



GROWTH IN CONDITIONS OF UNCERTAINTY: OPPORTUNITIES AND CHALLENGES

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ON THE NEED

“Budget deficit”

The full-scale war has been going on for two years in Ukraine, which is why the country operates in conditions of extremely high uncertainty.

The increase in defense spending, the fall in GDP, the reduction in the volume of economic transactions, and a number of other factors since the beginning of the full-scale war have led to an increase in the budget deficit. The forecast for 2024 is 20.6% of GDP¹ (for comparison, in 2021, this figure was 3.8%). In monetary terms, Ukraine needs USD 43 bln. in 2024.²

The main source of deficit coverage is external financing in the form of loans and grants. According to the NBU, Ukraine received USD 32.2 bln of international financial assistance in 2022 and USD 32.7 bln in 9 months of 2023.³ There has been a change in the structure of assistance: the share of grants decreased while that of loans increased.

| | 2022 | 2023 |
|--------|-------|-------|
| Loans | 47,3% | 58,5% |
| Grants | 44,2% | 30,6% |
| IMF | 8,4% | 10,9% |

Unlike in 2023, Ukraine has less clarity about the sources and amounts of coverage of the budget deficit for 2024⁴. The support of the European Union is moving along a clearer trajectory within the financial instrument Ukraine Facility (EUR 50 bln for 2024–2027, of which EUR 39 bln is direct budget support).⁴ A decision on financial support from the United States has not yet been adopted.⁵

At the same time, signals from partners about the need to implement reforms are becoming more distinct. On the one hand, they should serve as a condition for obtaining funding and a tracker of Ukraine's progress towards the EU. On the other hand, reforms should become a catalyst for economic growth and sustainability, help create conditions for attracting investment and gradually reducing the deficit, as well as reducing dependence on external financing.

“Money in exchange for reforms”

On September 14, 2023, U.S. President Joe Biden announced the appointment of Penny Pritzker as U.S. Special Representative for Ukraine's Economic Recovery,⁶ which is a very clear signal. She will cover the issues of investment mobilization, business attraction, and support for reforms as well as interact with international partners through a multi-donor platform for aid coordination, etc. In one of the first interviews after her appointment, Pritzker noted that the conditions for obtaining funding from

* Text written as of early November 2023

the United States would be to ensure proper management of funds and implement reforms so that Ukraine became a member of the EU and the Western trade bloc.⁷

Back in March 2023, the IMF approved a four-year program under the Extended Fund Facility (EFF) worth about USD 15.6 bln.⁸ The program aims to support economic and financial stability, restore debt sustainability, and promote reforms that support Ukraine's recovery on its path to EU accession. Traditionally, the program provides for a set of structural beacons that the Ukrainian side must implement in order to receive funding.

In turn, the Ukraine Plan, on which the Ukrainian government is currently working, will become the basis of the above-mentioned Ukraine Facility tool. The Plan is a vision of Ukraine's economic growth in the short and medium term. It will provide for a set of measures to carry out reforms and attract investment. Obtaining funding under the tool will also be directly related to the implementation of reforms and the quarterly review of the Plan.

Therefore, it is important to consider these reforms not as a "condition" for obtaining financing but as a foundation for growth.

"Rethinking opportunities"

Ukraine should look for opportunities for economic growth within the country now, in conditions of war and high uncertainty. Ukraine Plan within Ukraine Facility and the IMF program provide a framework for growth and reform.

Ukraine needs external financial revenues on a regular basis to cover its needs and maintain macro-financial stability. On the one hand, we must continue consolidating the support of our partners. On the other hand, we must work to increase internal revenues.

The first urgent need is the effective management of limited public finances. The second is to increase internal revenues by reforming the bodies responsible for administering and filling the budget (Customs and Tax Services).

International partners seek guarantees for the effective and targeted use of the financial assistance provided. Therefore, the next important step is the effective control over the receipt and use of funds. To do this, it is necessary to reform the bodies exercising such control (the Accounting Chamber and the State Audit Service of Ukraine).

However, unless justice is ensured and the rule of law guaranteed, the increase in internal revenues, the effective control of their use, the creation of conditions for attracting investments, and much more will not have the desired effect. Therefore, the reform of justice and law enforcement agencies should become a solid foundation that guarantees the protection of rights, freedom of economic activity, and liability for violations.

This document is built on the principle of "follow the money," which emphasizes the key stages of this route: obtaining funds, their distribution between needs, expenditures, control of use, and investigation and prosecution of those responsible if necessary. The institutions located on this route first of all need to strengthen their capacity, and their combination needs reforming. An important condition for the effectiveness and impact of these reforms is the comprehensive nature of their implementation.

PART 1.

Financial revenue management

Sustainable and systematic reconstruction of the country is impossible without an increase in the volume of internal financial resources and their effective and transparent administration, including under martial law. In this context, we should consider the work of the State Tax Service and the State Customs Service, which, in particular, are responsible for filling the budget.

The State Customs Service (hereinafter referred to as CSC, customs) transferred UAH 48.3 bln of customs and other payments to the national budget in October 2023. Compared to October 2022, actual revenues increased by 48.8%, or UAH 15.8 bln.⁹

At the same time, personnel, technical, and procedural problems in the SMS can lead to the growth of the shadow economy, which exacerbates the loss of revenues, including those of the national budget. The Ministry of Economy's recent assessment of the shadow market amounted to 31% of GDP during the 3 quarters of 2021.¹⁰

Constant personnel changes do not contribute to improving the efficiency of customs. Since the customs separated into an individual structure in 2018, its management has changed 7 times. This was mostly due to probable and proven corruption offenses.¹¹

The state is already taking the first steps towards reforming the personnel policy in the SMS. In April 2023, the Parliament adopted the draft law No. 6490-d as a basis, which proposed:

- the change of the competitive procedure to select the SCS management;
- the introduction of an annual performance audit by international experts;
- certification of customs officers.¹²

Ukrainian customs also needs harmonization with the European Union; this applies to the implementation of policies and the establishment of interaction between business and customs. Although slowly, there are changes in this direction. For example, Ukraine began to use NCTS, eliminated the possibility of law enforcement agencies interfering with customs control, which used to lead to delays in delivery and damage to the goods.¹³

Business, citizens, and the expert community also have many questions for **the State Tax Service of Ukraine** (hereinafter referred to as the STS, tax service), which performs the function of control over the correctness of calculation, timeliness, and completeness of payment of taxes, fees, and other mandatory payments to the budget.

The main problems in the work of the tax service nowadays include, in particular, the following:

- punitive role of tax authorities instead of the service one;
- complex and non-transparent administration of taxes (including the problem of blocking tax invoices);
- non-transparent competition for the STS head;

- corruption in the tax authorities;
- discretionary powers (the right of an official or state body to adopt decisions at their discretion), etc.

Some work on the tax service reform is already underway. In April, a draft law was submitted to the Verkhovna Rada of Ukraine, which, among other things, proposed to:

- change the procedure for competitive selection of the head of the tax service based on the best practices of competitions to anti-corruption bodies (SAPO, NABU, NACP);
- introduce an annual external performance audit of the tax service;
- conduct a one-time certification of tax officials to determine whether they correspond to the positions held;
- increase the amount of wages for tax officials.¹⁴

Given the systemic problems, customs and tax services require comprehensive institutional and technological reform with a systemic development policy. In a situation where the country has limited financial resources, improving the work of these institutions is an urgent task.

In the Memorandum with the IMF, the Ukrainian authorities speak of their intentions to improve revenue mobilization through a well-established, transparent, and taxpayer-friendly administration of taxes and customs fees.¹⁵

PART 2.

Control over the use of funds

For the effective and rapid reconstruction of Ukraine, an unprecedented amount of repair and reconstruction work, design services, and goods for construction is needed. In particular, according to the World Bank, as of March 2023, the reconstruction of Ukraine would require USD 411 bln.¹⁶

To avoid abuse and inefficient spending, **effective and lawful allocation of funds**, in particular **through public procurement procedures**, is crucial. Procurement should be conducted in compliance with the principles of transparency, legality, and fair competition; reliable safeguards are necessary to avoid waste and overpricing.

Ukraine already has powerful tools and worthy positions in the field of public procurement. The principle of "everyone sees everything," **embodied in the** Prozorro system, means openness of information and documents on the choice of the winner and contracts.

However, the transparency of procurement does not guarantee its effectiveness. Effective state control over the legality of procedures and the efficiency of spending money in them is crucial. Such control shall be exercised by **the State Audit Service**

of Ukraine and its territorial bodies (hereinafter referred to as the State Audit Service). In addition, **the Accounting Chamber** controls the cash flow to the national budget and the use of the money on behalf of the Verkhovna Rada.

The legislation gives the State Audit Service the authority to conduct several types of state financial control: among them are both individual ones related to specific procurement transactions and comprehensive ones, during which the activities of controlled entities are checked. Some measures, such as procurement monitoring, are open and aimed at preventing violations and eliminating them. Within the rest of the measures, public auditors visit the controlled institutions.

Currently, MPs have submitted a draft law, which, if adopted, will allow stopping payments under contracts, but this is a risky initiative¹⁷. Despite the fact that procurement monitoring has a preventive potential, auditors start more than 70% of monitoring sessions after the conclusion of the contract. This approach needs to change. The existing legislative initiative needs to be finalized. For effective control, monitoring should begin before the contract is concluded.¹⁸

The Accounting Chamber exercises control through financial audit, performance audit, examination, analysis, and other control measures.¹⁹ Its scope of work covers the receipt and use of the national budget funds.

The supreme audit institution has great potential to influence the efficiency of budget revenues and expenditures. The Accounting Chamber has only recently begun to work in this direction, gradually moving from inspections and checks to external audits. The issues of reforming the Accounting Chamber, introducing international standards, changes in personnel policy, enhancing institutional capacity, etc. are acute. As of early November, three draft laws have been registered in the Verkhovna Rada, which offer different variations of the reform of the body.

However, there are a number of problematic aspects and several areas for **improving the work of state financial control bodies** in Ukraine:

- **enhancing the institutional capacity** of state financial control bodies and minimizing political influence. In particular, this is the legislative and technical elimination of loopholes that allow those responsible for violations to avoid responsibility, as well as solution of the issue of automatic access of state financial control bodies to the necessary information systems and registers, unification of practice. However, it is also important to provide for how to prevent abuse by the state financial control bodies in the implementation of powers and tools;
- **the need to shift the focus to prevention and identification of significant violations** that caused damage to the budget. For example, thanks to preventive control, procuring entities could eliminate violations before concluding a procurement contract, that is, before financial resources are spent;
- **further digitalization of control measures:** development of electronic tender documentation and electronic contracts; introduction of an updated system of risk indicators; integration of the Prozorro system with the systems of the Treasury, court registers, sources of verified personal data; development of electronic tools for the work of public auditors, etc.

State control in the field of public finance should be one of the priority areas for improvement, since it is the filter that prevents embezzlement of funds. The reform of control bodies should take place simultaneously for all key institutions. This will strengthen the system as a whole, as well as increase confidence in Ukraine on the part of international partners. Evidence of the latter, in particular, is also the potential inclusion of the State Audit Service and the Accounting Chamber in the list of reforms that Ukraine needs to carry out in order for the United States to continue providing financial support.

PART 3.

Rule of law

The experience of Ukraine over the past 10 years has demonstrated that the most difficult thing is to implement justice and law enforcement reforms. It is these systems of bodies that should monitor the legality of the actions of other state bodies. These institutions can easily harm the development of a corruption prevention system, as well as negatively (or positively) impact the trust of investors.²⁰ Therefore, to achieve progress, justice, and the rule of law, judicial reform and changes in law enforcement agencies must remain a priority.

Currently, judicial reform is underway in Ukraine, which is designed to ensure independent and impartial justice. The high-quality work **of the High Council of Justice** and **the High Qualification Commission of Judges** will solve the issue of a lack of personnel in the judicial system and bring to justice those judges who commit disciplinary offenses. Judicial reform is a long-term investment whose active implementation will provide significant results in 4–5 years.

The work of **the prosecutor's office** is no less important. It is designed to carry out procedural management of the work of pre-trial investigation bodies, which ensures the proper performance of their powers by the latter as well as stops cases of unjustified interference by these bodies in the work of both business and individual citizens. The proper work of disciplinary and prosecutorial self-government bodies, as well as the certainty of their powers and the depoliticization of the work of the prosecutor's office, can contribute to the further development of this system.

Law enforcement and security agencies also play an important role in ensuring the proper functioning of the economy. They can stop embezzlement, ensure the proper collection of evidence so that the perpetrators can be held criminally liable. Therefore, it is important to assess the effectiveness of **the State Bureau of Investigation, the National Police, the Bureau of Economic Security, and the Security Service of Ukraine**. At the same time, both guarantees of control over the performance of these institutions and their accountability should be observed. Transparent selection of the heads of these agencies and assessment of their professionalism and integrity lay the foundation for effective and capable institutions.

It is important to strike a balance between the freedom of economic activity and the reduction of the impact of the shadow economy on the real sector. The key in

this regard is reforming the body responsible for countering offenses that encroach on the functioning of the state economy, namely **the Bureau of Economic Security**. The actions of this body can both deter enterprises belonging to the real sector of the economy from conducting legal activities and stimulate them.

Therefore, to ensure an effective restart of the Bureau of Economic Security, it is necessary to:

- lay the foundation and ensure the development as well as the sustainable functioning of the institution that will be responsible for counteracting offenses related to economic activity;
- pay attention both to the selection of an independent and professional head of the institution and to the re-certification of employees of this body;
- introduce an independent audit of the activities of the Bureau of Economic Security, which will contribute to the efficiency of its operation;
- improve the national criminal procedural legislation.

This is extremely important because in the process of reconstruction, operations will be carried out that are primarily related to the procurement of goods and services, the funds for which can be allocated by international partners. This may increase the risk that such funds will be laundered to further legalize them. However, excessive attention from tax control and law enforcement agencies to enterprises operating legally may demotivate them from participating in the reconstruction.

ON THE OPPORTUNITIES

To summarize, the main priority of domestic policy for Ukraine in the context of the war and after it is reforming and strengthening the institutions responsible for managing and controlling funds, as well as ensuring the rule of law. Systemic changes in these areas are a long-term process that is not limited to the adoption or amendment of legislation.

Nowadays, the circumstances of Ukraine make international financial assistance crucial to continuing the fight against the aggressor. In turn, international partners are increasingly interested in Ukraine becoming more independent economically from their support, which is likely to decrease over time.

Ukraine should become attractive to investors as soon as possible, able to guarantee the safety of capital and fair protection of rights and interests. This will not only facilitate Ukraine's path to the EU and strengthen relations with international partners, but also create a favorable environment to build economic potential within the country.

In this paper, we have offered a cursory overview of the main actors responsible for the collection, allocation, use, and control of public finances. We are convinced that if we work systematically to strengthen these key institutions, this will create the foundation for successful reconstruction and economic well-being in the future.

Therefore, the main opportunities that we have considered in this document are the following:

1. Strengthening the institutional capacity of the customs and tax services will create opportunities to increase and effectively manage budget revenues. The digitalization of processes in the focus areas of these bodies will simplify management, increase transparency, and allow synchronizing work with supervisory and financial control bodies.
2. Reforming the State Audit Service of Ukraine and the Accounting Chamber will allow for the development of a system of independent and professional control over the attraction and use of finances in the country. Enhancing the capacity and transparency of these bodies will ensure an increase in confidence on the part of the international community and society in the state.
3. The continuation of judicial and anti-corruption reforms and the reform of law enforcement agencies will contribute to the establishment of an impartial investigation, the inevitability of punishment of those responsible, and compensation for damages caused to the state.
4. Most of the institutions we have considered need to be improved in the following areas: transparent competitions, expansion of powers or avoidance of their duplication, financial capacity, staffing, impartiality, accountability, etc. However, one of the key conclusions that should be emphasized is the comprehensive nature of changes: it is necessary to enhance institutional capacity as a whole and not solve problematic aspects individually, to simultaneously reform the entire network, and not its separate components.

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