination on CBM to assist private domestic and foreign interests in securing investment opportunities.

USAID has been active in promoting energy efficiency through a variety of approaches. USAID has supported the Ukraine-US Program to Promote Sustainable Development which identified strategies to improve the policy and legal incentives for market-based mechanisms for energy efficiency. USAID activities also stimulated demand for energy audits provided by private energy

service companies (ESCOs), including facilitating entry by US-based ESCOs into the Ukrainian market. Finally, USAID collaboration with heating companies in the city of Lviv led to the installation by private sector companies of building-level heat delivery systems through condominium and cooperative associations.

5 Program Approaches

At the level of the National Electricity Regulatory Commission, USAID will continue to reinforce the Commission's regulatory authority and enforcement capacity in both the electricity and gas sectors. USAID will provide technical assistance to the NERC to develop concepts for gas and oil regulatory approaches and assist in drafting legislation, rules, and regulations. USAID will also facilitate the redefinition of the structure of the oil and gas sectors, and advise in the creation of markets that define operational rules to wholesalers. USAID will also assist the NERC and other government agencies in the formulation of gas tariffs, and possibly the regulation of tariffs for district heating.

USAID will collaborate with the EBRD and the World Bank in the development and implementation of the Initiative on Private Investment in Ukraine's Gas Transit System. This initiative seeks to create conditions that attract international investment in the transit system linking gas producer and consumer countries along Ukraine's borders. USAID will take the lead in developing and assessing the institutional and management options for ownership and operation of the four gas transit pipelines, identify key elements of the legal and regulatory framework that would mobilize international investment, and recommend a strategy that could form the basis for legislative proposals.

USAID will pursue approaches that result in the privatization of key segments of the energy sector, primarily through activities that enhance the financial viability of pre-privatized companies, and create the organizational conditions required for private strategic investment.

USAID will provide technical assistance and training through partnership arrangements to local electricity distribution companies (LECs) to improve their capacity to increase cash collections. USAID will also assist selected LECs in the development of business and investment plans and attract strategic private investors.

USAID will continue to provide training to the energy companies through the Utility Partnership Program, Management Training Unit and MBA Energy program.

USAID will continue to provide assistance to the Alternative Fuels Center that is promoting the legislative and regulatory changes needed to attract foreign investment into CBM industry in Ukraine.

A major new initiative will be to stimulate the adoption of energy-saving production and consumption techniques by end-users. Based on its previous and current development work in the field of energy efficiency, USAID will focus on demonstration projects in the municipal sector aimed at stimulation of low cost energy saving measures, improvements to local district heating.

systems, collection and dissemination of information on improved thermal performance, and stimulation of the domestic energy efficiency products industry. USAID will collaborate with the EBRD and the World Bank on providing technical assistance on loan preparation for district heating improvements in selected municipalities.

6 Development Partners

The World Bank, which is the other major donor in the power and gas sectors, which is concentrating on policy reform. The Bank has used its policy-based Electricity Market Development Project (EMDP) to help bring about policy improvements. The loan was suspended for more than a year and is expected to be reinstated in December. The Financial Recovery Plan (FRP) is a device to help bring about reinstatement of the EMDP. If the loan is not reinstated, then the Bank will concentrate purely on project financing. Activities in the gas sector are not as well defined, though the Bank and the Government agreed on a program to reform the gas sector. The EBRD is another major donor in the energy sector with several projects underway. It is the lead financier for the completion of two nuclear generating units at Khmelnytski and Rivna (K2R4). The EBRD is looking at the FRP as a test of whether the project will be financially viable. Neither the World Bank nor the EBRD can provide significant technical assistance although both can bring hundreds of millions of dollars in loan funds, as well as creative short term financing by the EBRD. Other donors include the British Know-How-Fund, the Government of Japan, the European Union/TACIS and KHF.

The commitment on the Ukrainian side to the goal of the SO is strong, but there is not complete agreement on the methods and approaches. The NERC is strongly committed to a competitive, market-based system, while the Ministry of Energy contains elements which want to maintain total government control and ownership of the power sector. Many in the Parliament, central government and local government still see power as a service that should be provided at nominal cost, or free if necessary. Of course they have no answers for how to pay for the fuel, equipment and labor costs of the industry. The long period of living off capital and subsidized fuel is coming to an end as all other financing sources are cut off, which will require substantial restructuring of the industry or cuts in service that are likely to be unacceptable. This situation probably will result in support for a market-based, sustainable system because there will be no viable alternative.

Ukraine SO 15

SO15 A more economically sustainable and environmentally sound energy sector

Timeframe 0-6

IR151 Improved regulatory environment for the energy sector

IR152 Development of a competitive financially sustainable energy production and delivery system

IR153 More efficient and effective utilization of energy

1511 Fully functional independent National Energy Regulatory Commission (NERC)

1512 A market based regulatory system for electricity

1513 A market-based regulatory system for oil and gas

1514 An independent wholesale electricity market operation

1515 Legal and regulatory framework to promote coalbed methane

1521 Increased commercialization of energy companies

1522 Effective privatization and financing of energy companies

1523 More economic fuel supply

1531 Development of a market for energy measurement and conservation equipment

1532 Improved efficiency of energy production and consumption by communal services

Strategic Objective 2.1

Increased Better-Informed Citizen Participation in Political and Economic Processes

1 Statement of the Strategic Objective

For democracy to succeed, well-informed citizens must participate in the political and economic decision-making processes. Active non-governmental organizations (NGO), an independent and unrestricted press, and free elections are all essential for citizens to make informed decisions and to participate. This strategic objective contributes to Ukraine's transition to a market-based democracy by strengthening these essential elements of democracy. An active civil society will also contribute to the broader reform process. NGOs or citizens who demand transparency and accountability would create a counterbalance to Ukraine's largely corrupt and erratic reform process. This strategic objective will also help empower Ukrainian citizens to participate in and drive forward Ukraine's political and economic transitions.

USAID/Kiev will consider progress towards the achievement of this strategic objective on track if public attitudes towards participation begin to change and more citizens strive to become involved. In addition, media support programs will be progressing satisfactorily if non-state media approach financial sustainability and are free from blatant government attempts to restrict freedom of speech.

2 Problem Analysis

In Ukraine, progress towards democratization is being made, albeit slowly and with difficulties. Independent newspapers, radio stations, and local television stations exist, but continue to face considerable obstacles. NGOs are forming rapidly and associations of NGOs are emerging in some cities. However, the absence of enabling legislation and citizens' inexperience with civil society continue to limit the development of citizen participation. Ukraine has held national elections under a generally adequate legal and administrative framework, but shortcomings have reduced citizen confidence in the fairness of those elections.

Attitudes towards the participation, rights and responsibilities of citizens, and the caretaker role of government are largely unchanged since Soviet times. Citizens associate democratic and economic reforms with social insecurity, rising crime rates, and ubiquitous corruption at all levels of government. Partial reforms have allowed elite and powerful interests to profit from the lack of transparency, competitiveness, and enforcement of contracts. The majority of the population has been unable--or sometimes simply unwilling--to demand changes that counter such trends. Moreover, even where legislation is clear, political processes are often conducted behind closed doors, and individual rights are ignored. These conditions have undermined citizens' confidence in the political process. With government largely run by former members of the Soviet nomenclatura, many citizens are skeptical of the benefits that "democracy" has brought. Furthermore, the worsening economic situation and the general decline in living standards for the

majority of citizens also inhibits citizen participation, as individuals find little disposable time or income to spend on activities other than meeting minimum economic needs

Those democratic reforms that have occurred have been implemented from above, rather than from the grass-roots. While this is a necessary impetus for reform, it is not enough. "Bottom up" pressure and change is essential for the ultimate success of democracy. NGOs in Ukraine, however, find it difficult to enlist public support due both to government reluctance to include civil society organizations in public-policy debates as well as apathy and lack of understanding of the role of civil society among citizens. In these circumstances, citizen participation in political and economic processes is extremely low.

A further constraint to increased citizen participation is the increasing control of the independent media by the government. The working environment for journalists has grown increasingly difficult in the past two years. Newspapers have been closed down, TV programs have been censored, and editors and journalists have been harassed, threatened and killed. Self-censorship is commonplace, further limiting the amount of objective information available to citizens. Violations of press freedoms were notably apparent during the parliamentary elections in March 1998, leading many to project that the situation will not improve prior to the presidential elections in 1999.

Finally, the worsening economic situation has made it difficult for independent media and NGOs to become financially self-sustaining. Citizens are often too busy trying to make ends meet and have neither the time to participate in civil society nor the resources to invest in NGOs or purchase newspapers.

3 Results Framework

Transition Hypothesis

Strategic Objective 2.1 is working to overcome the obstacles, detailed above, to greater citizen involvement in the political process and to facilitate citizens' oversight of government institutions. This will be done by supporting both the active participation of citizens in political and economic decision-making and the availability of reliable sources of information. Achievement of this SO will help Ukrainians play an active role in supporting the political and economic transitions underway.

Critical Assumptions

- (1) The government of Ukraine will maintain a minimum level of commitment to general reforms.
- (2) The government of Ukraine will continue to aspire to meet the criteria of Council of Europe Membership.

As of the drafting of this strategy, both of these critical assumptions hold. Although the

government has not embraced democratic reforms as fully as it could, and despite some serious set-backs for the independent press, the operating environment is not overtly hostile towards civil society. If conditions change dramatically and these critical assumptions fail to hold, USAID/Kiev will be compelled to reconsider its activities.

Causal Linkages

Progress towards the achievement of this strategic objective will be assessed by the percentage of citizens who understand democratic political processes and who make a concerted effort to participate. Nation-wide surveys of public opinion will be used to report on the following indicators:

- The percentage of citizens who understand the (democratic) political process, and
- The number of people who report that they participate in NGOs

Current levels of understanding and participation are extremely low. USAID/Kiev will consider SO 2.1 on track if opinion polls report an increase in both indicators, confirming that citizens are becoming more aware and willing to participate in political processes.

The main obstacles to greater citizen participation in Ukraine, as outlined in the problem analysis, are (1) a lack of confidence in the political process which leads to apathy, and (2) a lack of useful and unbiased information available to citizens. Though the economic situation also inhibits greater citizen participation, this problem is being addressed primarily through other SOs. USAID programs will support efforts by citizens and NGOs to influence the political process and uphold citizens' rights. When such activities are successful, and when free and fair elections are regularly held, citizens' trust and confidence in the system is built, and citizens are more likely to participate. The development of objective and independent sources of news and information, and more transparency in government decision-making are the other vital components of effective citizen participation. Accordingly, the following intermediate results, considered priorities by USAID and stakeholders, are critical to achieving the strategic objectives:

IR 2.1.1 Increased Confidence in the Political Process

The low level of confidence in the political process among citizens of Ukraine undermines their desire to participate. Citizens' participation will increase when Ukrainians begin to see clear examples that participating in civil society can lead to positive results. It is necessary, therefore, to support active and informed civic and advocacy organizations and to publicize any successful outcomes of their efforts. As citizens begin to believe that their rights will be upheld and see the benefits of participation, and as elections create a mechanism for broader accountability, citizens' confidence in the political process will increase.

IR 2.1.2 More Unbiased Public Information Available to Citizens

Citizens must have access to reliable information to inform their participation in democratic

political processes. Their access to information requires both increased transparency on the part of the government, and more effective unbiased news coverage by the mass media. Encouraging government transparency, greater availability of objective information, and more effective non-state mass media will help ensure that citizens have access to unbiased information upon which to base their political activity.

Contribution of other Strategic Objectives

Programs that increase citizens' participation and government responsiveness at the local level under SO 2.3 and that support NGO legislation and strengthen NGO capacity under SO 3.2 also contribute to the achievement of SO 2.1. Similarly, enhancing the rule of law under SO 2.2 is a vital link to building citizens' confidence in the political process, overcoming apathy, and, accordingly, encouraging greater citizen participation. Finally, the success of strategic objectives in other sectors, such as support to small and medium enterprises under SO 1.3, address some of the economic barriers to broader citizen participation. The intermediate results identified above, together with the contributions of other strategic objectives, provide a comprehensive strategy to increase the level of citizen participation in political and economic decision-making.

4 Program Approaches and Progress to Date

During the next four years, USAID/Kiev will continue to build upon achievements to date. The focus of activity will shift slightly to place greater emphasis on work with NGOs that enforce citizens' rights and demonstrate to citizens that their rights can be upheld and their concerns addressed through participation in the political processes. In addition, election support will be phased down after the 1999 presidential elections.

Ukraine has made some progress in its democratic transition. Since 1991, the number of non-governmental organizations (NGOs) has grown significantly. The number of independent newspapers that compete with the government press has also increased. Ukraine was the first post-Soviet state to undergo a peaceful transfer of presidential power following free and fair elections in 1994. In 1996, the adoption of the Constitution and the subsequent establishment of the Constitutional Court created a basis for adopting and implementing reform legislation. With USAID support, thousands of Ukrainians, including judges, journalists, attorneys, newspaper managers, political party activists, NGO leaders, civic activists, legislative drafters, municipal government leaders, law faculties, and trade union leaders, have received training that is contributing to their efforts to support democratic reform.

NGOs and citizens' awareness of rights

USAID will continue to support NGOs that pursue issues that have an impact on people's lives, particularly by influencing political process and upholding citizens' rights. Their successes will demonstrate to citizens that their rights can be protected and their concerns addressed through participation in democratic political processes. These NGOs will also play an important role in informing people about their rights and opportunities to participate.

This approach has proved successful. One USAID project, for example, supports a coalition of environmental NGOs that attempt to hold government accountable to environmental and public participation laws. The resulting efforts by citizens and NGOs to use their rights under the law have had a rather high success rate, advancing an issue of primary concern to citizens while increasing their confidence in the political process and legal system.

Legal advice to democratic trade unions has resulted in the successful resolution of several cases by trade union members. For example, the courts ordered an enterprise to reinstate and compensate the chairman of an independent trade union who had been fired for his union activities. Independent trade unions have also received training and information in collective bargaining, workplace safety, and pension reform. Similar legal advice and training is being provided to journalists, editors, and media lawyers under a media legal advocacy program.

Public policy, legal advocacy, and human rights NGOs have been strengthened through training and small grants, enabling them to advocate on behalf of citizens, produce informational bulletins and TV programs, conduct regular and well-publicized opinion polls, and investigate human rights violations. Women's NGOs have received assistance that has helped them address key issues such as domestic violence, inequality, and women's entrepreneurship.

Elections, another important component of democratic political processes, provide citizens an opportunity to hold the leadership accountable and create incentives for government to be more responsive to citizens' demands. USAID/Kiev has assisted the government with election administration and voter education. Political party activists have received training in campaign management, coalition-building, and fund raising. USAID/Kiev has supported their efforts to be active and informed participants in the constitutional debate and the drafting of new election laws. A new parliamentary election law was adopted and implemented for the March 1998 elections. This law contributed to greater representation in the parliament, cost savings through elimination of repeat and run-off rounds, and further development of national political parties.

USAID/Kiev provided comprehensive assistance prior to the March 1998 elections, including support for political party debates, voter education programs, and training for CEC officials. In addition, get-out-the-vote efforts contributed to youth voter turnout almost equal to that of all other age groups and USAID also supported an election observation effort by 17,000 non-partisan domestic monitors, the first independent election night news program, and an exit poll. These efforts contributed to relatively smooth election administration despite new changes to voting procedures under the new election law.

USAID will provide some assistance to promote transparency and fair administration of the upcoming presidential elections, however, as noted above, election assistance will be tapered off after 1999.

Independent Media

Television, radio, and print professionals will continue to receive training in business management, investigative journalism and other technical areas. A USAID-funded press center is providing journalists with access to a wide range of resources including the Internet, legal databases, and Ukrainian and Western wire services. In addition, USAID provided technical assistance to a loan fund that was established to support the development of self-sustaining and independent media-related enterprises. In response to the growing constraints on independent journalism, a new activity was initiated to provide legal protection to journalists and to monitor legal actions and persecution against the media. This program will fund lawyers who advise or represent individual journalists and will support lobbying efforts for legislative acts that support an independent press.

Programs to encourage government accountability through increased availability of information to the media have proved successful. Within the Public Education Program, a network of 25 press clubs has been developed throughout Ukraine where journalists meet on a regular basis with government officials to discuss issues such as privatization and economic reform. The weekly meetings at the Kyiv Press club are covered in newspapers, radio, and national television news programs, allowing government officials to reach a large audience while promoting the accountability of officials to the public.

5 Development Partners

Several other donors are currently providing grants to NGOs. Their efforts complement USAID's support to civil society and give additional NGOs an opportunity to expand activities that provide citizens with examples of the benefits of civic action. USAID leads or participates in donor meetings to coordinate assistance for NGOs, independent media, and elections.

6 Graduation and Sustainability

USAID/Kiev recognizes that both the political and economic transitions underway in Ukraine are likely to take generations to be achieved. Although it is too soon to speak about either graduation or sustainability, what is clear is that expanding citizen participation in both the political and economic transitions will move Ukraine forward towards eventual graduation. In addition, increased empowerment that enables Ukrainians to lead the reform process will help ensure that the changes introduced will ultimately be sustainable.

Ukraine SO 2 1

SO2 1 Increased, better-informed citizens' participation in political and economic decision-making

 Time frame 0-6

IR2 1 1 Increased confidence in the political process

 Time frame 0-6
 Partners all below

IR2 1 2 More unbiased public information available to citizens

 Time frame 0-6
 Partners all below

2 1 1 1 Increased perception that citizens rights are upheld

 Time frame 0-6
 Partners Ukraine Legal Foundation MOJ

2 1 1 2 Citizenry and NGOs influence the political process

 Time frame 1-6
 Partners Eurasia UNDP TACIS EE British Knowhow Fund

2 1 1 3 Elections are free and fair

 Time frame 0-6
 Partners Elections Canada CEC OSCE CE TACIS

2 1 2 1 From SO 2 3 Transparency of government operations increased

 Time frame 0-6
 Partners GOU Executive Admin CIDA, Rada committees

2 1 2 2 Readily available public information repositories established

 Time frame 0-6
 Partners Soros Eurasia Renaissance Foundation

2 1 1 1 1 Citizens & NGOs successfully advocate on behalf of citizen interests

 Time frame 0-6
 Partners Germany Eurasia CE CIDA UNDP British Knowhow Fund

2 1 1 2 1 (SO 3 2) Improved legal framework for NGOs

 Time frame 2
 Partners Soros Rada Legal Reform Committee

2 1 1 3 1 Informed electorate

 Time frame 0-6
 Partners British Knowhow Fund

2 1 2 1 1 From SO 2 3 Citizens access to decision-making for ensured

 Time frame 0-6
 Partners Municipal Government Council of Advisors Pytyp Ortyk CIDA

2 1 2 3 Better independent news coverage

 Time frame 0-6
 Partners Dutch Soros Eurasia

2 1 1 1 2 Citizenry aware of rights

 Time frame 0-6
 Partners Ukraine Legal Foundation MOJ

2 1 1 3 2 More transparent electoral administration

 Time frame 0-6
 Partner Elections Canada CIDA CE

2 1 1 3 3 Improved legal framework for political parties and election administration

 Time frame 1
 Partners Rada Legal Reform committee

Critical Assumption
 1 The government will maintain a minimum level of commitment to general reforms
 2 The government will continue to aspire to meet the criteria of Council of Europe Membership

Strategic Objective 2.2

Legal Systems that Better Support Democratic Processes and Market Reforms

1 Statement of the Strategic Objective

The establishment of and respect for rule of law is essential to the success of market-oriented democratic systems. Ukraine, like other former Soviet republics, is striving to overcome a 70-year history of communist rule where law was subverted to the dictates of the party leadership and the population had little expectation of the State as guarantor of rights. While the country has made tangible progress since independence in enacting legislation and instituting policy reforms, the challenge of creating an entirely new, Western-oriented legal system and transforming the existing political-legal culture is enormous. The Government of Ukraine's uneven commitment to far-reaching reform of the country's legal system not only retards economic growth by discouraging investment, it also poses a serious long-term threat to the democratic order as citizens come to question the integrity and legitimacy of poorly functioning political institutions.

USAID/Ukraine has developed a strategy that is assisting the relevant institutions and actors to lay the groundwork for a law-based system compatible with the requirements of a market economy and democratic rule. The Mission will consider this objective having been achieved when the laws needed to support free-market democracy are in place and effectively enforced through fair and timely judicial processes.

2 Problem Analysis

Overcoming the institutional and social-psychological legacy of the Communist past in order to erect a legal system that supports free-market democracy is a formidable, long-term undertaking. At the time of independence, Ukraine's governing elite lacked both the knowledge and technical capability to put in place a modern legal system appropriate to the demands of the market-oriented, democratic society they professed to want to build. It also became clear that as corruption flourished in the transition away from central planning, and in the absence of effective regulatory and enforcement mechanisms, entrenched interests hostile to the establishment of the rule of law began to coalesce. The GOU itself was hobbled by institutional and political conflicts that slowed the pace of reform, including reform of the legal system.

Citizens, meanwhile, had little understanding of their democratic rights or of their newly acquired responsibility to hold government accountable for the fair administration of justice. During the Soviet era, people survived by finding clever ways to circumvent the rules, the arbitrary application of which only added to a general disrespect for law and lack of confidence in the government's commitment to safeguard citizens' rights enshrined in the Constitution.

Widespread cynicism on the part of a population that is disenchanted with the changes taking place during this transition period is arguably the greatest impediment to the creation of a well-functioning legal system. Citizens see corruption in virtually every aspect of public and private life and a legal (and political) system that continues to favor those who already have

acquired wealth and power, often through questionable means. The Kuchma Government's recent action to close down and otherwise intimidate a number of publications critical of its policies is an abuse of authority that vividly reinforces the perception that Ukraine is not a law-governed society. So too, the enormous gulf between reform-inspired legislation and pronouncements on the one hand, and the lack of effective implementation and enforcement on the other, has contributed substantially to low levels of citizen confidence in public (as well as private) institutions. Heightened expectations about the onset of a law-based society that accompanied the collapse of communism have largely been dashed, deepening the level of cynicism.

While the new constitution established the judiciary as an independent branch of government with sole responsibility for administering justice, the courts continue to confront formidable obstacles --material, institutional, and political-- to fulfilling that role. Inadequate budgetary resources and insufficient training of judges, including poor access to new laws and legal decisions, together with low levels of citizen confidence in the basic legal system and a high degree of Executive Branch influence on the judiciary undermine the effectiveness and authority of the courts.

A more immediate constraint on progress in achieving this strategic objective is the presidential election scheduled for October 1999. With political factions already jockeying for partisan advantage, it will be difficult for the parliament to adopt much of the constitution-related enabling legislation that is desperately needed.

3 Results Framework

Critical Assumptions

The paramount critical assumption with respect to significant progress on the strategic objective remains the existence of requisite political will within the national government to take steps to strengthen the country's nascent legal and regulatory infrastructure and to ensure the impartial application and enforcement of Ukraine's civil and criminal laws. Achieving the SO is also predicated on the GOU, in cooperation with Western law enforcement agencies such as the U.S. Department of Justice, devoting additional resources to bolstering the capacity of the judicial system and to combating corruption. Any genuine commitment to establish a law-based society must unite demonstrated political will and sufficient resources.

Causal Linkages

Constructing a legal system required for a modern democratic, market-oriented nation will depend on erecting a legal infrastructure consisting of effective institutions and well-crafted and fairly-enforced laws. The achievement of four intermediate results is crucial to fulfilling this strategic objective: establishing a well-functioning court system, enactment of key legislation codifying civil and criminal codes based on Western norms and practices, effective enforcement of laws and legal decisions, and a citizenry prepared to hold the government accountable for observing the law and safeguarding people's rights. These results, in turn, require elevating the capabilities of legislators and judges (through training and related technical assistance) while also increasing citizens' awareness of laws and rights and ensuring their access to competent legal counsel. Ultimately, the sustainability of the new system will depend on both performance and the

emergence of a broader legal culture where laws are obeyed because they are viewed as fair and legitimate (and not primarily because transgressions are punished)

IR 2 2 1 Courts Carry out Their Role as Ascribed to Them by Law

A well-functioning court system that garners the confidence of the citizenry is the central pillar of an effective legal system. This entails the judiciary fulfilling its constitutional role as an independent branch of government which depends largely on its acquiring the institutional capability to discharge its responsibilities. Upgrading the level of juridical knowledge and skills of sitting judges and staff, and improving the courts' capacity to operate independently is essential. Training, support for the new judicial training center, procurement of legal databases and other resources, and technical assistance in improving court management all contribute to strengthening judicial independence, especially given the limited budgets allocated to the courts by the government and the lingering practice of executive branch and other influence on judicial decisions.

IR 2 2 2 Constitution, Civil and Criminal Codes, and Supporting Legislation Meeting Western Standards are Enacted

Ukraine still lacks a post-Soviet civil code, civil procedure code, and other fundamental legislation essential for economic and democratic reform, as well as certain legislation that is necessary to meet Council of Europe membership requirements. Furthermore, there are significant shortcomings in the institutions and processes for drafting, adopting, and implementing such legislation. USAID activities address these shortcomings in many ways by providing targeted support for specific legislative drafting working groups, a program to strengthen parliament's analytical and legislative drafting capabilities for more effective participation in national policy debates, training for parliamentarians and staff on specific reform topics as well as on ways to improve parliamentary rules, procedures, and structure, improving the professional capabilities of parliamentary staff, encouraging greater responsiveness to individual constituents and NGOs/citizens groups, and support to non-governmental public-policy and advocacy organizations that are attempting to influence legislation.

IR 2 2 3 Citizens Hold Government Accountable to the Law

At the same time that USAID is augmenting the capabilities of key government institutions involved in the creation of a Western-oriented legal system, it is also seeking to reform that system by empowering citizens who are generating pressure for adherence to the rule of law. Even the existence of an independent court system and adequate legislation would be insufficient to ensure the establishment of a rule of law-based society in Ukraine in the near future. Selective application of laws and lack of enforcement of judicial decisions result in very little accountability of corrupt and illegal actions, which in turn reinforces citizen apathy. An active citizenry pressuring the GOU to fulfill its responsibility in establishing the rule of law is particularly important in the early stages of the formation of the legal system, and USAID will place increasing emphasis on programs that empower citizens and NGOs to have their legal rights enforced and to hold others accountable to the law. Activities to achieve this goal include support to legal advocacy NGOs, business associations, consumer and special interest groups, *pro bono*

legal clinics, legal support centers for non-state media and independent trade unions, and associations of advocates (defense attorneys) This support takes the form of small grants, training, and technical assistance, as well as a successful program to publicize legal information, the availability of legal services, and successful examples of legal advocacy in the media Yet another initiative that may be replicated is the organization of integrity-building workshops in municipalities that have active citizen groups and a certain degree of political will to address corruption issues The workshops bring together business, media, NGOs and local government officials to develop anti-corruption action plans that all participants believe are attainable and that they have committed to implementing Public-private committees are then established to follow through on implementation of the action plan, drawing on support from a wide variety of existing USG assistance programs In sum, USAID activities will continue to promote the development of the rule of law in Ukraine through a combination of increased public awareness of laws, increased access to qualified lawyers and legal services, increased and more efficient actions by legal rights and advocacy NGOs, and widespread dissemination of examples of citizens successfully using the courts and legal system to uphold their rights and hold government accountable to the law

IR 2 2 4 Improved Enforcement of Judicial Decisions and Criminal Laws

Without effective enforcement of laws and legal decisions there is no prospect of establishing a functioning law-based system and increasing citizen confidence in the integrity of the judiciary In addition to the requisite political will on the part of the government to ensure compliance with the law, agencies responsible for enforcement require adequate resources and know-how to carry out their function The US Department of Justice is integrally involved in this last endeavor and its success will help determine the fate of the entire rule of law effort in Ukraine

Because the rule of law provides the foundation for a sustainable market-based democracy it is not surprising that this Strategic Objective and its complement of intermediate results are closely linked with others across the entire assistance portfolio What follows are some of the more prominent linkages

Additional linkages with IRs from other SOs

SO 1 3 A functioning legal system is indispensable to the establishment of a legal and regulatory environment necessary to support the growth of private enterprise Would-be domestic and foreign investors need to feel confident that legal rights and responsibilities are clearly delineated and that disagreements can be adjudicated fairly (and judgments enforced) in accordance with the law, in the court system

SO 2 1 Increasing citizen participation in the political process requires that people have a degree of confidence in their ability to effect change Corruption and a government's inability or unwillingness to enforce the law fairly is likely to spawn intense cynicism and convince citizens they are powerless to do anything to alter the situation Activities under SO 2 1 to strengthen both advocacy-oriented NGOs and independent media contribute to a more engaged civil society determined to hold the three branches of government accountable for their actions Much of what has become public about high-level government corruption and abuse of power is the result of investigative reporting by enterprising journalists in the independent press

Special Initiative on Sexual Trafficking The effort to combat the trafficking of Ukrainian women has an important legal component focused on training for those government agencies with responsibility for law enforcement along with public education on legal rights aimed at both would-be and actual victims of sexual trafficking. A functioning court system and effective law enforcement are both pivotal to the success of the anti-trafficking effort.

Women's Legal Rights Initiative A new program funded by the Global Bureau's Office of Women in Development (G/WID) to promote awareness and realization of women's legal rights will be starting in Ukraine, Bulgaria, and Kazakhstan. Activities designed to increase public awareness of women's rights, strengthen the capacity of relevant NGOs to advocate effectively on these issues, and to work with appropriate government agencies to safeguard these rights, contribute to the establishment of a robust legal regime.

Corruption The battle against corruption has taken on greater priority in the Mission's assistance strategy as corruption, whether in the public or private realm, has come to be viewed as one of the paramount constraints on Ukraine's political and economic development. A professional and well-functioning judiciary committed to the fair application of law --the core IR of SO 2 2-- would constitute a major victory in the struggle to establish the rule of law in Ukraine. A number of activities being pursued under other SOs are explicitly designed to enhance transparency, reduce corruption, and thereby contribute to the emergence of a law-based society.

4 Progress to Date

The foundation for a Western-based legal system was laid with the adoption in 1996 of Ukraine's new post-Soviet constitution, a generally progressive document that guarantees citizens an impressive set of rights and establishes the structures of national government. That adoption of companion enabling legislation such as an updated civil code has lagged, that endemic corruption has produced tremendous cynicism in the population, and that the judiciary faces serious hurdles --material, institutional and political-- in fulfilling its constitutional role as an independent branch of government overseeing the administration of justice, all point to the enormity of the task in putting in place a legal system suited to the needs of a modern democratic, free-market system. Transforming institutions and mindsets is a long-term undertaking.

Still, since independence and the dissolution of the Soviet Union, Ukraine has made important headway in establishing the rule of law. Formation of a Constitutional Court, creation of a judicial training center, computerization of court administration and installation of electronic legal data bases, widespread dissemination of legal information such as citizens' rights, introduction of mechanisms for alternative dispute resolution, reform of law school curricula, improvement in the education of legal professionals, and more widely available legal advocacy and representation for citizens, all underscore the country's progress in the rule of law sphere. Not coincidentally, these are areas in which USAID as well as other Western donors have been active, providing technical assistance, training, and other assistance.

But progress registered on discrete activities does not provide a full picture of the changes, some admittedly difficult to measure, that have begun to take hold in erecting a legal system more

supportive of democratic processes and market reforms. Though the Constitution establishes an independent judiciary, judges have only recently begun to see themselves part of an independent, co-equal branch of government. The same can be said for members of the Verkhovna Rada. Despite the inefficiency of its internal procedures and its lukewarm support for economic reform, parliament is also emerging as a prominent actor in national policy making. In both cases, USAID and other donor-supported programs to bolster the institutional capacity of the courts (e.g. judicial training center) and the parliament (legislative drafting and analysis) have contributed to this emerging sense that these bodies should have a co-equal role in the governing process.

The norm of free and fair (though by no means perfect) elections has also taken hold. Not only have citizens come to expect and demand an electoral process with integrity, but legislators and political leaders from across the ideological spectrum view the ballot box as the only legitimate path to power.

But the change that may have the most profound long-term consequences is the increasing incidence of citizens, primarily through NGOs, using the court system to hold government authorities, particularly at the local level, accountable for observing the rule of law. For example, one USAID project supports a coalition of environmental NGOs that attempts to hold government accountable to environmental and public participation laws. The resulting efforts by citizens and NGOs to use their rights under the law have had a rather high success rate, advancing an issue of primary concern to citizens while increasing their confidence in the political process and legal system. Similar projects that provide legal and advocacy support to journalists, members of independent trade unions, and special interest groups such as consumer and business associations, have had impressive, albeit limited, success. This trend has been greatly abetted by growing awareness on the part of citizens about the law, and by the expanding supply of competent legal representation and increased citizen access, in part through USAID-supported pro bono legal clinics. An ever larger number of NGOs in areas such as consumer rights, human rights, environment, and small business, is involved in legal advocacy.

5 Program Approaches

As described above, the Mission has developed a multi-faceted yet focused strategy for helping Ukrainian constituencies put in place a legal system consistent with the requirements of a modern, free-market democratic society. It should also be noted that the Mission will be carrying out a rule of law assessment in the next few months. While no major changes are expected in the SO 2 2 strategy, the Mission will use the assessment to refine its programs under this S O

USAID will continue to emphasize strengthening the institutional capacity of the courts and the parliament to assist these branches of government to fulfill their constitutionally-established role in the national political process. Activities to bolster the effectiveness of the court system, through training of judges, targeted technical assistance, and limited equipment purchases (e.g. computerization and access to legal databases), constitute the centerpiece of USAID's broader effort to reform Ukraine's legal system.

At the same time that USAID is augmenting the capabilities of key government institutions involved in the creation of a Western-oriented legal system, it is also seeking to reform that

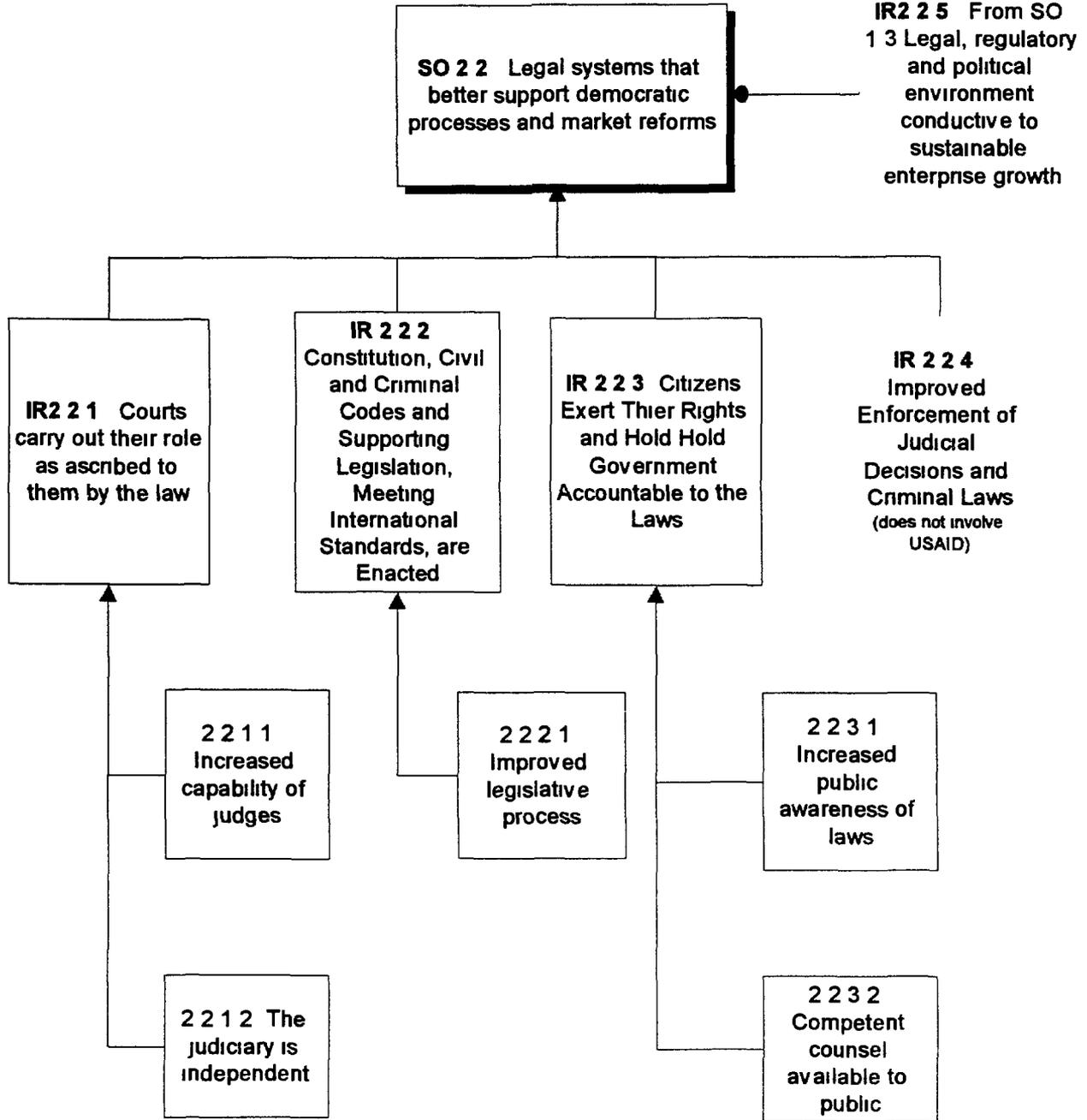
system by empowering citizens who are generating pressure for adherence to the rule of law. USAID will extend and expand the various activities that have supported citizen and NGO efforts to hold government accountable to the law. This includes targeted legal assistance to groups such as journalists, broader support for pro bono clinics at law schools, small grants for legal advocacy NGOs, and support for indigenous media programs that provide practical legal information and encourage greater citizen participation in demanding accountability under the rule of law.

In sum, through its efforts to bolster the capacity of critical institutions, most notably the courts and parliament, and its support for a number of legal reform programs involving government-to-government and society-to-society linkages, USAID is facilitating the transmission of knowledge, practices, norms, and values that undergird a rule of law-based society.

6 Development Partners

USAID continues to coordinate with the World Bank, EU/TACIS, OSCE, and other donors on legal reform issues. Most notably, USAID/Ukraine's programs are designed to complement the proposed World Bank Legal Reform loan which has been under negotiation for several years. USAID organizes and participates in donor meetings to coordinate assistance to the courts, parliament, and specific legislative drafting initiatives. Coordination meetings often include Ukrainian government counterparts as well as NGO development partners such as the Ukrainian Legal Foundation.

Ukraine SO 2 2



Critical assumptions

- 1 Political will for legal/regulatory infrastructure strengthening and impartial application and enforcement of laws
- 2 Adequate resources devoted to strengthening the capacity of judicial system and to combating corruption

Strategic Objective 2.3

More Effective, Responsive and Accountable Local Government

1 Statement of the Strategic Objective

Improving the capacity of local governments to manage resources and provide services is crucial to the success and sustainability of Ukraine's overall reform effort. Assistance at the local level has not only visible impact on people's lives, but also improves public perceptions of and experience with democracy and economic reform. In cities, towns and villages, the interaction between citizens and government is most vigorous. There is evidence that local governments with the capacity to exercise well-informed choices in partnership with citizens and civil society can solve problems, identify and maximize opportunities, narrow the gap between resources and responsibilities, and engage the central government on policies that encourage local initiative. In fact, the recent IFES Survey, conducted in the spring of 1998 by SOCIS-Gallup, indicated that from 1997 to 1998, there was a 14% increase (from 2% to 16%) of citizens who indicated that local government is the most likely branch of government to resolve the economic problems facing Ukraine in the next year. This may very well be an indication that public confidence in local government officials is growing.

Much of USAID/Kiev's programs that support democratization, housing, finance, privatization and private enterprise, environment, health, and training have taken place in or directly benefitted cities or towns. In 395 Ukrainian communities, USAID/Kiev is working at the grassroots level with citizens, NGOs and local governments to bring about positive change. More than 1000 community-based activities help to build responsive, well-run communities and increase public confidence not only in local government but also in the transition to a free-market economy and democratic society. These efforts help bring about tangible improvements in people's lives. Strengthening local government capacity and encouraging citizen participation at the community level under SO 2.3 is the key to the sustainability of these efforts.

USAID/Kiev will consider progress towards the achievement of this strategic objective on track as targeted local governments and citizens begin to work together to solve priority community problems and to identify opportunities for future development. These efforts will help bring about tangible improvements in service delivery. Sharing positive experience and lessons learned with other local governments in Ukraine and in the region will facilitate the duplication of effective approaches in other localities, enabling a broader impact of USAID programming.

2 Problem Analysis

A range of problems needs to be addressed in order to improve the potential for local government. These include

Insufficient capacity of local governments No guidelines or training for local officials from the central government have accompanied the transfer of responsibilities and powers to the local level. As a result, the leadership of many municipalities lacks the basic skills and capacity

necessary to manage resources and assets or provide urban services effectively. Local governments need to obtain basic skills in strategic planning, improved administration, financial management and the identification of new sources of revenue.

Inadequate authority and resource base The Law on Local Self-Governments, adopted in July 1997, gave localities more direct control over tariffs and the supply of municipal services. Although this law was a very important step forward, numerous additional acts must be passed and implemented to provide local governments with adequate tax and budgetary authority. For example, local governments still lack a workable legal, regulatory, and institutional framework for titling and registering real property. Revenue shortfalls and inadequate fiscal autonomy are further complicated by unclear divisions of fiscal responsibility and systems of deregulation between oblast and local level governments. A fair, transparent and predictable intergovernmental transfer system is necessary for municipalities to plan and budget.

Lack of citizen participation Ukraine does not have a history of active citizen participation. Consequently, local governments have little experience with democratic processes and citizen outreach. Some local governments also view NGOs as a threat and do not see the potential for NGOs to contribute to the solution of local problems. At the same time, citizens are often apathetic, do not understand their civic responsibilities, and have neither the time, nor the resources, to participate in civil society.

Finally, the current fiscal crisis afflicts all levels of government, including municipalities. Local governments cannot rely on receiving adequate funding from the national government and need to become more cost effective while also identifying new sources of revenue. This requires not only further local control over taxes and tariffs, but also the elimination of disincentives to increasing local revenue.

3 Results Framework

Transition Hypothesis

At the heart of the transition strategy for local government is the premise that democracy built from the ground up nurtures transparent, effective and accountable governance and meaningful advocacy and action on community interests. Through SO 2.3, USAID is helping to strengthen local government by improving their management skills, increasing their autonomy and resource base, and demonstrating the value of citizens' participation and government transparency.

Critical Assumptions

- (1) Continued commitment of the Government of Ukraine to increasing local level authority and fiscal decentralization
- (2) Current and new laws, regulations and policies on fiscal decentralization and local self-government will be implemented
- (3) Oblast level officials will not interfere with local level authority and decisions

Despite shortcomings in the legal framework for local government, there is currently potential for local level initiative, as demonstrated by the success of USAID/Kiev's local government program to date. However, the adoption and implementation of legislation that creates a clear delineation of powers and a transparent intergovernmental distribution of revenues will help realize this potential as well as significantly increase the likelihood of sustainability.

Causal Linkages

Progress towards the achievement of this strategic objective will be measured by

- The number of cities using financial analysis models

Computerized Financial Analysis Models (developed through USAID programs) provide municipalities with a clear picture of the current and projected state of local finances (revenues and operational and capital expenditures). This information enables local authorities to manage their resources and assets more effectively, both in the short and long term. In addition, local decision-makers are able to present the local budget to citizens in an easily understandable format. This facilitates local government transparency and accountability that encourages citizens to participate and enables local authorities to be responsive.

The financial analysis model has also been used successfully by local governments to remedy shortfalls in financial distribution from the national government and as such can be used to ensure more reliable revenue distribution. The program is a flexible, user-friendly model that can be amended and modified in accordance with the specific needs of municipal governments and changes in legislation. Data provided through the financial analysis model has also considerably strengthened the position of the Ukrainian Association of Cities (UAC) in its efforts to increase local government financial autonomy and establish a more transparent intergovernmental distribution of financial resources. Finally, the spread of financial analysis models to more than 50 non-USAID assisted municipalities helps capture the roll-out effect of USAID programming. Accordingly, USAID/Kiev considers the growth in the number of cities using financial analysis models to be a useful indicator of more effective, responsive and accountable local government.

USAID has identified the following four intermediate results as necessary to achieve "More effective, responsive and accountable local government." Each of these IRs addresses shortcomings outlined in the "Problem Analysis" section.

IR 2.3.1 Improved Management

Ukraine's transition to a democratic political system and market economy requires a complete change in the way local authorities manage city finances and administration, as well as municipal services and assets. Rather than wait for guidance and resources from the center, they are being given increased responsibility, often with little guidance and resources, and, accordingly, need to develop new skills to take the initiative themselves. They must learn how to plan and prioritize strategically, manage the local budget, develop business and investment/financing plans, and improve their management of municipal services and assets. As their capacity increases, local leaders, in collaboration with the citizens, will be able to better identify and meet the needs of the

community and will be more able to make an impact on the daily lives of the population

IR 2 3 2 Legal Sustainability Ensured

The potential impact of even the most skilled local leaders will be limited as long as the legal framework for local self-government remains unclear and denies local government access to predictable, fair and transparent sources of revenue. Local governments in Ukraine have had responsibilities thrust upon them without the necessary legal authority or a financial devolution. The development of a well-defined legal framework, and one that is in accordance with the Council of Europe Charter of Local Self Government, that provides local government with authority and resources is therefore also central to strengthening local government in Ukraine.

IR 2 3 3 Citizen Participation at the local level institutionalized

The transition to a democratic political system requires not only that local officials have the capacity to manage their resources and assets effectively, but also that they introduce mechanisms for citizen participation, ensure access to public hearings and other decision-making fora, and support NGOs. Institutionalized interaction between citizens and local decision-makers will not only enable the local leadership to decide how best to spend limited resources, but also will build citizen understanding and support for local policies.

IR 2 3 4 Transparency of Government Operations Increased

The final component of strengthened local government is increased transparency of government operations. Such openness and access to information will not only enable citizens to participate constructively, but will also build citizen confidence in political processes at the local level. By sharing information with the public, local governments demonstrate their commitment to fostering local level democracy and citizen participation. In addition, procedures such as the use of competitive bidding in procurements, increases the transparency and accountability of local governments.

Contribution of other strategic objectives

Programs that increase citizen participation, build citizen confidence in political processes, and strengthen the rule of law under SOs 2 1, 2 2 and 3 2 support the development of democracy at the local level. In addition, the restructuring of the intergovernmental finance system under SO 1 2 also will make an essential contribution to the achievement of SO 2 3. Finally, as municipal development is truly a cross-cutting issue, SOs and Special Initiatives in the areas of economic growth, environment, and health programming that promote development or address citizen needs and concerns at the local level reinforce the efforts of SO 2 3.

4 Program Approaches

The strength of SO 2 3 lies in an approach that not only promotes democracy and increased local government capacity in the abstract, but that provides tangible evidence that priority community concerns can be addressed more effectively through local government initiative and citizen

participation USAID/Kiev will continue to build upon experience to date in promoting (1) democratic governance -- transparency, accountability, responsiveness, citizen participation and effectiveness, (2) improved fiscal and financial management, including the development of operating and capital budgets, financial planning, business and investment plans, and economic development plans, (3) improved management capacity and administrative practices, (4) improved municipal services delivery and tariff reform, including improvement in the quality of service and the efficiency of service provision in the areas of public transportation, heating, water/sewer, solid waste, and housing, and (5) continued strengthening of the Association of Ukrainian cities as the lobbyist and professional association for local governments

With the concerted efforts of USAID contractors, the Ukrainian Association of Cities (UAC), and knowledgeable mayors, city officials and Rada deputies, new national legislation will eventually form new legal and financial frameworks which will increase local fiscal autonomy, authority and control. However, the new laws and regulations will result in increased demands on local officials, requiring additional knowledge, tools and skills. Therefore, USAID will work with its contractors, clients, NGOs and the UAC, to be an active partner in the process of the drafting, consideration and implementation of legislation affecting local governments and intergovernmental finance reform.

Technical assistance under the Municipal Development Loan Fund Project will help local officials in two pilot cities develop the needed budgetary, management and planning skills, and to work constructively with a citizen's task force, in order to produce a business/investment plan and a loan proposal for a priority infrastructure project.

Based on the Mission's upcoming strategy on tariff reform, there may very well be the provision of technical assistance at the local level to restructure some communal services and to reform the setting of tariffs, and, at the national level, to reform tariff laws and regulations, restructure accounting rules and create an automated reporting system, which will institute changes in the administration, operation, financing and provision of services to improve the quality and efficiency, while reducing the costs and setting fair tariffs.

The Community Partnerships Program between American and Ukrainian cities will continue to focus on training and education in the areas of citizen participation, economic development, housing and communal services, budget and transportation. In addition, partnerships will be built between communities and education institutions, using Ukrainian, American and Polish experts. After two years, the current program may evolve into a partnership program similar to the Local Government Partnership Program in Poland.

The development and dissemination of best practices through USAID contractors and organizations, such as the Municipal Management Center and UAC, will continue. Local government officials and citizens can benefit from innovative practices based on successful programs and pilots in Ukraine and the region. USAID will also continue to support the UAC's research, analytical and lobbying efforts pertaining to critical legislation.

Through the local government focus areas of the Poland-American-Ukraine Cooperative Initiative USAID will support its conferences, seminars, workshops and study tours to bring together local

government officials and municipal development experts for the benefit of both countries. There is particular interest in the area of budgets and finance, economic development and communal services.

5 Progress to Date

While local governments in Ukraine continue to face significant challenges USAID has made progress that will serve as a foundation for continued development of local government over the period of this strategy.

USAID has provided local governments with training and technical assistance in management, financial planning, municipal operations and budgeting through in-country and cross-border exchanges with public and private organizations. Dramatic improvements in nine communities' transportation services resulted in significantly improved public perception of local government. Six cities also adopted financial analysis methods and operating/capital budgets to help exercise their new authority to raise revenue and plan expenditures. Over 50 cities are using the Financial Analysis Models developed under this program.

USAID-sponsored activities have promoted more open and responsive city government operations, public accountability of local officials, and increased citizen participation. Open and competitive procurement procedures, budgeting processes, distribution of annual reports, and public hearings have been introduced in communities that received USAID assistance. A zoning manual has been distributed, and five cities have developed zoning rules and enlarged boundaries and schemes of planning restrictions. Ten local governments received assistance in instituting and implementing computerized titling and registration.

Laws on Local Self-Government and State Power and on Local Administrations were passed. The USAID-supported Ukrainian Association of Cities (UAC) assisted in drafting the Local Self-Governments bill, passed in July 1997, and continues to assist in the development of and lobbying for bills regarding local taxes and fees, communal property rights, the State budget and the budget system in Ukraine. UAC's membership continues to grow (from 79 in 1996 to 232 at present) and has become more effective in its lobbying of the central government for greater decentralization.

The implementation process for housing sector reforms has been documented in how-to manuals and model legislation. Through outreach programs, 4,200 officials and thousands of residents in 196 localities throughout Ukraine have access to information on condominium conversion and private maintenance and management services. On October 1, 1997, responsibility for delivering technical assistance under this program was transferred from USAID's contractor, PADCO, to the entirely Ukrainian-run Housing and Municipal Reform Support Center, an NGO formed by former PADCO employees. This serves as a promising example of sustainability of USAID activities.

The Urban Water Project in Lviv introduced a successful model for financially viable and sustainable vodokanals. The USAID-funded Ukraine Council to Promote Sustainable Development endorsed an action plan on institutional, management and tariff reform for Ukraine's

urban water/wastewater sector, which was forwarded to the Cabinet of Ministers. These reforms were included in the recent Law on Taxation of Profit of Enterprises.

These activities have demonstrated that increasing local government capacity to manage and promoting democratic processes and transparency can bring about tangible improvements that build citizen support for the leadership and the reform effort. The interest in replicating USAID models and approaches in other cities confirms not only the success of these programs, but also the opportunity to make a significantly broader impact.

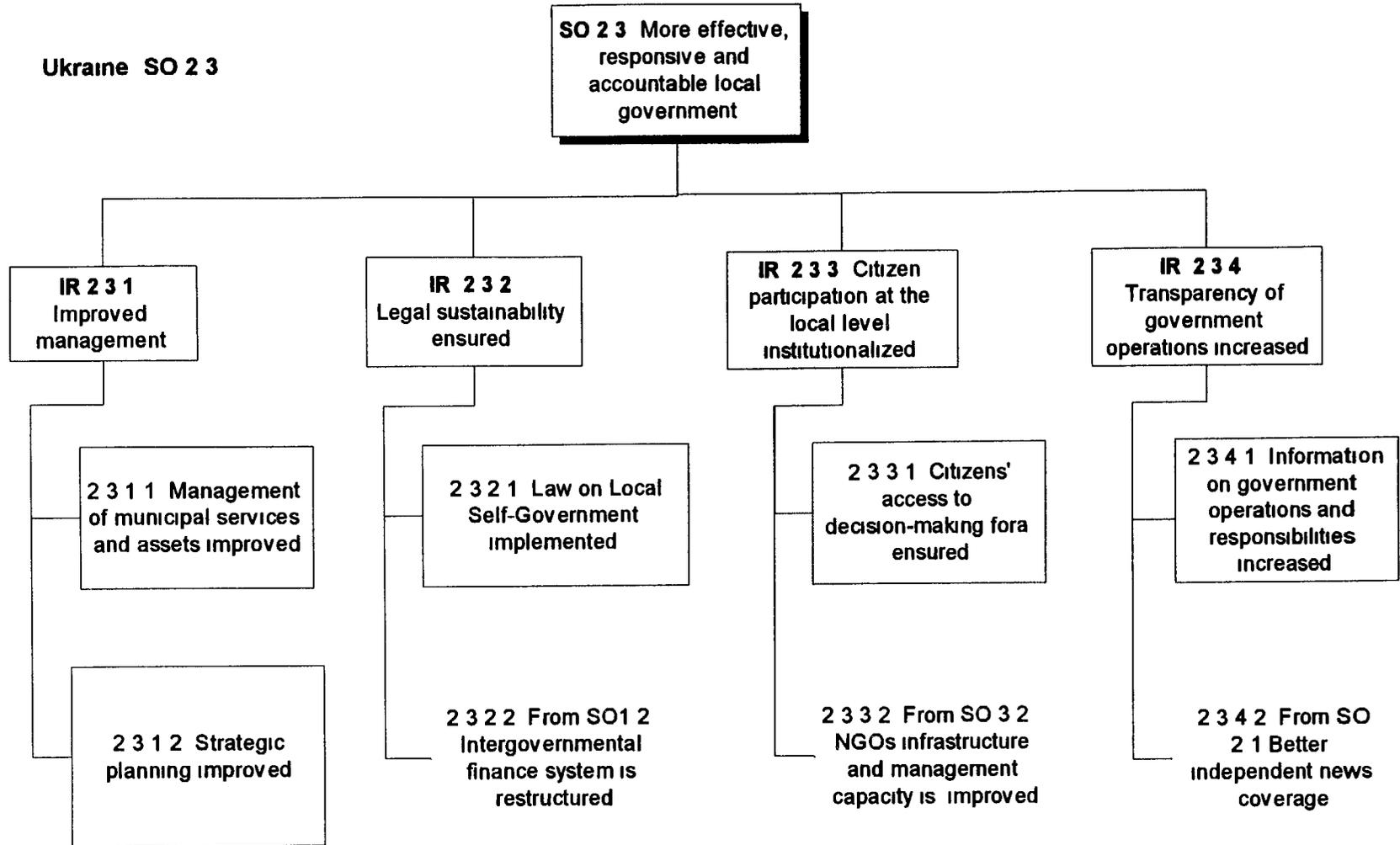
6 Commitment of Development Partners

Many donors and international organizations are working to strengthen local government. A Municipal Development Working Group has been established and meets regularly to discuss donor coordination. Participants have included USAID, the World Bank, EU TACIS, the British Know How Fund, the EBRD, and representatives from the German, Swedish and Dutch embassies and foundations. USAID is also working closely with the World Bank on the Municipal Development Loan Fund Project.

7 Sustainability

The long-term sustainability of more effective, responsive and accountable local government will be ensured by the development and implementation of the necessary legal framework for local legal and financial autonomy, the strengthening of indigenous capacity of organizations, such as the UAC, to provide the institutional support for local government, the consolidation of the management and financial capacity of local governments, and the spread of improved management and democratic processes at the local level. SO 2.3 is making a concerted effort to ensure that these results are achieved.

Ukraine SO 2 3



Strategic Objective 3.2:

Improved Sustainability of Social Benefits and Services

1 Statement of the Strategic Objective

Ukraine's transition from Soviet-era central planning and authoritarian rule has imposed substantial hardship on the vast majority of the population. As price controls were lifted, food, housing, energy, and other basic goods and services were no longer affordable to people dependent on government pension and invalid benefits or on fixed wages. Explosions of inflation ignited by attempts to cover budget deficits by printing money eliminated family savings accumulated over many decades -- leaving the elderly with no cushion to protect them from the new economic realities. The abrupt end of the arms race placed millions of manufacturing employees on indefinite lay-offs or in part-time employment. With economic growth still elusive, few people have access to proper jobs. The absence of a financial sector to redirect investment funds stifled the growth of new opportunities. Endemic corruption, punitive taxes, intrusive regulations, and xenophobia reduced to a trickle the level of foreign investment, which have supported transition in Central Europe. And worsening budget deficits froze pensions and other government benefits far below subsistence levels. Most people are denied access to decent quality, affordable health care reflected in rising rates of infant mortality and epidemics of diseases long-controlled in the west.

Improving sustainability of social benefits and services would help strengthen the flailing political support for economic reform in Ukraine. With over half of Ukraine's population living below the poverty line, such support will soon evaporate, if measures are not taken to shelter the most vulnerable groups in society. Ukrainian citizens cannot be expected to envision and aspire to a more promising future, when their present, immediate welfare is in such a precarious position. The newly poor resent the bewildering "reforms" that have destroyed their living standards. They have turned to political parties calling for a "return to the normalcy" of socialism. These parties have effectively slowed or even blocked reform -- further exacerbating social and economic problems and discouraging foreign aid.

2 Problem Analysis

Socialist economies are ill-equipped to combat poverty or to manage social insurance systems. The very reforms necessary to create a private economy have stripped away the foundations of socialist social protection systems. Basic goods and services had been guaranteed by the very price controls that have had to be dismantled to allow market incentives to work. Enterprises which had provided their employees with health services, kindergartens, and, even, vacation sanatoria, can barely afford to pay wages. Contributions to the state pension system, to unemployment benefit systems, and disability funds have fallen precipitously.

Constructing new social protection systems to enhance general well-being and to target assistance to the most vulnerable segments of the population is one of the most pressing challenges facing Ukraine. Economic reforms require the creation of new social protection systems if forward movement toward the goals of reform are to be sustained. New social protection systems must include restructured social insurance systems -- pensions, unemployment payments, and health benefits, and, in Ukraine, systems to help those harmed by the Chernobyl catastrophe. They must also include the creation of social assistance systems to guarantee subsistence levels of goods and services to the poor.

By virtually every measure, social conditions in Ukraine have deteriorated significantly since independence seven years ago. From the low-level of pension benefits -- received many months late and wage arrears that may never be paid - to health care beyond the reach of many families, and the lack of an even a minimum safety net for the impoverished population, Ukrainians suffer severe social privations. With spending on social programs absorbing nearly 30 percent of GDP - few expect the government to ease their burdens.

Another important element of the challenge to social sector reform that is frequently overlooked concerns certain attitudes prevalent in the population. One consequence of the Soviet-era "womb-to-tomb" social welfare system was to nurture the culture of entitlement and a disempowering psychological and material dependence on the State. Measures aimed at recovering the costs of service provision or rudimentary attempts to narrow eligibility for certain benefits based on need have met with stiff resistance from citizens and from political forces claiming to champion their interests. Ukrainian citizens' expectations notwithstanding, the State cannot possibly provide the level of support to which the population had grown accustomed during Soviet times.

3 Results Framework

Critical Assumptions

Ending the culture of entitlement and making social protection systems sustainable will depend on several key factors. The first critical assumption is the deepening commitment among national decisionmakers and influential elites to carry out reform of the social sector. There is little prospect for revamping the social benefits system, whether health care delivery, pensions, unemployment, or assistance to vulnerable families, in the absence of the active support and collaboration of the Ukrainian Government.

The GOU has shown some willingness to begin the painful process of social sector reform. In collaboration with USAID, it responded quickly to the need to increase tariffs for housing and communal services by creating the targeted housing subsidy program. This has enabled it to raise prices for housing and utilities faster than in any other country of the former Soviet Union. This year, after several false starts, it has begun the difficult task of reforming the state pension system. It is beginning to replace the outmoded and inaccurate system of collecting and distributing social statistics to comply with international standards and to provide better means of identifying the poor. But this critical momentum must be maintained and nurtured.

The second critical assumption is that the economy will begin to record positive growth. Increased revenues and the ability to bring into the formal economy the vast and growing "gray" economy will provide the essential fiscal foundation for the establishment of a sustainable, market-compatible system of social benefits at reasonable tax rates.

In order for social service NGOs to succeed in providing social services a third critical assumption must also be in place- that the GOU is committed to legislative reforms that would be more conducive to the self-sustainability of the third sector. This would allow all NGOs to become more effective in the delivery of their services.

Causal Linkages

Erecting a sustainable system of social benefits depends on more efficient provision of services. In the current resource-scarce environment, improved targeting of benefits through a rational and fair needs-based system is the most promising approach for increasing the efficiency of service delivery. Better targeting, in turn, requires improved methods for assessing need. Its success also

necessitates that those who can afford to pay their fair share do so, in effect providing the resources needed to support programs for those deemed eligible for assistance

USAID has already demonstrated that expert advice can influence these traditional barriers to reform. By providing computers and, more importantly, by providing expert assistance to implement modern systems, to design software and reporting systems, and to train staff officials in modern management, USAID has succeeded in initiating reforms. This technical support must continue – tied to the implementation of new, streamlined social protection programs. Local offices must be consolidated, the bureaucracy slimmed, and proper information systems designed and implemented (see also Strategic Objective 2.3)

Support for the NGO sector has to be provided with a full understanding of the obstacles to its development. The failure rate among NGOs is still quite high. According to the Boston-Kiev Sister City Association, which has researched the topic, and anecdotal evidence from a number of intermediary training organizations, most NGOs have a life expectancy of only a year or two. This is partly owed to the difficult economic conditions under which NGOs operate. How can NGOs expect to garner volunteers and community support when almost everyone else is struggling to make ends meet? Also, most NGOs providing social services are often run by members of the client base itself, who possess a great deal of energy and enthusiasm for their work, however they frequently lack the necessary management, organizational and financial skills to make their organizations viable.

Another major obstacle looming over the third sector is the legal environment in which NGOs operate. NGOs are entangled in a web of laws and regulations which make it difficult for them to earn income to become sustainable without being treated in the tax code as a for-profit business. Legislation establishing the legal status of NGOs is pending in Parliament, but has not yet been passed. Thus, improving the legal and regulatory environment under which NGOs operate is an important part of the NGO program. This will benefit not only social service NGOs, but NGOs in general.

IR 3.2.1 Increased Efficiency in Public Sector Delivery of Services

The failing state pension system poses the greatest single threat to the fiscal threat to the State Budget. Although the state pension system is "off-budget," supplementary funds must be sought from the budget to meet the growing needs for "social pensions" and to pay the growing arrears, which exceed 2.5 billion hryvnya today. The solvency of the pension system, therefore, adversely affects Ukraine's overall fiscal position. With 14 million pensioners supported by about the same number of tax-paying workers, little can be done to improve the position of pensioners without major reforms in public pension system. Pensioners, denied proper support, turn increasingly to parties opposed to further market reforms. Pension reform, therefore, is vital not only for the

well-being of the pensioners themselves, but also for the creation of a political climate more favorable for reform

The burgeoning "gray" economy means that as much as one half of all productive activity escapes paying taxes and contributions to social insurance funds. The result is excessive tax burdens on enterprises and individuals in the formal economy, perpetuating the continuing phenomenon of high taxes and widespread tax evasion, wage arrears and growing budget deficits. Compliance with tax and social insurance systems will require a combination of reducing the burden of taxes and building effective enforcement systems. Better information systems and better-trained and better-paid personnel will be key elements in implementing this principle. It is estimated that a completed program of pension reform by the year 2002 could save the GOU up to 4 billion Hrn per year, which would allow the timely payment of pensions, reductions in payroll taxes, and increases in benefits.

USAID will support the following activities

- Building a firm, rational and consistent legal, regulatory, and administrative framework to support the three-pillar pension system – including the solidarity system, the beginning of a mandatory funded system, and safe, voluntary, private pension plans,

- The development of sound actuarial pension models within the GOU to allow accurate evaluation of alternative pension reform scenarios and better management of the state pension system,

- The creation of a national database of all pensioners to allow automated pension calculations, auditing of pension expenditures, and reduced administrative costs,

- The creation of a nationwide database of all working Ukrainians modeled on the Social Security Administration database in the USA to improve collection of payroll contributions, eliminate workbooks, improve labor mobility, and allow auditing of all social protection programs, and

-- Consolidation of revenue collection in State Tax Administration and providing the Pension Fund with full responsibility for calculating and distributing pensions

Faced with scarce resources, the GOU has no choice but to continue the process of eliminating untargeted programs and concentrating resources only on the neediest. New statistical systems for identifying the neediest must be developed by modernizing social statistics and developing the capacity to analyze needs. Fraud and abuse of social insurance systems must be dramatically reduced and subsidies to the non-needy eliminated.

The success of the housing subsidy program has provided financial relief for many poor families. Among the approximately 4 million households receiving housing subsidies, about 600,000 suffer severe economic privation with per capita household income below 37 hryvnya per month. The GOU is creating, with the assistance of the USAID, a guaranteed minimum income program to assist these "poorest of the poor." This program will allow the elimination of many poorly-targeted social assistance programs as well as laying the foundation for the elimination of privileges which cost the State Budget an estimated 5 billion hryvnya.

The State Committee for Statistics has asked USAID for help in improving the quarterly survey of income and expenditures and in developing a new methodology for setting the poverty level. These reforms are urgently needed in order to assess the breadth and the depth of poverty among households in Ukraine. In addition, the State Committee has asked for assistance in improving the quarterly survey of household income and expenditures including measures to improve the sample, automating data entry, and redesigning the report (including detailed tables and figures). Since these data provide the single most important picture of the economic and social status of Ukrainian households, this task will be important for achieving political consensus concerning the problem of poverty as well as for providing a timely measure of the needs of the population for social assistance. This work will be continued in collaboration with the World Bank and the IMF. The donors have already committed statistics experts to work with the State Committee and are actively collaborating with USAID Implementing Partners.

Because Ukraine entered the competitive economy cautiously, unneeded workers were placed on forced administrative leave. They remain on the enterprise's records, but they are not working, nor are they or paid or eligible for severance or unemployment insurance payments. Approximately three million Ukrainian workers are currently on administrative leave. Workers released from employment receive three months severance pay at 100% of previous earnings. Since the IMF recommended the elimination of severance payments because they inhibit the

mobility of labor and because of the high cost, enterprises have waited until they are nearly bankrupt before terminating workers, and then do not have the resources available for severance payments

IR 3 2 2 Building an NGO Network

Even a robust state-administered system of social services and benefits cannot hope to meet the needs of the country's most vulnerable citizens, particularly during this period of transition when national, regional and local governments are severely resource-constrained. Local NGOs, community groups, and charitable foundations all play a crucial role, in compensating for the inadequate coverage of State-supported programs. In addition, various types of social service delivery organizations are developing the requisite know-how to contract with the government, primarily at the municipal level, for the provision of selective services. These organizations can also become effective advocates for increased funding for, and necessary reforms of, the system of social benefits and services.

Under its Democratic Social Service NGO Program, USAID is not and will not attempt to create new NGOs, or to indefinitely prop up organizations bound to fail once support fades away. Instead, USAID will continue to try to pick existing NGOs that have a good community standing and a strong chance at survival. Those NGOs that survive will be, not only sources of inspiration, but tangible examples and sources of technical expertise that can be replicated elsewhere in Ukraine.

Through a consortium of organizations which have expertise in targeting the neediest segments of society -- children, the elderly and the disabled, respectively, USAID provides competitively-awarded seed grants to NGOs serving these groups who have good community standing and a strong chance for survival. Future plans will also assist NGOs working in drug and alcohol rehabilitation, a serious societal problem partially resulting from the economic despair, which needs to be adequately addressed. This NGO effort is related to and coordinated with USAID's democracy and health projects.

An important aspect of USAID's assistance to social service NGOs has been the cost-share requirement in which NGOs match USAID seed grants with their own funding or in-kind contributions. NGOs are able to meet these conditions, usually by counting public support, such as volunteer labor, or in-kind contributions, such as government provided office space. Under the current program, initial grants require 25% cost share, a second grant requires the level of cost

share to rise to 40% Future rounds of grants will further increase the cost share requirement In this way, USAID will wean local NGOs off of donor assistance, but do so in a way that realistically assesses current economic conditions and increases the NGOs chances for survival

3 2 2 1 Improved Infrastructure and Management Capacity

In order to become more efficient and effective in their work, NGOs need to build on the skills and human resource assets they already possess through continued training In this manner, they will also be able to increase the number of clients they are able to service Although great strides have been made in working with indigenous NGOs, they are still mostly in early stages of development, with few being ready for advanced organizational organs such as boards At the same time however, the synergy that can be created by building partnerships with the local business community and municipal government and having them directly involved in the activities of an organization would enhance fundraising efforts, strategic planning, democratic governance, transparency and the mission of the NGO

3 2 2 2 Increased and Diversified Resource Base

With the GOU 's dire financial situation and the clear message from the donor community that support is finite, the stark reality of crafting plans for independent survival is inevitable As NGOs increase their management capacity and put their own house in order, it only follows that they will be able to explore additional opportunities for diversifying their resource base As they become more effective and efficient internally, their energies can be focused on new prospects for securing support

Crucial to the success of NGOs is their ability to raise resources from within their community to help make them self sustainable Sources could include, businesses, local government, or volunteers In fact, an exciting development is occurring under USAID-sponsored "Corporate Challenge Grants Program", a program in which NGOs find corporate sponsors and their donations are matched dollar-for-dollar up to a certain limit Originally it was anticipated that this would be a "top-down" effort with western firms donating funds to Ukrainian NGOs on a demonstration basis that could then be held up as "examples" to Ukrainian firms In fact, in a positive turn of events, the opposite is occurring NGOs have sought out their own local corporate partners, and all but one of the first 35 corporate challenge grants were from entirely Ukrainian firms This suggests that one of the most meaningful legacies of USAID assistance could be the long-term relationships formed under this program

In addition to continuing the successful Corporate Challenge Grant program, new initiatives include expanding the Corporate Challenge grant to Government-Challenges for local government contributions that would be matched, NGO-Business Apprenticeships, to reinforce training in business skills development and to provide hands-on learning opportunities in real-life business environments for NGOs planning on developing or expanding business activities Also, a Recoverable Grant mechanism would serve as a source of inexpensive capital to concretely support these businesses, with full repayment of the grant within one year

3 2 2 3 Improved Legal Framework for NGOs

The recognition and legal status of NGOs in Ukraine is still not well defined. Unfortunately, legislation establishing the legal status of NGOs is pending in Parliament, but has not yet been passed. Not only do NGOs operate in an atmosphere of legal limbo, but their ability to raise funds to become sustainable is limited by confusing and contradictory tax regulations. These issues need to be addressed on a professional level, by legal specialists who can work with the NGO community in promoting appropriate legislation.

Improving the legal and regulatory environment under which NGOs operate will continue to be an important part of USAID's program. The USAID-sponsored International Center for Not for Profit Law (ICNL) is focusing intensively on an analysis of the legal environment and will be working with the NGO and donor communities to devise a strategy to achieve clarification in related areas of legislation such as the civil code and tax code. An in-house legal specialist will be added to the CAP staff to work with local NGOs and ICNL. Due to the overwhelming issues to be resolved by the GOU currently, failure to achieve these reforms should not lessen USAID's commitment to the sector, but it will mean that the prospects for individual NGOs will be somewhat dimmed, and expectations for the development of the sector should be tempered accordingly.

3 2 4 Effective Delivery of Humanitarian Assistance

3 2 4 1 Humanitarian Assistance is Provided in Response to Disasters as Occur

3 2 4 2 Selected Government Social Service Institutions and NGOs Supported with Equipment and Supplies

The importance of having on-the-ground, experienced facilitators who can organize, coordinate and implement disaster relief efforts is perhaps just as important as the supplies and services they provide when a natural or man-made disaster strikes. Time is of the essence in these situations, and with GOU resources declining, there is bound to be an increased need to assist in those efforts, as well as to continue the cooperation with indigenous NGOs and government social service agencies in addressing the needs of vulnerable groups. At the same time, USAID also has provided humanitarian assistance through government social service agencies and local non-governmental organizations (NGOs) to meet the immediate critical needs of Ukraine's most vulnerable citizens. Since 1994, USAID's Counterpart Humanitarian Assistance Program (CHAP) has provided more than \$50 million worth of humanitarian aid to government social service institutions and local NGOs providing needed social services. In the last year alone, this program has provided approximately \$10 million worth of clothing, bedding, footwear, furniture and other humanitarian assistance to all 280 orphanages and boarding homes for the elderly and severely disabled under the Ministry of Social Protection. In addition to providing humanitarian support to government social service institutions, USAID provides humanitarian aid to the most needy through local social service NGOs. Since 1995, USAID has provided assistance to over 2 million needy Ukrainians distributed through over 300 local NGOs.

Disaster relief has also been made available to those who have suffered from emergencies or natural disasters, such as the floods that occurred in Kolomyia in August 1997, the mudslides that caused damage to homes in Dnipropetrovsk last spring, the Donetsk mine blast disaster and most recently the flooding and mudslides in the Transcarpathian region of Ukraine. By the year 2000, all 24 Ukrainian oblasts (regions), the Autonomous Republic of Crimea and the cities of Kyiv and Sevastopol will be provided with humanitarian assistance CHAP, which obtains and distributes excess military property as well as other donated items to needy individuals, governmental social service institutions and Ukrainian NGOs.

In addition, NGO Development support has been effectively leveraged by providing humanitarian assistance through partner NGOs. This tactic helps boost the partner NGO's authority demonstrating the greater impact that can be achieved in the distribution of aid and the contribution to the sustainability of the organizations through more coordinated efforts.

Contribution of other Strategic Objectives

Because the social welfare of the population is so closely tied to many spheres of life, practically every other SO contributes to SO 3.2 Private sector development (SO 1.3) which would allow for the improvement in economic conditions would obviously have a profound effect on the social sector in general. SO 2.3 programs promoting citizens' participation and government responsiveness would also be related to this SO, as would support for NGO legislation, as would SO promoting health reforms and assistance.

4 Program Approaches and Progress to Date

Despite a number of formidable obstacles, Ukraine, with the help of foreign donors and international financial institutions, has made some headway in creating more sustainable social benefits and services in selective areas. Working closely with GOU counterparts in key ministries, USAID has helped to design and implement a number of social sector reform programs and more generally played a catalytic role in moving the government to give greater priority to social sector restructuring.

Among the most notable social sector reform achievements since 1995 which USAID contributed are

-- Improved cost recovery for housing and communal services, saving the State budget an estimated \$1 billion per year,

- Successful housing subsidy program, including automated caseload management and financial reporting systems, which provides targeted assistance to some four million poor families,

- Models to forecast Unemployment Insurance and Employment Fund revenues and expenditures and trained relevant staff,

- A pilot quarterly household labor force survey, coordinated with the IMF/World Bank's revised household budget and expenditure survey,

- Systems created for monitoring the social protection needs of the population,

- New system created for reporting wages and contributions to the State Pension Fund that allows improved tax collections, relates pensions to employment history, and will lead to the eventual elimination of work books,

- Fiscal models for accurate budgeting of social assistance programs

USAID's social sector reform strategy will build on these achievements to create an efficient and effective social benefits and services system that allows continued progress on economic reform. This will include reform of the state pension system and the introduction of viable private pension funds, building an NGO network, and providing humanitarian assistance to address problems of acute human suffering during the transitional period.

5 Development Partners

Other donors also recognize the importance of social sector reform in Ukraine. The IMF conditionalities for the Extended Funding Facility (EFF) have included requirements for better targeting of social assistance, the elimination of general entitlement programs, as well as

improvement of state pension system administration The World Bank has been exploring for several years the possibility of providing credits to support pension reform It has expressed willingness to collaborate with USAID on phasing-in some elements included in USAID's pension reform strategy

European Union Technical Assistance to the CIS (EU TACIS) has provided training and policy assistance in the area of pension reform and is currently collaborating with USAID contractors in developing the social safety net The British Know-How Fund is also developing a scope of work for a modest program to support targeted assistance Bilateral donors --- including regional German Governments and the Government of Canada and the British Know-How Fund are also engaged in pilot projects related to improvements in the state pension system and active labor programs to create jobs and retrain workers

USAID also works closely with other donor organizations in NGO development, particularly through the Donor's Working Group, which includes EU-TACIS, UNDP, the Netherlands Embassy, British Council, the Mott Foundation, International Renaissance Foundation (Soros) One of the projects the Donor Group has developed is a database to track all NGOs that apply for or receive assistance from any member of the donor community This information will provide background on the NGO for purposes of coordinating efforts and checking for the NGO's history and reliability A separate database on which the British Council has taken the lead, provides information on the different donors and programs which will be accessible through the Internet, with public access available throughout the NGO Resource Center network

USAID and the USAID-funded Eurasia Foundation programs have taken the lead in the most comprehensive and substantial support to NGO Development

6 Graduation and Sustainability

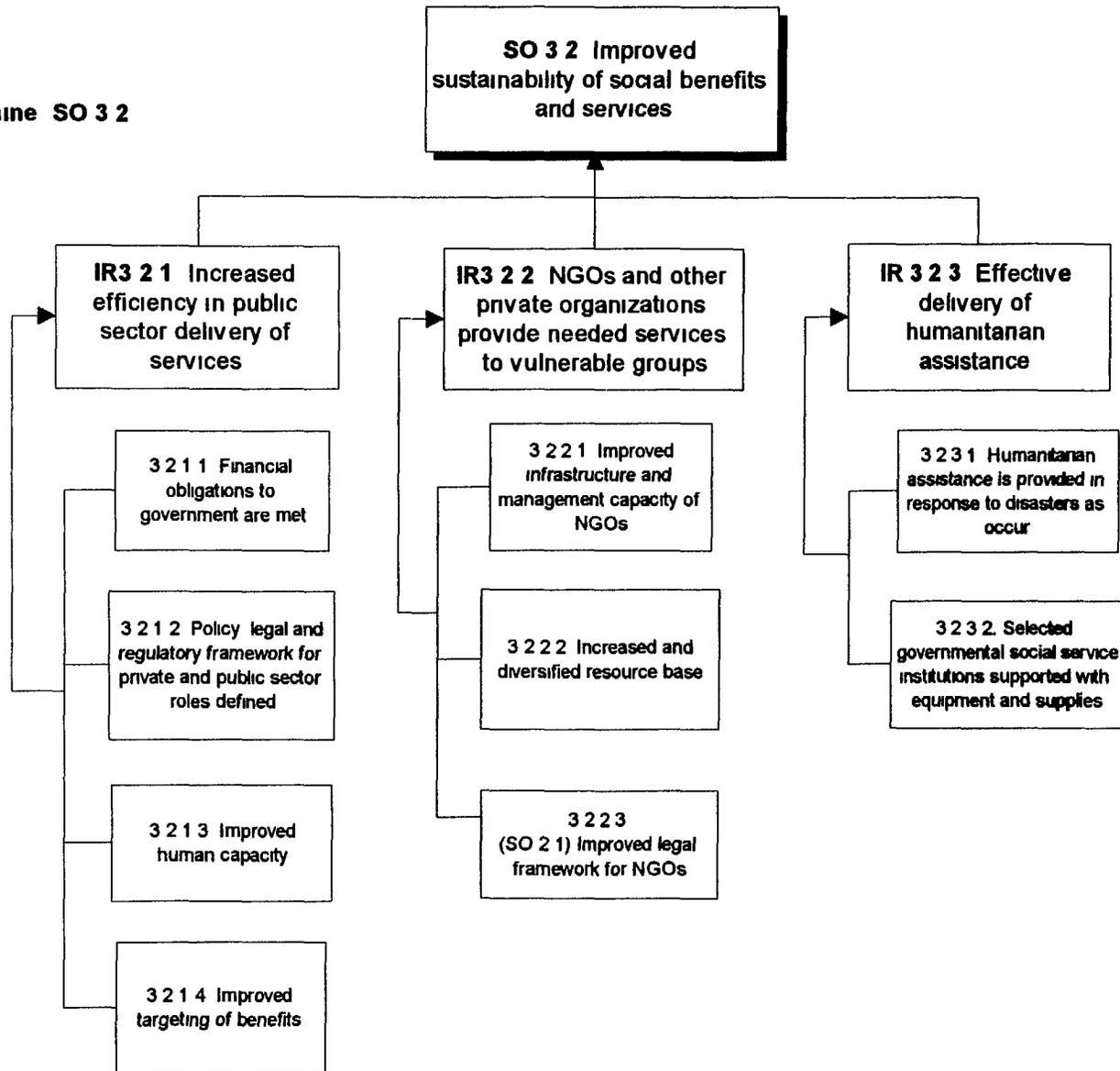
Estimates at when Ukraine may actually achieve the transitions it aspires to vary from ten to twenty years, and some would say that even this is an optimistic guess Unfortunately, the economic situation in Ukraine will only deteriorate in the near future and with that, government support of vulnerable groups in society will dwindle as well, before the government is able to reform its social benefits system The realistic goal that can be sought in the time frame of this plan is that the on-going reform process continues to move ahead

USAID must play a pivotal role in redirecting thinking among policymakers and decisionmakers This includes not only recommending new approaches but also training policymakers how to continue the process of change and development as USAID support is reduced The most effective means to do this is to work alongside officials in the design and the implementation of reforms USAID-sponsored projects have successfully created teams of U S experts and GOU policymakers committed to reform, which have demonstrated the power of "learning by doing" among GOU counterparts In addition, training seminars developed as part of ongoing projects

are raising skill levels among officials. Observational tours for key counterparts to the U.S. and to Europe have offered practical examples of successful social protection systems.

For the foreseeable future, USAID will also support efforts to build a sustainable network of public and private Ukrainian institutions and NGOs whose mission is to alleviate to the extent possible the privations imposed on the most vulnerable members of Ukrainian society as a result of the difficult economic and political reform process.

Ukraine SO 3 2



Strategic Objective 4.1

Improved Health Care Service Delivery

1 Statement of the Strategic Objective

One of the casualties of the Ukrainian transition toward a market system has been the continuing decline of the country's health care delivery system, which under Soviet times had provided citizens free, though generally low quality, medical treatment. The lack of available and/or affordable quality health care has contributed to an overall deterioration in the physical (and mental) well-being of the population. This decline is represented by a recent steep rise in infectious diseases in Ukraine. The inability of the health care system to adequately forecast and respond to potential epidemic incidences of diseases increases the danger to the population. In addition, there has been a significant decline in life expectancy, particularly among males.

There is a strong linkage between the health of the Ukrainian population and the economic conditions of the country and Ukraine's potential for progress in making needed democratic and market reform. Experience from other parts of the world strongly suggests that sustainable economic growth often depends directly on the health of a country's work force. Lesser developed countries that have registered the most economic progress over the past few decades are those which invested substantially in education and health care. The current GDP spending on health is at 3.8%, whereas the recommended WHO percentage is 7-15%.

This strategic objective seeks to reverse the decline of the health status of Ukrainian citizens by assisting in the transformation of Ukrainian Health Care systems to a sustainable sector capable of meeting the overall needs of the population.

2 Problem Analysis

The USAID/Ukraine health strategy addresses the problem of a disintegrating health care system and the accompanying deterioration in the population's health. The Mission goal is to support programs that create an enabling environment to address two principal challenges: (1) supporting a sustainable, primary health care (PHC) service delivery system, and (2) the establishment of a health care financing system that assures reliable access to public and/or private service providers.

Declining Health There has been a sharp increase in the mortality rate for Ukraine in recent years. Overall, data suggests that middle-aged, male mortality is the greatest contributor to the increased mortality trend in Ukraine. The largest contributors to years of life lost by males in Ukraine (1996 data) are degenerative diseases, followed by circulatory illnesses, accidents, and neoplasms. Ukraine has a high infant mortality rate, estimated at 14 per 1,000 live births in 1994 and rising to 14.3 per 1,000 in 1997. The average infant mortality rate for the rest of Europe is about 6 per 1,000 births. Ukraine's birth rate is currently below replacement level and falling. Since 1991, the number of deaths in Ukraine exceeded births. Abortion is still used as the most common method of fertility control.

The prevalence of disease is an important measure for evaluating the health of a population. In 1996, cardiovascular diseases were the leading causes of death overall. Reported malignancies have risen from 139.9 per 100,000 in 1985 to 160.8 per 100,000 in 1994, among them skin, breast, uterine, thyroid, lymph and bone marrow cancers (Note: Some of the increased rates for men and women probably reflect better diagnostic procedures.) Clinical training, providing fundamental, basic-technical equipment (e.g., blood pressure cuffs) to clinics, and using western standards and protocols, are important components to improve health conditions in Ukraine. An efficient and effective method of service delivery is the use of family practice/primary care medicine in providing a wide-range of preventive services to the larger community rather than incurring higher cost specialty care services for more routine services.

Inadequate Data Collection Mechanisms Among the concerns for the health system in Ukraine, the Ministry of Health (MOH) is unable to systematically gather reliable health information. Comparison of data with prior Soviet information is misleading because of quality and methods of original data collection. Many of these methodologies are still employed. Nonetheless, in many cases, Ukrainian data is the best information that is available.

Monitoring and control of infectious diseases is becoming of increasing concern as the capacity of the population to obtain a basic level of care continues to be severely tested. Approximately three-quarters of all children in Ukraine have received necessary vaccinations. Sexually transmitted diseases (STDs) are on the rise with the incidence of syphilis increased from 5 per 100,000 in 1987 to 200.7 per 100,000 cases in 1996. AIDS cases rose almost 10-fold, from 35 per 100,000 in 1995 to 311 per 100,000 in 1997. The incidence of tuberculosis for example increased 45.1 percent from 1990 to 1996 with 45.8 per 100,000. Ukraine contributed to more than half of cholera mortality in all of Europe. These problems will continue to rise unabated unless programs are implemented to accurately track and predict rates of disease. A Health Information System with data collection and surveillance components is necessary to begin the control of infectious diseases in Ukraine.

Environmental and Occupational Risk. Aggravating the already depressed health levels of the citizens of Ukraine is the immense level of environmental contaminants to which they are exposed. Ukraine's potable water infrastructure is severely compromised both from external sources of contamination and a lack of proper maintenance and operation of treatment/distribution system. As a consequence, there has been a steady increase in water-borne and parasitic diseases, 18.5% between 1990 and 1994. The impact of environmental releases is reflected largely by an increase in respiratory disease in the adult population. Accidents are the largest single cause of death and disability among young people and working age men. Occupational health and safety risks in Ukraine are substantially greater than in the West, the lack of preventive measures represents a significant cause of exposure to conditions resulting in debilitating and often fatal accidents. Though the Government has begun to develop some safety standards, enforcement is lacking. Additionally, health personnel have not been adequately trained to treat, much less prevent, accidents.

Lack of Healthy Lifestyles Lifestyle choices of the average Ukrainian are significantly affected (in real terms) by declining socio-economic status and lack of awareness of healthy behaviors.

Attention is not on fostering a healthy lifestyle but rather on survival in a transitional economy. These poor lifestyle choices include poor diet, smoking, and excessive drinking. The average diet has a high fat and carbohydrate content and is low in protein and vitamin-rich foods such as meat, vegetables, and fruits. This type of diet creates health problems related to malnourishment, micronutrient deficiency-related disorders and cardiovascular/gastrointestinal diseases. Limited incomes and declining standards of living have contributed to serious psychological depression in the population as well. Psychological disorders have increased by 16.5% in the last five years. Many problems are preventable, and could be treated earlier, more successfully, and less expensively. Prevention programs to educate the public regarding healthy lifestyles should be provided via primary care delivery systems.

Current Health Care System of Ukraine During the Soviet era, the “success” of the health care system was measured by more hospitals built, more beds filled, and more doctors educated. Quality of health care services was measured by a high degree of physician specialization, rather than upon measures of the health status of the population. Ukraine’s health system, still following much of the old Soviet framework, is not workable in the present environment. Over the last six years, the real level of state expenditures on health in Ukraine has decreased substantially, with health care budgets having been cut by two-thirds. The collapse of the industrial sector has resulted in reduced revenues to the government, increased unemployment, and reduced wage levels or delayed wage payments.

The health care system is burdened by an overabundance of facilities and health care professionals. Within Ukraine, there are 27 oblast (regional) health administrations that oversee and fund a system of 3,900 hospitals, 7,200 polyclinics and ambulatories, 230,200 doctors, and 595,100 medical staff. There is a critical need for health care planning and/or competitive incentives to rationalize the number of staff and facilities needed in both the short- and long-term to adequately meet the needs of Ukraine’s population. Ukraine continues to maintain approximately twice the European average and somewhere between three to four times the U.S. average of hospital beds and doctors to the population.

Closing health care facilities and laying off medical staff, as well as limiting the training of new health care providers, is controversial in Ukraine and will not, by itself, improve the health status of the population. However, some measures in these areas, combined with changing the nature of the way in which health care is delivered via a preventive health care model, will decrease the economic burden of health care through prevention of disease, resulting in fewer patients days at the more costly tertiary care centers.

A private health care market has started to develop in Ukraine. The growth of the private market is a direct result of the breakdown in the government-funded system and the market economy transition process. However, there are very few doctors completely practicing privately, in part because the legal status of doctors that practice privately is not defined and their tax status unclear. In addition, hospital admission practices are limited and somewhat inflexible. Consequently, doctors do not want to risk losing access to hospital facilities and resources or other social benefits such as pensions, day care, schools, and health care.

3 Results Framework

Transition Hypothesis

Creation of an affordable and effective health care delivery system requires a shift in type of care provided and the system of finance. Reforms toward a financially stable primary care health system will be effected through health care administrators at all levels of government and within the health care system embracing new health care management practices and making policy, regulatory, and legislative changes to create an environment that fosters these contemporary management practices. Through SO 4.1, USAID's Health Office is strengthening the capacity of health care workers to provide more efficient, cost-effective health services by improving their clinical skills and upgrading their basic tools of support.

Critical Assumptions

- (1) The MOH will continue to promote reform efforts toward a primary care health system for Ukraine including its relationship to structural, policy, and legislative reforms. The MOH will give meaningful consideration and take action with respect to the necessary down-scaling of the health care infrastructure and will work toward increasing the overall percent of GDP allocated to health.
- (2) Work at the oblast and clinic level will continue to progress in restructuring health care toward a more efficient system of primary care and away from costly tertiary/specialty care.
- (3) The MOH and other government authorities will facilitate the implementation of Health Partnership programs sponsored by USAID.

Causal Linkages

Progress towards achievement of this strategic objective will be assessed by the percentage of the population served by primary health care and by changes in policies, regulations and legislation related to health care reform at the national and oblast levels.

The main obstacles to this objective will be at the national government level. Consequently, USAID programs will support oblast level "experimental" or demonstration sites creating primary care systems. The results of USAID-funded experimental site activities will be used to promote policy reform initiatives at the national government level necessary to replicate the successful aspects of the demonstration programs at other sites around Ukraine.

IR 4.1.1 Provision and Utilization of Health Care Services Improved

The health care system which currently is operating in Ukraine is experiencing an increase in the levels of a number of negative health indicators. One avenue to improve this system is to restructure the manner in which health services are delivered. Implementation of primary care health care will provide more efficient and effective delivery of health services to the population.

11

Training health care providers in prevention techniques and family medicine will reduce the number of referrals to specialists. Provision of basic medical equipment not currently included as standard practice (e.g., blood pressure cuffs, otoscope, etc.) will enhance the ability of those providers to offer effective service. Strengthening of health information systems to include management and surveillance will provide data for predicting disease outbreaks and better decision making. A public education campaign will focus on health promotion featuring such health issues as diet and lifestyle, risky sexual behavior, substance abuse, mental health, chronic disease care and prevention of accidents. Training and public education are integral to every element of primary care provision. Supporting the technical capability of health care providers and relevant institutions, outreach to public and private facilities regarding basic health, disease prevention and the services available through the PHC clinics, is considered essential to achieving substantial progress toward all intermediate results.

IR 4.1.2 Legislative and Policy Reforms, Supportive of Primary Health Care, Adopted at the National, Local, and Oblast Level

Health care financing and service delivery reform is an important part of USAID's efforts to rationalize Government of Ukraine (GOU) expenditures for health care (and other social services) and to improve health care delivery to the citizens of Ukraine. This will be accomplished by improving and reforming the finance and fee for service of the Ukrainian health care system, providing national and local technical assistance and training to restructure the organization of the health care system using hospital restructuring, and developing primary health care based systems. Restructuring the country's health care finance system will require oblast and municipal administrations to implement policies and legislative measures necessary to support these changes.

4 Program Approaches and Progress to Date

USAID's work in the health sector in Ukraine, to date, has emphasized seven priority areas -- health care financing, women's health, infectious diseases, pharmaceutical management, hospital partnerships, breast cancer assistance, and Chernobyl related childhood illnesses. Additional emphasis is now being given on establishing other types of ongoing health partnerships.

Since 1994, USAID has worked with the Ukrainian Health Sector testing out different reforms, including financial management, user fees, family medicine/primary care, insurance systems and system restructuring. The Women's Reproductive Health Initiative began in 1995 to increase health care provider knowledge and access to all contraceptive options, improve access to safe maternal health services, increase the capacity of the Ukraine medical system to continue to provide training in reproductive health issues. As part of USAID's humanitarian relief efforts, adult diphtheria vaccine was provided to the MOH to combat the 1990's diphtheria epidemic. A follow-on program to strengthen Ukraine's management of infectious disease prevention and control efforts focuses on improving access to and utilization of accurate, appropriate, and timely health and management information, specifically as to the management of vaccine-preventable diseases. There are three technical areas related to rational pharmaceutical management: formulary development and management, rational use, and pharmaceutical policy/legislation.

Under a NIS Regional Cooperative Agreement, five hospital partnerships have been instituted including Neonatal Training Centers, Emergency Medical Service Training Centers, Infection Control Initiatives, Nurses Training Centers and Health Management Education Training. USAID launched two breast cancer programs in Ukraine in 1997. Both programs focus on screening and diagnosis for early detection and improved breast cancer care, treatment, and survival. In response to Congressional concern, USAID is supporting a cooperative agreement to screen and treat childhood physical and mental illness related to the Chernobyl accident.

Environmental/occupational health factors are cross-cutting and will be integrated into the health sector programs. The health sector programs will incorporate environmental information into the health information systems, linking environmental and public health institutions, and promoting community-based approaches for responding to environmental issues.

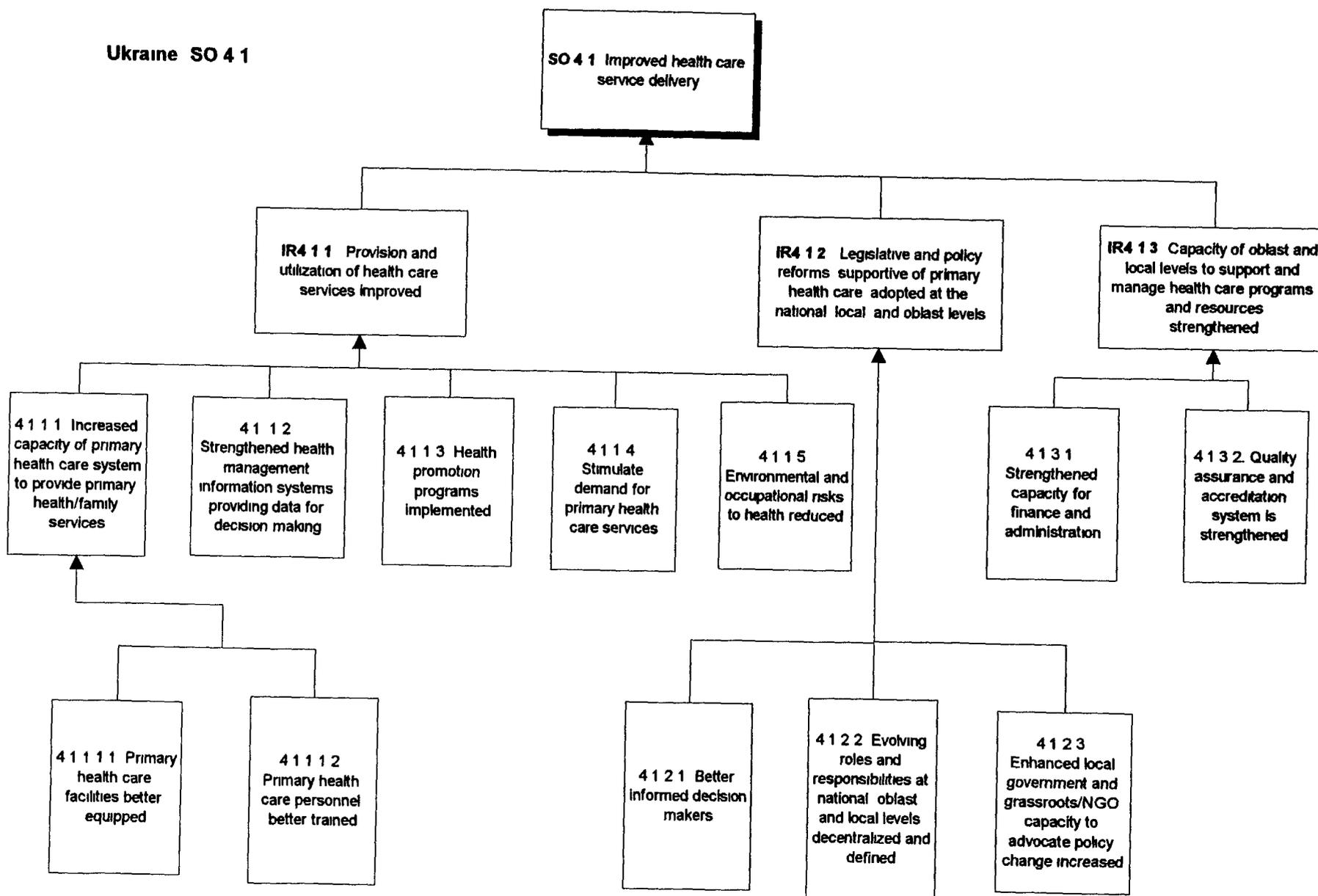
5 Development Partners

USAID continues to coordinate with UNDP, UNICEF, UNAIDS, World Health Organization, UNFPA, World Bank, Canadian Embassy, Soros, International Federation of Red Cross, Kiwanis International, Rotary International and the Interagency Immunization Coordinating Committee. In October 1998, USAID held a coordinators meeting with its implementing partners, including national and international donors. This was well received and will continue on a semi-annual basis. USAID participates in donor level meetings within several health sectors, including family planning, HIV/AIDS, infectious diseases, Chernobyl illnesses and birth defects.

6 Graduation and Sustainability

USAID recognizes that change within the health sector will continue to be cumbersome and complex. Changes within the health sector, to date, have been slow but steadily increasing as western practices are embraced. Hospital partnerships, medical exchanges, delivery of medical supplies, assistance in the diphtheria epidemic and a focus on Chernobyl's child victims have established the shift toward western standards. Primary care is taking root within major cities and some small provinces in Ukraine. Policy and legislative changes have been made at oblast levels. At all levels, government officials have declared primary care as the future for health care in Ukraine. As primary care training and equipment become more commonplace and as the public begins to see the value of this model of service delivery, it will become embedded in the Ukrainian health care system.

Ukraine SO 4 1



Strategic Objective 4.2

Cross-Cutting Initiatives

Special Initiative on Poland - America - Ukraine Cooperation

In an effort to strengthen further the emerging cooperative relationship between Ukraine and Poland and to take advantage of acquired expertise and lessons learned in Poland as a result of its success in consolidating the transition to free-market democracy, the U S has launched a trilateral initiative to foster programmatic linkages between the two former communist countries. By helping to multiply and deepen state-to-state and society-to-society ties between Poland and Ukraine, PAUCI (Poland, America, Ukraine Cooperation Initiative) seeks not only to accelerate Ukraine's transition away from Soviet-era central planning toward a robust market-based system, but also to anchor Ukraine more firmly in the new Europe, of which Poland is rapidly becoming an important part. A democratic and economically prosperous Ukraine is a powerful force for stability on the European continent.

In a broader context, this initiative will also help Ukraine with European integration, as it will foster closer cooperation not only with Poland, but with countries that have been designated membership in the EU, such as Estonia, Slovenia, the Czech Republic, and Hungary. It will allow Ukraine to draw from the experience of not only Poland, but other Central European nations and learn valuable lessons in European integration.

As presently conceived, the USAID-funded component of the Poland-America-Ukraine Cooperation Initiative (PAUCI) will focus on three areas: macro-economic policy reform, small business development, and local government reform -- all viewed as critical to improving citizen's lives and to advancing the reform process more generally. The latter will involve efforts to strengthen civil society primarily through work with non-governmental organizations (NGOs) and local governments, while Polish NGOs will also be instrumental in work to bolster Ukraine's nascent small business sector. Poland's impressive progress in building a stable democratic political order and establishing a market-based system that has spawned economic growth offers a wealth of relevant lessons for a country such as Ukraine still struggling to overcome the legacy of communist central rule. It should be noted that these three areas will be considered priorities, though activities in other areas, such as journalism training and combating trafficking in women will also be considered.

Prospects for expanding into other areas are quite good given that the initiative is building on existing linkages across the portfolio but most notably with respect commercial ties, particularly along the Polish-Ukrainian border where trade has flourished. For example, the NewBizNet project, which provides business services, advice and training to would-be entrepreneurs, and the work of the Alliance, a group of NGOs involved in small and medium enterprise development, offer a base from which to launch joint efforts to stimulate economic growth and employment opportunities at the local level. In the democracy sphere, Polish and Ukrainian NGOs, whether oriented toward policy advocacy or social service delivery, have started to work collaboratively to

pursue common goals in areas such as environmental protection, combating domestic violence and sexual trafficking, and overall strategies for improving sustainability. And USAID/Ukraine even now funds third-country training programs whereby Ukrainian participants travel to Poland to benefit from expertise residing there.

Activities undertaken as part of PAUCI also should be viewed in the context of USAID assistance efforts in Ukraine more broadly. Almost since the inception of USAID's presence in Ukraine, the Mission has been funding programs geared toward macro economic reform, small business development and democracy strengthening to which parallel, PAUCI activities will tangibly contribute.

After some initial delays in refining the conceptual framework and achieving consensus on the initiative's overall design, PAUCI was launched on October 29, in Kiev, with a joint statement signing ceremony by Ukrainian Vice Prime Minister Serhiy Tihopko, Polish Deputy Foreign Minister Przemyslaw Grudzinski, and U.S. Ambassador Stephen Sestanovich. Although this was the formal launching, a number of activities are already underway, including work to boost the capacity of small business associations and to establish local environmental management units in selected cities, and study tours and exchanges involving municipal government officials, business entrepreneurs and experts and activists from different fields.

Other activities are being developed and are scheduled to commence in the coming months. Some of these will deal with capital markets development and fiscal policy reform, local government administration, media training and election coverage round tables, joint assessments by central bank officials of Ukrainian banking institutions, and unemployment insurance and pension system reform. PAUCI will also incorporate a public outreach and education component to inform citizens in both Poland and Ukraine about the extent of existing and planned cooperation. What these activities all have in common is their link to a broader goal of trilateral cooperative efforts that make a difference in the quality of life for ordinary citizens.

Conscious of certain historical, political and other sensibilities, PAUCI stresses that any lessons learned from the Polish experience must not be mechanically applied in Ukraine but need to take account of local conditions, traditions, practices etc. to ensure these lessons are relevant and therefore more likely to yield comparable results. In a related consideration, the initiative is deliberately crafted to support two-way learning. Although the principal emphasis is on Ukraine's adoption of appropriate policies and practices based on the Polish experience, PAUCI does call attention to those areas such as municipal transportation where advances in Ukraine can serve as the basis for introducing new, more effective practices in Poland. Another tangible benefit accruing to Poland is the improved prospects for long-term sustainability for participating Polish non-governmental organizations and institutions as they acquire greater expertise in provision of technical advice. This, in turn, could serve to strengthen a planned Polish Know-How Fund that would deliver technical assistance beyond Poland's borders.

At the end of four years, the period covered by this strategy document, USAID/Ukraine expects the Poland-American-Ukraine Cooperation Initiative to have brought about demonstrable

changes Progress toward strategic goals of the assistance program will be abetted by USAID's recent decision to incorporate a Poland-Ukraine cooperation component into most major contracts in the various strategic assistance areas Activities in banking system regulation, commercial law development, fiscal policy reform, democratic local governance, and social sector restructuring are all now in the planning stage These activities complement ongoing assistance programs in Ukraine and Poland, respectively

Special Initiative on Global Climate Change

1 USAID's Climate Change Initiative

Under the Global Climate Change Initiative, USAID is exercising its leadership role in assisting developing and transition countries to combat the threat of global climate change by developing the human, institutional and technological capacity to undertake meaningful participation in the UN Framework Convention on Climate Change (UNFCCC) effort to reduce greenhouse gas emissions. USAID-assisted countries may participate in the UNFCCC in numerous ways, ranging from integrating climate change priorities into national development or energy strategies, implementing joint implementation (JI) or clean development mechanism (CDM) projects, or participating in emissions trading regimes.

2 Relevance of the Climate Change Initiative to Ukraine

Ukraine is among the ten largest carbon emitters in the world, largely because of the gross inefficiencies in energy production and consumption. Industry and electric power generation account for approximately 75 percent of Ukraine's CO₂ emissions from commercial energy consumption while the residential sector accounts for 14 percent. Industry alone accounts for 70 percent of total energy consumption.

USAID has identified Ukraine as one of nine key countries that are, or will become, significant contributors to greenhouse gas emissions. While 1995 CO₂ emissions of 13 tons per capita were below the 1990 levels of 14.3 tons per capita, this was achieved as a result of decreased industrial production and reduced supply of fossil fuel. As the economy makes progress on its transition to a market economy and economy activity resumes and accelerates, CO₂ emissions are expected to increase unless significant measures are implemented to either restore sinks or minimize sources.

Burning of fossil fuels either for the production of electricity or in industrial processes is responsible for around 85 percent of carbon dioxide emissions, the major component of the greenhouse gases that cause global warming. In Ukraine electrical energy and heat use is extremely inefficient, primarily in the industrial and municipal sectors. Extensive implementation of energy efficiency measures will address a wide range of Ukraine's economic and environmental problems, and be essential, and inevitable, to improve overall economic competitiveness, to improve social standards, to reduce pollution including greenhouse gases and to reduce the burden of import costs for foreign fuel.

As the largest opportunities for energy efficiency improvements to address global climate change lie in fossil fuel-based sectors of the economy, significant progress in limiting CO₂ emissions may be achieved by promoting investments in Ukrainian enterprises that embody more energy efficient technologies. Moreover, because Ukraine's CO₂ emissions are currently below 1990 levels, Ukraine qualifies as a potential seller of carbon credits to international investors who may wish to offset carbon liabilities elsewhere.

3 USAID's Strategy

USAID proposes to support Ukraine's participation in the UNFCCC by promoting "climate friendly" development by creating a collaborative process through which the combined efforts of governments, the private sector, and non-governmental organizations can be focused on promoting market-based transfer of environmentally sound technologies and infrastructure. USAID will adopt a strategy that encompasses two phases

Phase I In this phase, USAID will work with the Government of Ukraine to establish legislative, regulatory and market structures, and the local institutional capacity to participate in emissions trading regimes. This includes monitoring, verification, and certification of CO₂ net emissions and project baselines, as it is required under the Kyoto Protocol. The significant result of this phase will be the creation of this institutional capacity, and the signing of a bilateral agreement between the US and Ukraine on a Joint Implementation Program that specifies a general framework and specific conditions to stimulate Joint Implementation and Activities Implemented Jointly (AIJ) projects and participation in other flexible market mechanisms, including the "price" of CO₂ credits in terms of the value of private investment with improved energy efficiency

USAID will continue to build on its existing electric utility partnership program. This program has to stimulate partnerships with energy-intensive and progressive industries (chemical, steel, pulp and paper, automobiles and agriculture). It will partner private firms with counterparts in Ukraine for increasing productivity and environmental soundness through improvements in management, production processes and technologies

Phase II During this phase, USAID will oversee the installation of monitoring and verification methodologies by the US Environmental Protection Agency. In addition, USAID will start to facilitate public-private partnerships that transfer environmentally sound technologies and investment and mitigate the impact of greenhouse gas emissions. USAID will build on the work that it has done under pilot projects and seek partnerships with international electric utilities and equipment manufacturers

Market-based incentives will be channeled through the USAID Environmental Program. The Environmental Strategy will focus on programs to promote creation of regulatory and non-regulatory incentives for economic development that is less carbon-intensive. The program will also focus on policy and regulatory reform and engage private financial institutions in the creation of the economy that favor clean investment

Progress during this phase will be measured by the value of investments and the volume of CO₂ credits facilitated by USAID

Special Initiative on Sexual Trafficking

In response to the escalating problem of sexual trafficking of women in Ukraine, as well as a growing interest among government officials and non-governmental organizations to halt this problem, the U S has launched a major anti-trafficking initiative. Working closely with Ukrainian counterparts and indigenous women's groups, participating USG agencies have developed a multi-pronged strategy -- in line with President Clinton's 1998 Executive Memorandum -- which works to prevent potential victims from being trafficked, protecting women who are, and prosecuting those responsible for this crime.

As economic conditions have deteriorated in Ukraine, a growing number of unemployed and under-employed women, many with high levels of education, have sought financial opportunities abroad. Following promises of a lucrative job in a foreign country, some women arrive at their destination only to find themselves forced into prostitution through coercion or violence. The Ukrainian Government estimates that thousands of women have been trafficked to Western Europe and elsewhere, almost always by organized crime outfits, to enter the sex trade.

Even for those women who know, or strongly suspect, that they will be employed as prostitutes, research indicates that the majority are not aware of the slave-like conditions that await them. These victims will have their passports and documentation confiscated, their freedom curtailed, and all their wages taken to pay for the cost of "sponsoring" their trip abroad. When these women return home, often with HIV/AIDS or other sexually transmitted diseases, they face ostracism from their families and communities, further reducing their prospects of reintegration or securing employment.

The Anti-Trafficking Initiative is an array of inter-related activities aimed at addressing the prevention, protection, and prosecution components of the problem. The first prong of the Initiative -- prevention -- has received the greatest emphasis by the Mission. Within its framework are numerous activities designed to reach the most at-risk women who are deemed especially susceptible to the allure of overseas employment. Working through print and broadcast media, secondary schools, and existing NGOs and community groups, USAID and the Department of State are supporting programs that inform potential victims about sexual trafficking and its inherent dangers. In addition, USAID, as part of a public-private effort, is funding the production of a nation-wide television docudrama that details the real-life story of a trafficked woman. This docudrama, coupled with a televised education campaign, should help inform women even in the most remote areas of the country.

The centerpiece of the Initiative's prevention component is the opening of three Trafficking Prevention Centers in January 1999. These Centers -- located in Donetsk, Dnipropetrovsk, and Lviv -- are aimed at younger, often well-educated women, who feel they have few options in the prevailing economic climate, making them more at-risk of being trafficked. At the Centers, these women can find business skills training, job employment information, and assistance in accessing other USAID programs that include micro-credit and small business loans.

USAID's most recent prevention piece of the anti-trafficking initiative is a Women's Economic Empowerment Program that will begin activities in early 1999. As a compliment to the Trafficking Prevention Centers, the Empowerment Program is also designed to increase economic opportunities for women through developing and strengthening business associations that represent the interests of women entrepreneurs and engage in national level policy debate, by providing seed grants for economic-oriented women's NGOs, and through women's credit union loans for new businesses.

The second component of the strategy to combat sexual trafficking of Ukrainian women -- protection -- revolves around the provision of services to potential and actual victims of trafficking. Through the Trafficking Protection Centers, women can access legal services and information, as well as referrals for free medical and counseling services. These health services will be provided through an existing network of indigenous organizations, as well as the USAID-funded Community Health Partnerships Program and Women's Wellness Centers. It is anticipated that both programs will incorporate a training activity for health care providers to heighten awareness about domestic violence and trafficking cases, as well as treatment methods. These health centers will also serve as a referral service for women who need additional support that can be provided through NGOs or specialized organizations.

The third dimension of the anti-trafficking initiative -- prosecution -- centers on effective enforcement of existing laws that ban this exploitative practice. Recruiting women into the trafficking network, and moving them across international borders, requires considerable organizational capacity. This lucrative business is largely run by organized crime entities, which in some countries operate with the active or tacit cooperation of corrupt government officials. Other relevant legal issues concern the prosecution of traffickers, corruption of government officials and police, and facilitation of the victim's return from abroad. The U.S. Department of Justice, FBI, and the Department of State are working with their Ukrainian counterparts on these legal aspects of the trafficking issue.

As part of its anti-trafficking strategy, USAID is developing a data collection/analysis and performance monitoring plan. To date, the Mission has established performance indicators and set preliminary targets to gauge progress in reducing sexual trafficking. Working through existing sources and information acquired by the DOS/IOM public information effort, USAID and its implementing partners will continue to gather crucial data on the nature of the problem and use this information to refine the Initiative as it proceeds.

Because trafficking cuts across so many different sectors -- health, economic growth, D/G -- the Anti-Trafficking Initiative embraces a multi-sectoral approach that supports broader Mission goals spanning all strategic assistance areas. The empowerment of women, whether through creating greater economic opportunities, educating them about their rights, or providing mechanisms for effecting policy change, all work to integrate them more fully into the Ukrainian economic and political life. This greater level of participation will accelerate progress in achieving USAID strategic objectives.

For example, increasing economic opportunities for women through small loan programs and business training -- part of USAID/Ukraine's broader assistance strategy -- contributes to the strengthening

of the fledgling small-business sector, widely acknowledged as one of the engines of growth and job creation in market-based systems. In the political arena, public education efforts centered on women's legal rights can bolster the country's emerging civil society by encouraging women's participation in the political process.

An encouraging by-product of the Anti-Trafficking Initiative has been increased collaboration among women's organizations, groups which have historically failed to cooperate due to competing agendas and competition for scarce resources. The active collaboration among the groups has made them more effective interlocutors with the GOU which, in turn, has helped forge cooperative working relationships between civil society, municipal leaders, and national government.

Finally, the effort to combat sexual trafficking in Ukraine also helps to integrate gender considerations in a more systematic way across the Mission's assistance portfolio. The lack of empowerment among women, and their secondary status in Ukrainian society, remain the root causes behind the trafficking issue.

Kharkiv Initiative

1 Background

Our objective is to assist the Kharkiv community in accelerating regional economic growth by helping to create a favorable business climate that will result in (1) an overall increase in private investments (both foreign and domestic) and (2) a development of trade links with the US private sector. The ultimate goal is to strengthen the private sector, in order to empower the people of Kharkiv to take control of their own resources and to improve their lives.

Kharkiv was the third largest industrial, scientific/research, and educational center in the former Soviet Union, after Moscow and St. Petersburg. With decreased demand for the output of these large, predominantly military-industrial enterprises, the economy of Kharkiv threatens to fall into stagnation if the small and medium private enterprise sector does not grow rapidly. Small and medium enterprises (SMEs) currently employ only approximately 8 percent of the workforce, and unemployment is high (nearly 35% of workforce), so there is great opportunity to make an improvement in the lives of the people of Kharkiv through promotion of SME development that will lead to increased employment and higher income levels for many people in the region.

2 Problem Analysis

Many obstacles are slowing private sector growth in the Kharkiv region. The local government does not sufficiently understand the role of the private sector in a market economy, the need for access to modern business skills before investment can be attracted to enterprises, and how to create an enabling environment for investors and businesses. Many of the problems with the environment for private enterprise development originate at the national level—including an excessive tax and regulatory burden for businesses, underdeveloped legislation on corporate governance, shareholders' rights, and bankruptcy, a lack of coherent vision regarding private ownership of land, and a financial sector that is unable to handle the needs of a market economy. Nevertheless, many constraints affecting enterprises within the region can be addressed by the Kharkiv government, these are discussed below.

Large Enterprise Restructuring The large privatized enterprises in Kharkiv have not yet moved from state-ownership to the private ownership, and most of these enterprises have not yet undergone financial or even operational restructuring. One of the reasons for this resistance is the expected impact from reorganization—increased unemployment, as redundant workers are fired as enterprises strive to become more efficient and competitive. Other factors preventing restructuring include lack of business skills and information about how to restructure and compete successfully in a market economy.

Growth of Small and Medium Enterprises Small and medium enterprises are a critical element in regional economic recovery. The expansion of the SME sector will provide labor with employment opportunities. Constraints to SME development that could be addressed at the local level—either by the Kharkiv government or by the donor community—include the excessively burdensome

regulatory environment, the lack of business skills, access to finance, and the inability for enterprises to own land

3 Program Approaches and Measurement of Success

The Kharkiv Initiative is a US Government effort, with USAID playing a part in its success. The Initiative is to be a participatory development process in which the US Government supports the reforms that the oblast and municipal governments undertake. The "first" USAID activity in support of the Kharkiv Initiative is collaborative strategic planning, as requested by the oblast. This exercise, a three-phase effort, is composed of an overall assessment of the region to identify those sectoral areas in Kharkiv oblast in which the greatest economic growth can be realized, second, further study of those areas identified in the first phase, and, third, specific action plans for each of those areas. Many of the action plans will rely upon Kharkiv Oblast Government to make reforms in order to realize economic growth.

While strategic planning is the first activity designed under the rubric of the Kharkiv Initiative, USAID, and other US Government agencies will continue to implement on-going activities in the region. These activities will support the overall directions identified by Kharkiv Oblast in the Joint Statement dated December 1, 1998, and include those which (1) stimulate entrepreneurial development by accelerating the creation of private businesses and generating new employment opportunities in the oblast, and (2) build a model of regional economic development and multifaceted cooperation with the United States.

USAID shall continue to work in the area of enterprise development, focussing on increasing employment in SMEs and increasing production by all sizes of privatized enterprises. Each of these represent positive change in people's lives: the former represents more people earning a salary by working in the SME sector, and improvements in the latter demonstrate a recovery in the large enterprise sector, which will imply increasing jobs and incomes for workers in privatized enterprises.

At the intermediate results level, success can be measured by looking at total time spent to register new business (e.g., local business climate more conducive to private enterprise development), number of consulting firms and business centers, and total number of clients served (a measure of market infrastructure), and number of firms that adhere to IAS accounting or have undergone financial restructuring (access to finance).

Assist in the Creation of a Positive Business Climate In supporting the overall directions of the Initiative, and within the strategic planning process, USAID will work with the city and oblast governments to identify specific measures to be taken by local governments and the donor community for addressing key constraints to a positive business climate. Possible outcomes will include promotion of public-private partnerships and encouragement and assistance in open dialogue between government officials and private sector on issues of economic and investment policy.

Develop Market Infrastructure Institutions and Services USAID's current programs focus on the local consulting sector capacity to develop and share a package of services (i.e., how to start up & register a new firm, how to do accounting and taxes, how to attract investment and access other sources of financing) needed by new and existing businesses, including both small/medium and large privatized firms

Helping Kharkiv Enterprises Gain Access to Sources of Financing Again, depending on the outcome of the collaborative strategic planning exercise, the US Government may also help introduce IAS accounting to make firms more attractive to investors, assist enterprises in undergoing restructuring, help to develop business skills among management of large privatized enterprises, and provide assistance on establishing business contacts with potential investors from US

**USAID
STRATEGIC PLAN FOR UKRAINE**

1999 – 2002

ADDENDUM 2

Strategic Objective 1.6 Increased Environmental Management Capacity
to Support Sustainable Economic Growth

February 18, 1999

Strategic Objective 1 6

Increased Environmental Management Capacity to Support Sustainable Economic Growth

1 Statement of the Strategic Objective

In deciding upon the inclusion of this Strategic Objective (SO) within the Mission's Strategy for Assistance to Ukraine, 1999 - 2001, the Mission's activities in and related to environment were reviewed. It was observed that environment work was included in a number of Mission SOs contributing to achievement of results in those specific SOs. For example, energy efficiency activities are included under SO 1 5, municipal water activities are now contributing to results within the SO 2 3 framework, and environmental health included within the Health SO.

Following this review and within the context of the overall Mission Strategy several options to achieve "environment results" were considered ranging from no specific environment SO, to specific environment intermediate results in relevant SOs, to a special objective. It was determined that a major environment focus would be to continue to address Global Climate Change primarily through activities under SO 1 5 but activities under a SO 1 6 would complement SO 1 5. Further, selective environment activities that contribute to achievement of intermediate results are properly placed under other SOs.

However, it was recognized that there was a need to a) highlight the dynamic interrelationship between environmental management and economic growth, b) focus selected current environment activities toward achieving results in this sphere, and c) consider future initiatives within this framework. Thus, it was decided to pursue SO 1 6 from both a strategic and an organizational perspective. In presenting this SO it is recognized that some intermediate results will be achieved through activities in other SOs.

Strategic Objective 1 6 contributes to increasing public and private capacity to address critical environmental constraints to Ukraine's sustainable economic growth. This SO contributes to creating the necessary conditions and incentives for a greater private sector role in environmental technology transfer, to increasing and improving the technological know-how and environmental management capabilities of private and public sector entities, and to creating an enabling environment for environmental investment financing.

Citizens play an important role in ensuring that both public and private entities protect environmental values in consonance with economic growth and employment creation. To the maximum extent possible, Ukrainian organizations (e.g., Work Groups for Sustainable Development, NGOs, Think Tanks, etc.) will be supported and guided so that they may carry out the activities to achieve policy and regulatory reforms.

In seeking to maximize Ukraine's reliance on market mechanisms to the extent possible in promoting environmentally sustainable economic growth, this objective contributes to integrating environmental policy initiatives and regulatory reforms into Ukraine's economic reform and restructuring activities at the national and local levels. Finally, linkages among environmental professionals in the region and between Ukrainian and American counterparts will be strengthened.

Achievement of this SO will require close coordination and collaboration with several other SOs: SO 1.5 (environmentally-sound energy restructuring), SO 1.3 (privatization small/medium enterprise), SO 2.3 (more effective, responsive, and accountable local government), and SO 2.1 (citizen participation). USAID will consider this objective met when

- The policy/legal/regulatory framework relative to environment management follows internationally accepted standards, allows for constructive engagement of local and regional level bodies in environment management, and implementation/enforcement of environmental regulations,
- Citizen groups (including Work Groups for Sustainable Development, Think Tanks, NGOs) are strengthened to the point that they are capable of providing substantive input on environmental issues to policy makers;
- Citizen views as represented by citizen groups are seriously considered and acted upon,
- The number of private and/or public entities using innovative environmental financing mechanisms is increasing, and
- The number of public and/or private entities adopting improved environmental management practices and/or technologies (including adoption of environmentally sound and energy efficient technologies) is increasing.

2 Problem Analysis

The present environmental situation in Ukraine may be characterized as being in a state of crisis that has arisen over a long period and is essentially due to environmental issues being ignored by Ukraine's policy makers. Over the past few years, world recognition of the environmental crisis in Ukraine, and specifically of the economic and social costs of Chernobyl, of urban pollution, of inefficient energy and natural resource use, of Global Climate Change and ozone depletion, has opened up a window of opportunity for local and national initiatives to reduce waste and improve safety and efficiency in the public and private sectors. However, political will, technological know-how, and management capacity must be further developed to fully integrate environmental objectives with Ukraine's economic growth objectives.

Ukraine's environmental constraints to economic development include

- Limited state budget resources are generally unavailable for environmental investment and those investments that do take place often are not aimed at the most cost-effective option or at the most pressing environmental priority
- Without external assistance, enterprises and authorities are unlikely to develop successful financing schemes for environmental investment
- Improved environmental management will increase productivity and make firms more attractive to private investors
- International interest in emissions trading and joint implementation in the context of climate change holds the greatest hope of generating funds for environmental investment, but only if Ukraine develops the administrative capacity to manage these programs
- With increased public awareness, communities (authorities, citizens, and enterprises) may be able to take modest steps at the local level to reduce harmful emissions and increase efficiency, even in the most pessimistic of budgetary scenarios
- Raising awareness, innovative financing, and voluntary measures will require increased access to environmental information. And,
- Policy and legal reforms are needed to make Ukraine's environmental laws effective toward compliance, consistent with EU directives, and to increase the use of economic incentives

Work on removing these constraints will contribute to increasing Ukraine's environment management capacity to support sustainable economic development

3 Critical Assumptions and Causal Linkages

a Critical Assumptions

The critical assumptions for achievement of this strategic objective are

Renewed commitment by the Government of Ukraine to pursue economic reforms
Achievement of selected intermediate results in other SOs (i.e., IR 2.3.1, IR 2.1.1.1)
Sustained work of established environmental NGOs
Responsibility for financing communal environmental infrastructure improvements will fall to municipalities, with support from donors and IFIs
Private sector investment in environmentally sound technology transfer is required as public sector and donor investment will not be sufficient to improve Ukraine's quality of life and to achieve environmentally sound development objectives in Ukraine
Donor interest and coordination in environmental issues is strengthened

Causal Linkages

Achievement of Strategic Objective 1.6 will be measured by the increased integration of environmental objectives into policies affecting Ukraine's economic development and growth and implementation/enforcement of these policies

The following Intermediate Results (IR) are key to the achievement of this Strategic Objective

IR 1.6.1 Strengthened policy, legal, and regulatory framework for environmentally sustainable economic development

Sustainable economic development requires decision-makers to consider the consequences of development and to choose those options that are least harmful, as well as cost effective. Decision-makers need timely alternatives analysis so that less environmentally harmful options can be explored before limited design funds are exhausted. A number of deficiencies in the current system require correction. These include unrealistic regulations and standards that have hindered rather than helped resolve environmental

problems An integrated policy framework or a legislative and regulatory framework that relies on market-based tools is needed to address deficiencies in environmental management in an economically viable manner

IR 1 6 1 1 Increased adherence of GOU to international environment treaties

Ukraine's adherence to international environment treaties would in turn contribute to strengthening its policy, legal, and regulatory framework Ukraine is signatory to over 100 international treaties, protocols, and agreements However, it needs to implement those agreements through its policy, legislative, and regulatory framework if it is to meet international standards and achieve international credibility As a member of the Global Climate Change Umbrella Group on Emissions Trading, it is essential that Ukraine develop the institutional capacity to administer emissions trading and joint implementation programs

IR 1 6 1 2 More internationally consistent, cost effective, and locally effective environmental regulations

Ukraine has developed a number of regulations that are more stringent than internationally accepted standards, are costly to implement, encourage corrupt practices to avoid environmental obligations, and discourage foreign investors These costly and unrealistic regulations also stifle innovation, deterring enterprises from exploring cost-effective and environmentally sound technologies to improve productivity It is essential for Ukraine to develop a regulatory environment that is in harmony with international standards, can be effectively implemented at the local level, and does not deter foreign partnerships

IR 1 6 1 3 Increased use of market based tools to achieve environmental objectives

In order to encourage technological innovation and technology transfer, Ukraine must develop and use market-based tools as the foundation of its regulatory tool kit

IR 1 6 2 Increased use of innovative environmental finance mechanisms and environmental investment

Traditional budget sources are no longer a viable option for financing environmental programs Ukraine must make use of innovative financing mechanisms such

as environmental funds, IFI programs, donor programs, pollution fees, private sector investments, joint ventures, joint implementation projects, and emissions trading. The present environmental investment climate has little hope of improvement unless USAID and other donors assist Ukraine to develop a range of financing approaches.

IR 1 6 3 Improved environmental management practices and adoption of environmentally sound technologies by private and public sector entities

Polluting, energy inefficient, wasteful, and often unsafe technologies characterize Ukraine's public and private sector. In order to compete in the global market, accede to the European Union, reduce costs, and advance its economic development, Ukraine must adopt internationally accepted standards and technologies for environmental management, production processes, and community infrastructure.

IR 1 6 4 Increased empowerment of NGOs and citizens to affect environmental decision-making

A well functioning market relies on full information and stakeholder participation. The development of environmental NGOs to advocate environmental issues in consonance with citizen concerns of job creation and economic development is an important component of raising citizen awareness and increasing citizen empowerment. Citizen groups (NGOs, communities, Work Groups, etc) need to be able to bring issues to the attention of Ukrainian decision-makers. Specialized groups (such as the Work Groups or Think Tanks) need to be able to recommend specific policy, legal, and administrative actions.

4 Performance Measures

As this is a newly organized Strategic Objective preliminary performance indicators for each of the intermediate results are listed on the attached table. It is recognized that they will require refinement over the next several months by the extended team.

5 Progress to Date

As this is a new Strategic Objective, the "Progress to Date" is presented as "Progress to Date in USAID Environmental Activities" as a foundation for this SO. As noted earlier, Ukraine's environmental crisis is complex and varied. USAID has responded by applying its resources (technical and financial) to assisting Ukraine in addressing a broad

spectrum of its environmental issues since independence

Since 1996 the US-Ukraine Council and the Work Group Program to Promote Sustainable Development has been implemented. This program marked the initiation of efforts to integrate economic and development objectives. Field demonstration projects in urban water, agriculture, industry, energy efficiency, environmentally sound business development, and international treaties were linked to work groups that proposed legislative and policy solutions to barriers to sustainable development encountered in the field. Ten policy/legislative reform proposals were sent forward through the Council to Ukraine's Cabinet of Ministers and to the Gore/Kuchma Commission for consideration. To date five of the ten reforms sent forward have been adopted. It is anticipated that the remaining five will also be adopted. Those adopted include reforms to Ukraine's tax collection system, capital reinvestment, and depreciation procedures affecting capital improvements and maintenance of water utilities.

USAID's environmentally sound technology transfer activities have also progressed in both the municipal and industrial sectors. An example at the municipal level is USAID's Lviv Urban Water Program which, through the transfer of USEPA computerized water system modeling technology, U.S. engineering technologies, and financial management and efficiency know-how, local capacity to provide water services was increased from 0-3 hours per day to 24 hours per day. A USAID pilot project in the Pasichna district achieved these results for 35,000 residents and significantly improved water services for an additional 70,000 residents. The installation of energy efficient pumps in nearby pump stations has enabled improved water services for an additional 200,000 residents in the city of Lviv. In the industrial sector, USAID projects helped to generate \$3.4 million in annual savings in ten Donetsk and Dnipropetrovsk enterprises, and improved energy efficiency in 24 enterprises.

USAID also sponsored workshops and seminars on environmental financing and market based tools. It sponsored a Ukrainian-U.S. conference on Global Climate Change and Greenhouse Gas Mitigation through Ukraine-U.S. emission trading and joint implementation projects.

Progress was also made on increasing the number of viable environment non-government organizations (NGO) in Ukraine. The network of environment NGOs has grown from approximately 150 in 1994 to 562 in 1997, an increase of 275%. The focus will now shift to building institutional capacity within these organizations and to coordinating these efforts with

the establishment of the new Regional Environment Center in Ukraine

6 Program Approaches

Policy/Regulatory Framework

USAID will continue to participate in the Ukraine Council and will build on its work to date in developing the Work Group Program to Promote Sustainable Development. Through a one year grant to the UNDP, USAID has shifted management, coordination, and financial responsibility for the Program to the UNDP. USAID will collaborate with the UNDP (which is carrying out a USAID grant) in identifying alternative sources of support for viable Work Groups. It is expected that these Work Groups will continue to propose legislative and policy solutions to barriers to sustainable development with decreasing dependence on external support. Activities under SO 2.3 which contribute to "more effective, responsive, and accountable local government" will facilitate effective implementation of environmental regulations at the local level. Work on tariff reform under SO 2.3 is directly relevant to SO 1.6.

Innovative Finance Mechanisms

One of the most common constraints to environmental financing in the NIS is the lack of capacity to identify viable projects and to prepare project proposals. Ukraine is no exception. As host to the October 1998 sub-regional meeting of the Project Preparation Committee of the Environmental Action Program for Central and Eastern Europe, Ukraine became the focus of World Bank, EBRD, and other bilateral donors. USAID will collaborate with the World Bank and EBRD to identify projects to qualify for loans from environmental/energy efficiency, communal, and micro-enterprise funds and credit facilities. USAID will direct technical assistance towards facilitating cross-border and U.S. partnerships to promote foreign investments and joint ventures, including joint implementation projects in support of Global Climate Change Initiatives.

Improved environmental management practices/environmentally sound technologies

Low cost options to reduce industrial emissions are addressed principally in SO 1.5 in the context of energy efficiency. However, under SO 1.6 there are several ongoing activities contributing to other

aspects of pollution prevention and waste minimization (otherwise known as cleaner production) with the goal of increasing productivity. The World Environment Center (WEC) has been implementing a pollution control program working primarily with steel and chemical companies. It is now in a dissemination phase and is looking to use a Ukrainian entity to continue the work. ECO Efficiency will select two cities for pollution reduction activities. ECO Prava work will soon come to a conclusion. The Environmental Research Institute of Michigan (ERIM) is working on developing the GIS as a tool in environmental management and working to develop a Ukrainian entity to carry out this work. This has potential for enforcement of environmental policies.

USAID has invested heavily in laying the foundation for cleaner production in Ukraine. A next step may be to sustain the lessons learned from these activities by partnering with existing institutions and the new Regional Environmental Center.

In addition, under SO 2.3 USAID will provide technical assistance and training to roll out its successful Lviv Vodokanal project to six to eight municipalities in Ukraine. The approach is improving municipal water management as a communal service. However, the roll out package will include technical assistance and training in sustainable environmental management, energy efficiency improvements and available technologies, and improved financial management, including consumption based billing. Technical assistance will also continue building local technical capacity in municipal vodokanals to identify system weaknesses such as contamination sources.

Citizen empowerment to affect environmental decision-making

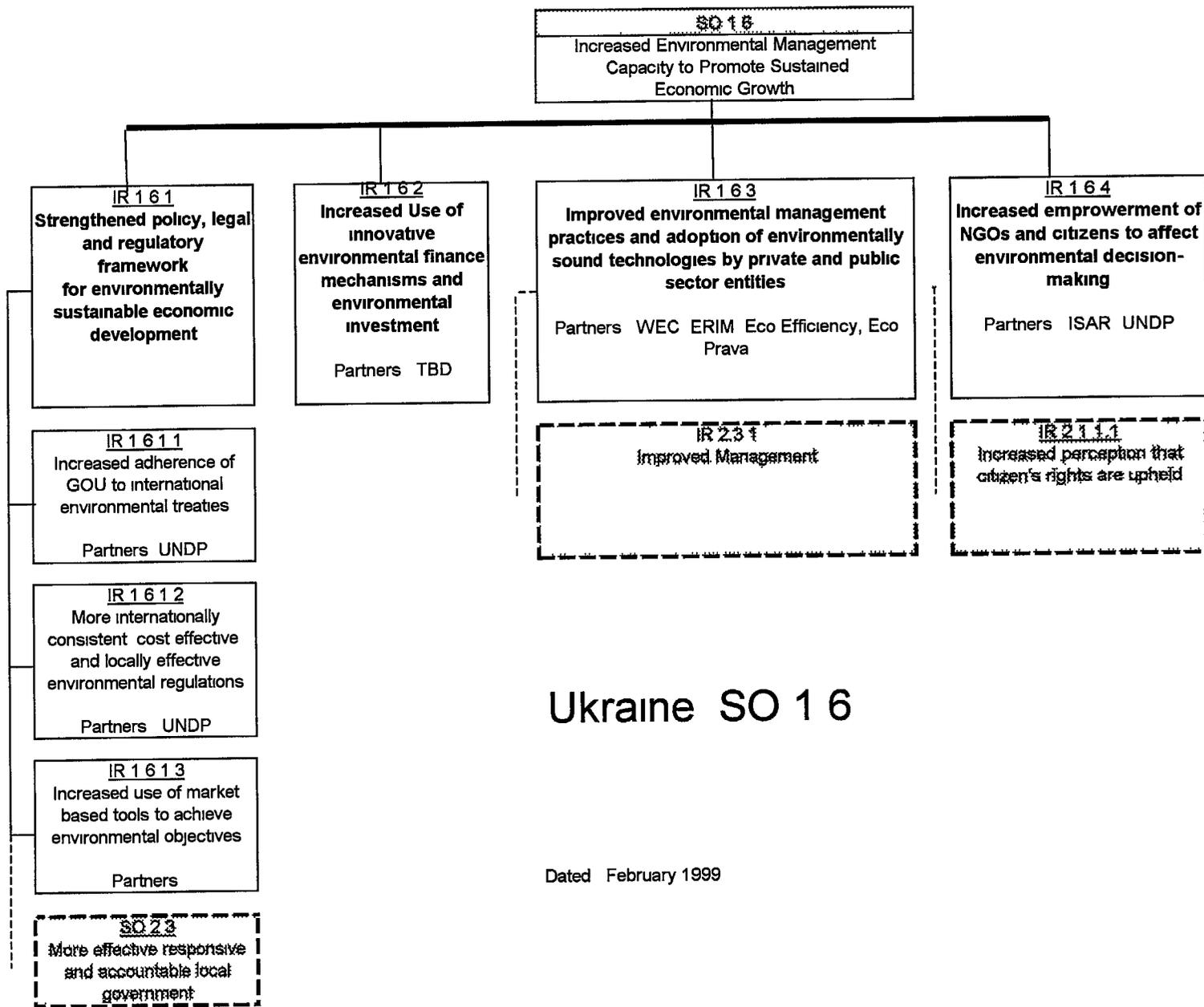
USAID has provided specific support to develop environmental NGOs. A significant number have been established and in the remaining months of this activity work is underway to leave in place an indigenous support network. In the future it is expected that environmental NGOs will be assisted through NGO strengthening activities under SO 2.1. The focus of SO 1.6 will be strengthening citizen participation in environmental decision-making through the Work Group Program implemented through a grant to the UNDP.

7 Commitment and Capacity of Other Development Partners in Achieving the Objective

Much collaboration and coordination (both internally and externally) is required if this SO is to be achieved and redundancy avoided. USAID will continue to work closely with The World Bank, EBRD, and other donors on environmental issues. The Environment for Europe EAP Task Force and the Project Preparation Committee have committed to focus donor attention on the NIS for the period 1998-2002. USAID will collaborate with the UNDP in implementing the Work Groups for Sustainable Development Program. In FY 1998, USAID partnered with the OECD to assist Ukraine in initiating a National Environment Fund. The Government of Denmark has continued to provide technical assistance with this effort. USAID will also work closely with other USG organizations, such as the Environmental Protection Agency (EPA), in implementing USG supported environment initiatives. The EPA is working on the Regional Environment Center.

8 Sustainability

The long term sustainability of environmental reforms will be achieved by the integration of environmental objectives into Ukraine's economic development objectives. Likewise, the sustainability of Ukraine's economic development depends on the successful integration of environmental objectives into its economic development objectives to protect and sustain the nation's productive capacity.



Ukraine SO 1 6

Dated February 1999

Strategic Objective 1 6 Increased Environmental Management Capacity to Promote Sustained Economic Growth

PERFORMANCE DATA BASELINE, TARGETS, AND ACTUAL RESULTS

PERFORMANCE INDICATOR	INDICATOR DEFINITION AND UNIT OF MEASUREMENT	BASELINE DATA		CALENDAR YEAR			
				1998	1999	2000	2001
		YEAR	VALUE	Target	Target	Target	
IR 1 6 1 Strengthened policy, legal and regulatory framework for environmentally sustainable economic development							
IR 1 6 1 1 Increased adherence of Government of Ukraine to international environmental treaties							
Government of Ukraine adopts policies and formulates laws and regulations which promote the tenets of the international environmental agreements on which it is a signatory							
IR 1 6 1 2 More internationally consistent, cost effective, and locally effective environmental regulations							
Policy/legal/regulatory framework recognizes internationally accepted standards and allows for constructive							

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PERFORMANCE INDICATOR	INDICATOR DEFINITION AND UNIT OF MEASUREMENT	BASELINE DATA		CALENDAR YEAR			
		YEAR	VALUE	1998	1999	2000	2001
				Target	Target	Target	
engagement of local and regional level bodies in environmental management and implementation of environmental regulations							
IR 1 6 1 3 Increased use of market based tools to achieve environmental objectives							
IR 1 6 2 Increased use of innovative environmental finance mechanisms and environmental investments							
Number of private and/or public entities using innovative financing mechanisms							
Environmental fund established at local/regional level							

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PERFORMANCE INDICATOR	INDICATOR DEFINITION AND UNIT OF MEASUREMENT	BASELINE DATA		CALENDAR YEAR			
				1998	1999	2000	2001
		YEAR	VALUE	Target	Target	Target	
IR 1 6 3 Improved environmental management practices and adoption of environmentally sound technologies by private and public sector entities							
Number of public and/or private entities adopting improved environmental management practices and/or technologies							
Amount of energy and dollar savings derived from improved environmental management and/or adoption of energy saving/waste minimizing technologies in selected sectors							
IR 1 6 4 Increased empowerment of NGOs and citizens to affect environmental decision-making							

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PERFORMANCE INDICATOR	INDICATOR DEFINITION AND UNIT OF MEASUREMENT	BASELINE DATA		CALENDAR YEAR			
		YEAR	VALUE	1998	1999	2000	2001
				Target	Target	Target	
Number of target groups participating in natural resources management and/or advocacy for environmentally sound economic development in their communities							

150