

Governance and economic growth

OeNB/NBU East Jour Fixe on Ukraine

Vienna 12 September 2019



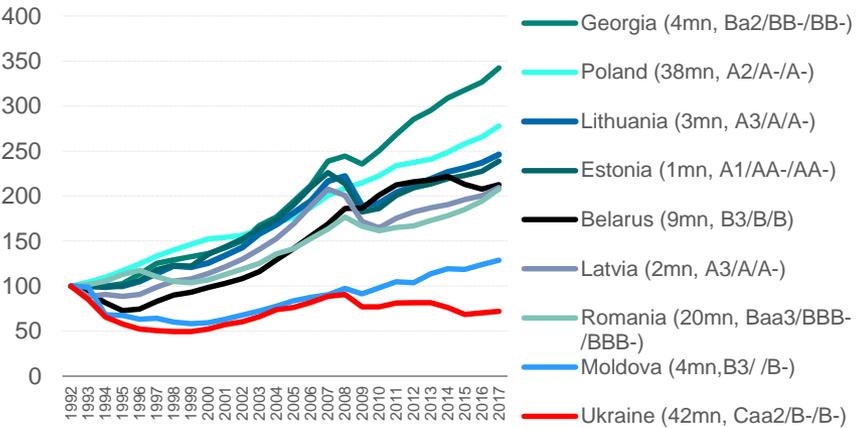
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- Why governance is important for economic growth
- Governance dividend
- Governance reforms in Ukraine
- EBRD contribution
- What remains to be done

The great divergence

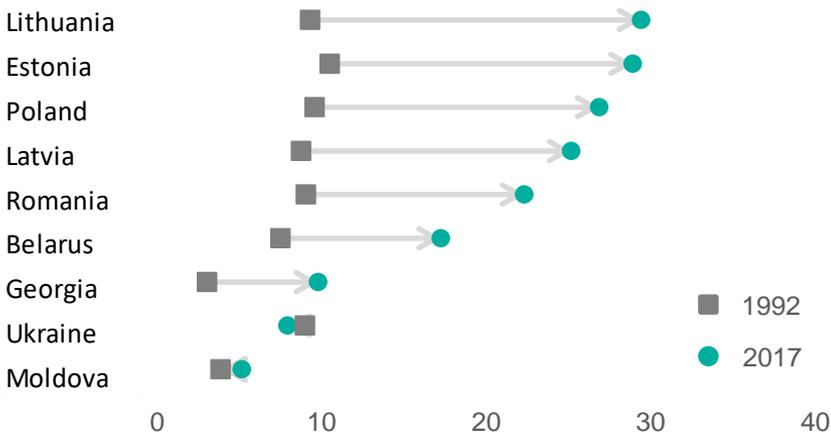
Ukraine has been one of the most disappointing EMs globally

Cumulative real GDP growth [1992=100]
Population, Sovereigns rating (Moody's, S&P, Fitch)



Ukraine's real incomes stagnated

GDP per capita, constant prices, PPP adjusted



- Ukraine and Poland entered transition from the same level
- Ukraine was considered to be one of the most promising former Soviet Republics (strong industrial base, the best soil in Europe, reach in minerals, young and highly educated work force)
- 30 years later – Poland is three times richer than Ukraine

Sources: State Statistics Service of Ukraine, National Bank of Ukraine, IMF WEO Apr 2018, rating agencies, EBRD calculations

What happened in meantime?

Comprehensive reforms in Poland

- First stage of reforms 90-91 “Shock therapy”
 - liberalization of prices and foreign trade;
 - privatization;
 - macroeconomic stabilization;
- Later, reforms driven by NATO and EU integration

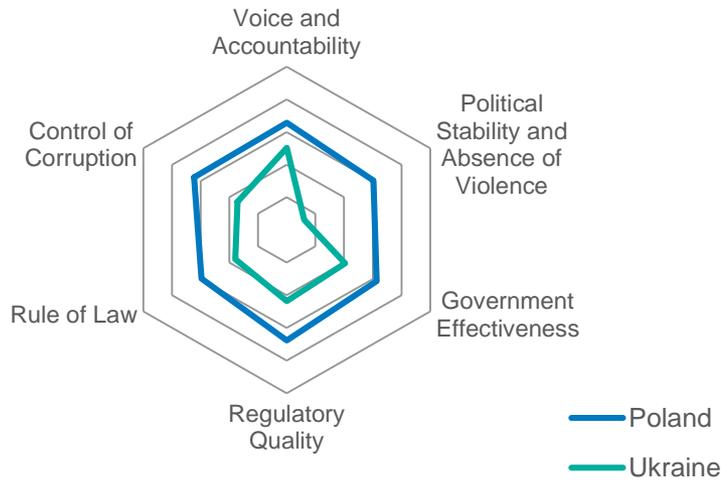
Lack of political will for reforms in Ukraine

- Old communist elite continued to dominate politics
- Spontaneous privatization leading to assets stripping and creation of oligarchs
- Vested interests
- Lack of reforms
- Absence of EU anchor

Lack of reforms led to significant governance gap

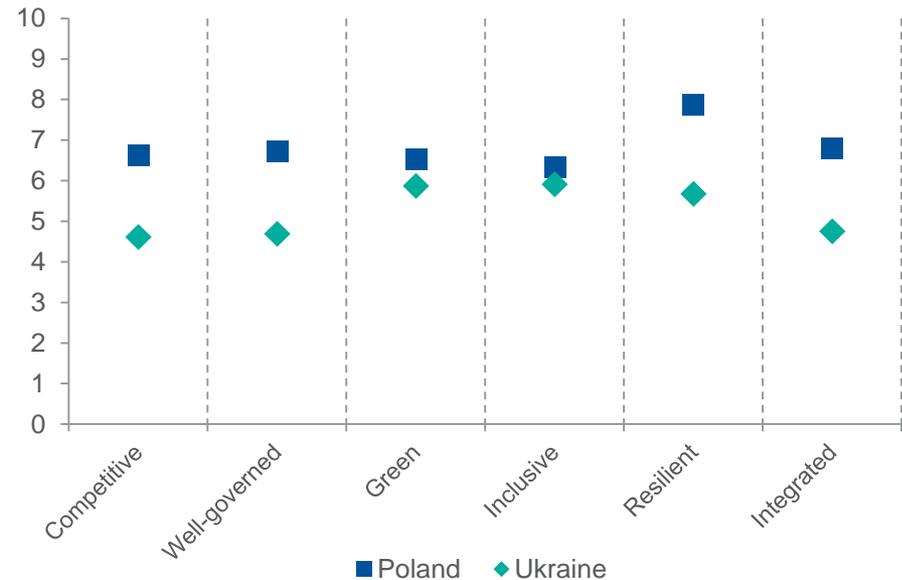
Worldwide Governance Indicators

scores on a scale of [-2.5,2.5], in 2017



EBRD's Assessment of Transition Qualities (ATQs)

scale of [1, 10], where 10 is the best possible score





What we mean under governance?

- At its core, governance is about the quality of institutions and the processes that they support
- Institutions are, in turn, understood broadly as the rules of the game in a society
- Adam Smith referred to the market forces of supply and demand as the invisible hand that drives the economy
- Yet to function effectively, the market itself depends on the other “invisible hand” – the quality of rules and regulations of markets and within firms

In this sense, governance can be seen as the “invisible hand” of oversight that allows the classical invisible hand to work its wonders of efficiency

Weak governance makes investment riskier



It leads to increased reliance on political and personal connections,



which in turn distorts market signals and results in suboptimal allocation of capital and labour in the economy.



A large literature documents the importance of institutions for economic development

- Better institutions are strongly associated with better long-term economic growth, and thus higher per-capita incomes. (Hall and Jones (1999) and Robinson et al. (2005))
- Poor-quality institutions and the absence of secure property rights make returns to investment more uncertain. This discourages investment and undermines long-run growth. (Mauro (1995))
- The detrimental effect of corruption on firm growth is three times greater than the negative impact that extra taxes would have. (Fisman and Svensson (2007))



The governance deficit may be particularly problematic for upper-middle-income economies

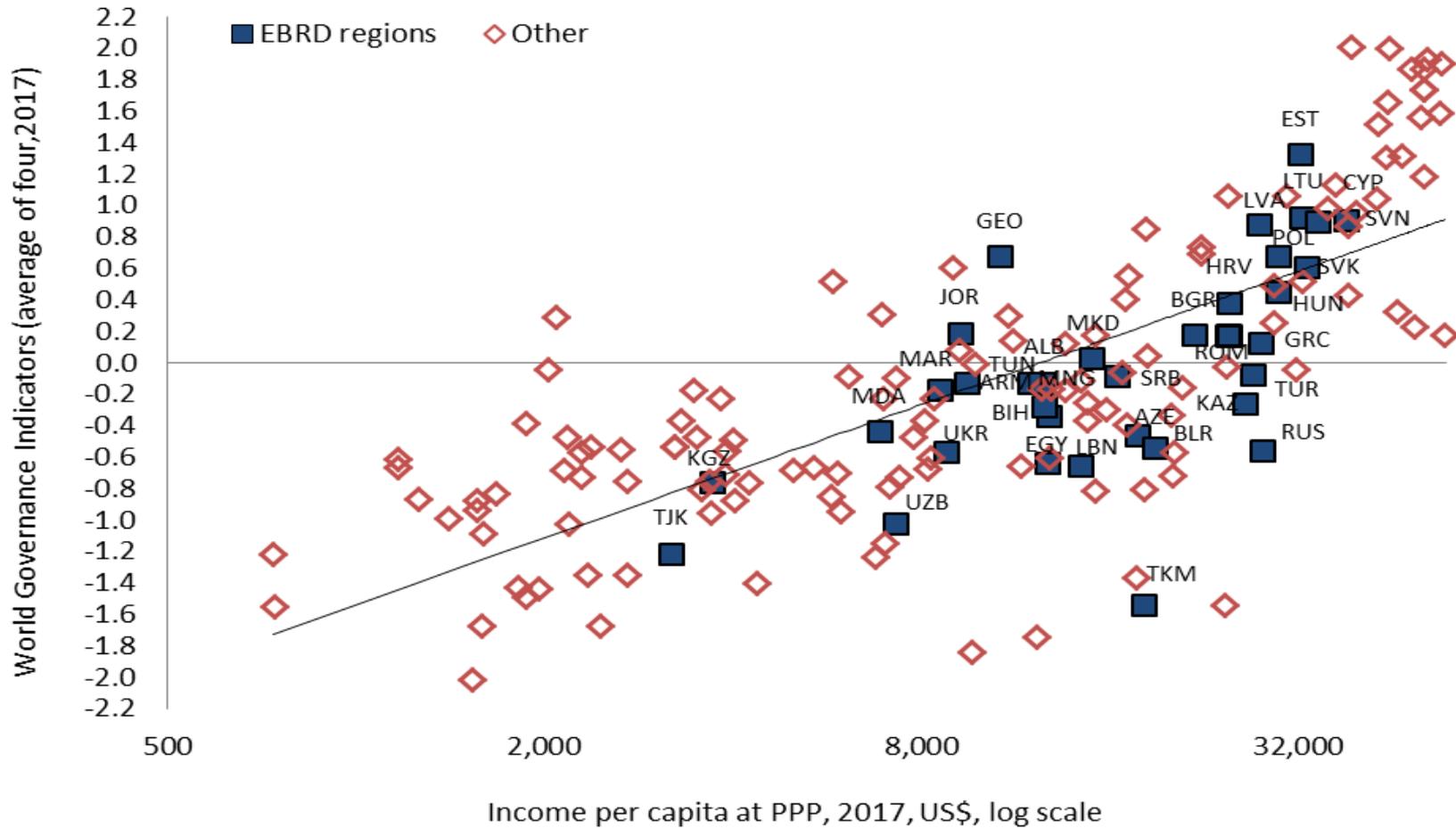
- Because they rely on innovation and entrepreneurship, rather than on cheap labour, economies of scale and imported technologies
- Good governance is essential for secure property rights and strong incentives for entrepreneurship and innovation. (EBRD (2019))
- Poor governance is a major driver of individuals' decisions to emigrate reducing the stock of available human capital



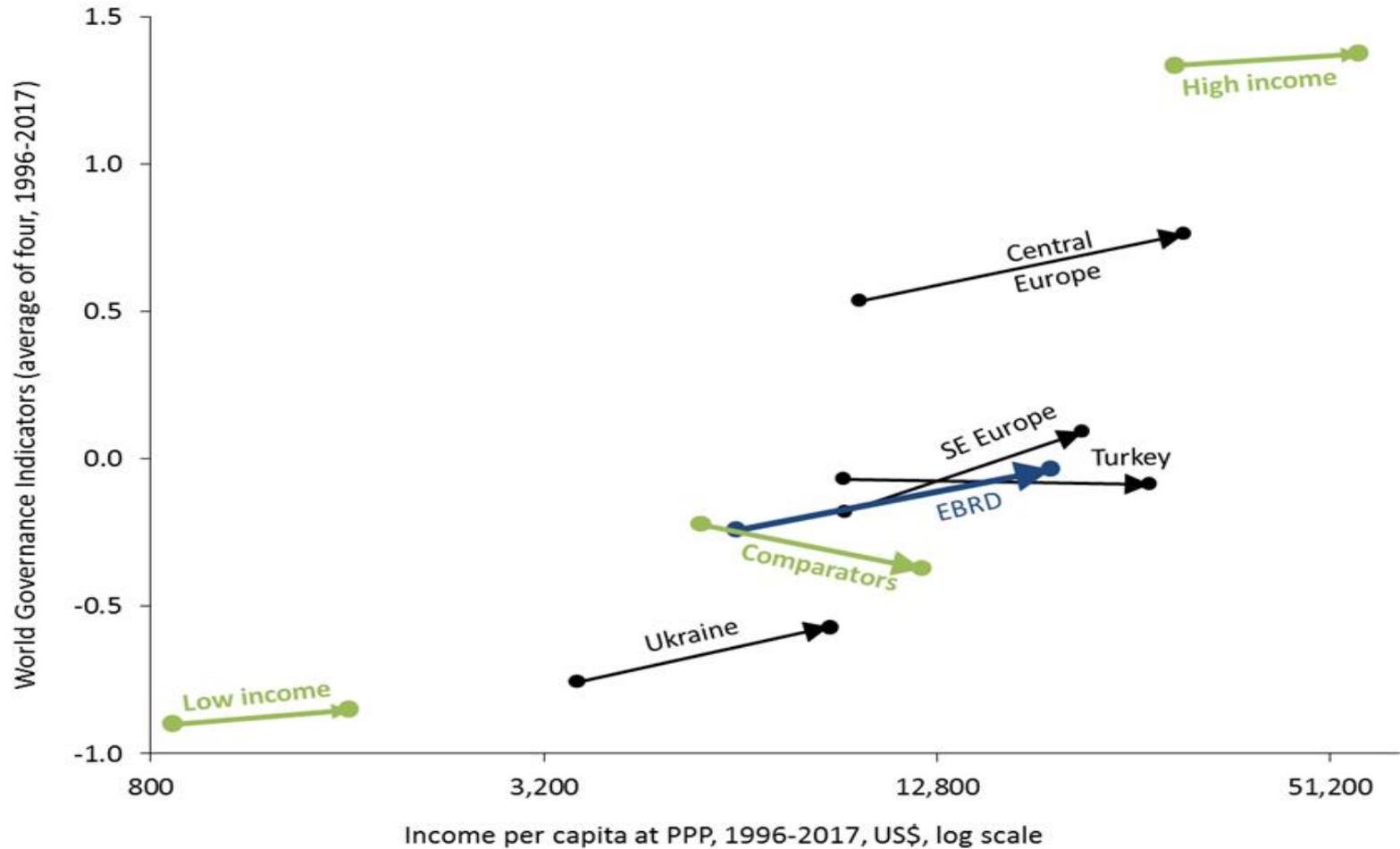
Quality of corporate governance also matters

- Differences in firm performance are to a significant extent driven by differences in firm governance.
- Better corporate governance and management practices enable firms to combine human capital, physical capital and material inputs more efficiently.
- Across the EBRD regions, affiliates of multinational companies consistently display the higher-quality management practices than domestic firms.
- Among domestic firms, listed companies tend to be better managed than state-owned enterprises or family-owned firms.
- Furthermore, firms run by professional managers score more highly in terms of management quality and the use of CEO time than firms run by family owners.

Better governance is strongly associated with higher per-capita incomes



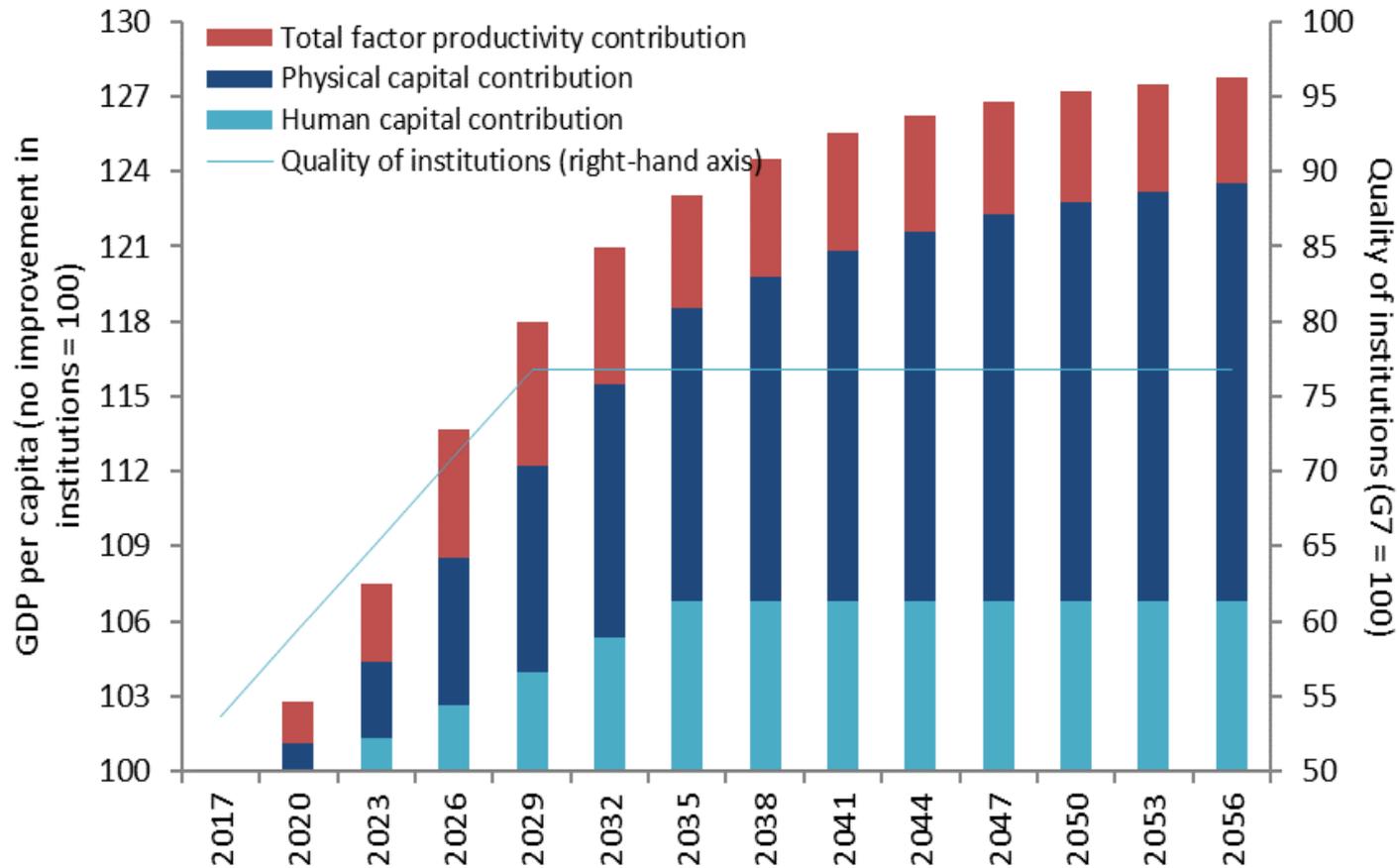
Quality of governance in Ukraine is below EBRD average level



Governance dividend (1)



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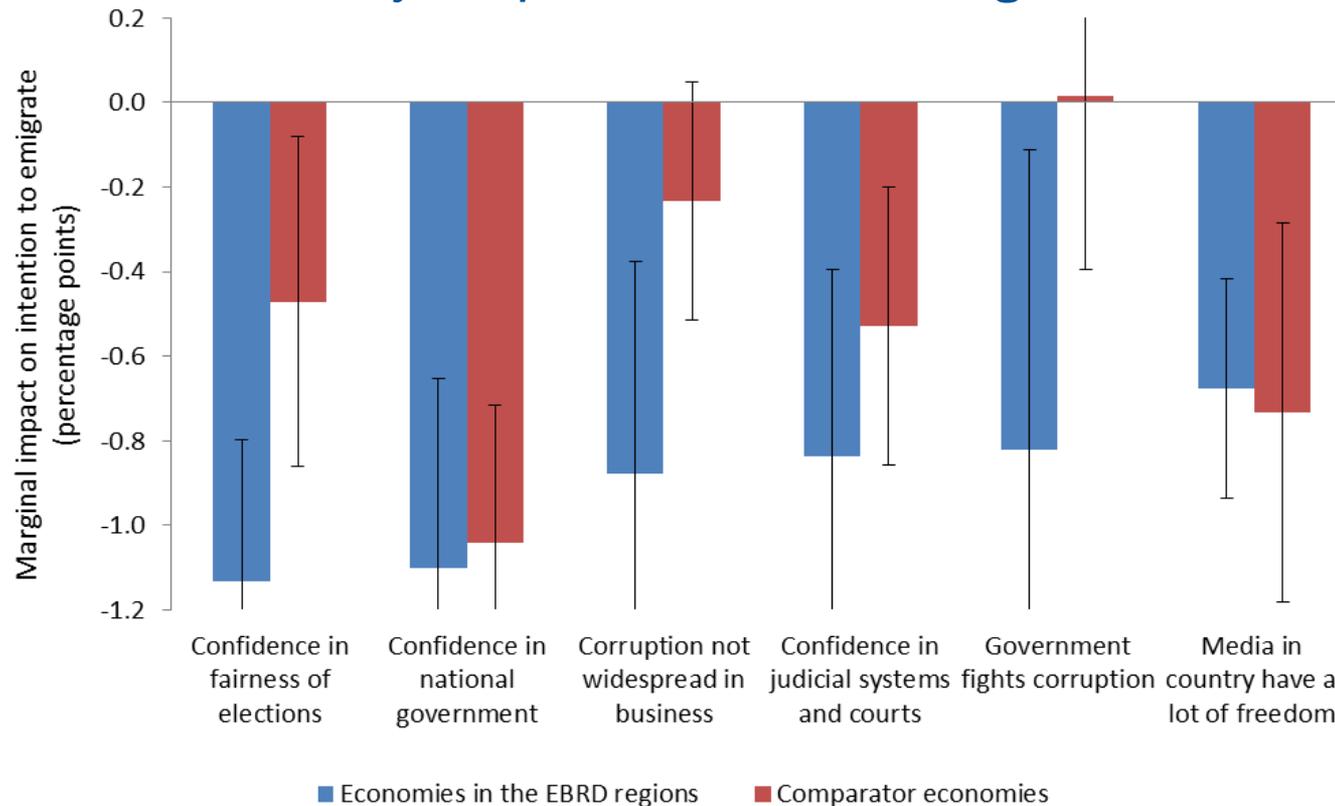


The analysis shows that closing half of the gap in the quality of economic institutions relative to the G7 economies would yield a sizable growth dividend, largely through greater investment in physical and human capital. This growth dividend can be further traced to improvements in productivity and growth in output of individual firms.

- In addition to the income effect, better governance is strongly associated with higher life satisfaction and lower intentions to emigrate.
- One standard deviation improvement in the index of confidence in institutions is associated with a 12 per cent of a standard deviation improvement in life satisfaction. In a country like Ukraine, the same is derived from a US\$ 270 per month rise in income, holding confidence in institutions constant.

Governance dividend (3)

People with low levels of confidence in public institutions are more likely to report an intention to emigrate

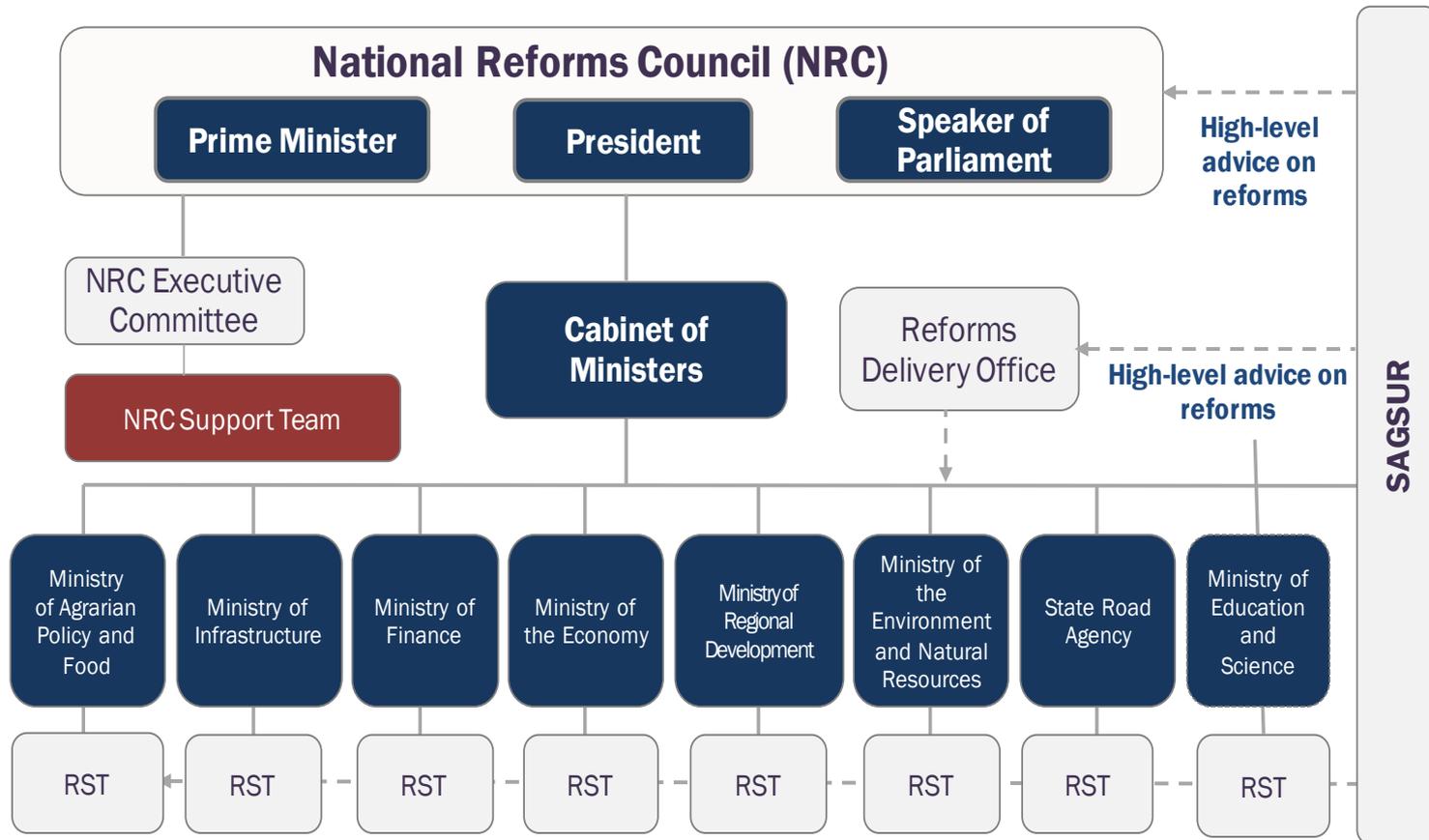


This analysis examines links between perceptions of governance and intentions to emigrate for economies in the EBRD regions and comparator economies with similar income levels, using data from the Gallup World Poll

What has been done?

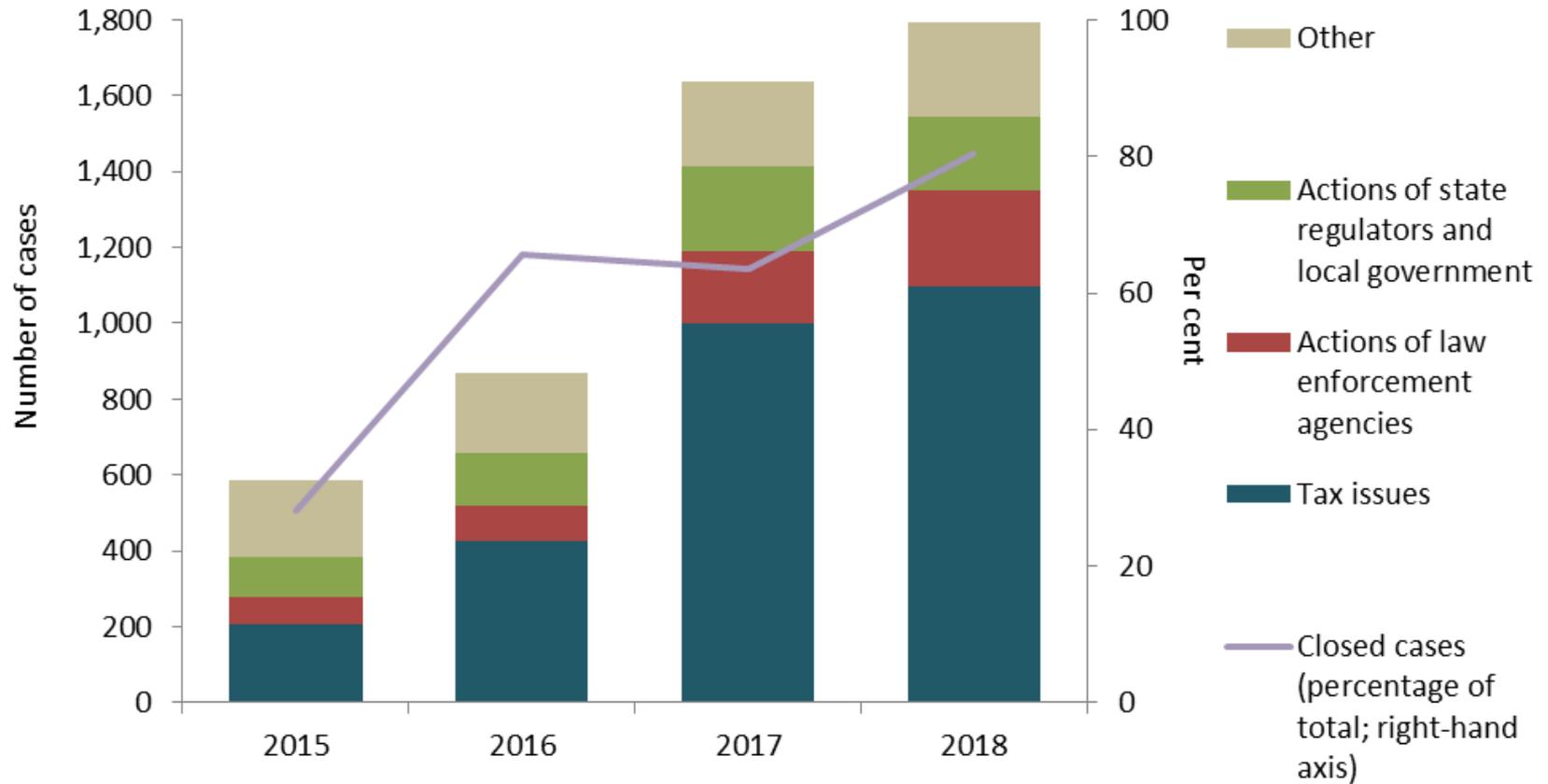
- Macroeconomic stabilisation was achieved
- Major cleaning operation in the banking sector was completed
- Gas sector was reformed and price arbitrage and room for corruption eliminated
- Improved corporate governance in major SOEs (Naftogaz, Railway, Post office, Ukrenergo, Energoatom)
- Implementation of the electronic public procurement system, ProZorro, for all public institutions that significantly reduced abuse in public spending (estimated yearly savings are at \$2 billion)
- Some progress in the tax administration (revenues collected as a result of decreasing corruption within the tax system are estimated at approximately \$3 billion)

Ukraine Reform Architecture programme – a snapshot



EBRD contribution (2)

In the period 2015-18, the Business Ombudsman Council received more than 4,800 complaints



- Corporate governance
 - Naftogaz
 - Railway
 - Post office
 - Ukrenergo
 - Energoatom
 - SOBs
- Reform of gas and electricity markets in line with the EU 3rd Energy Package

What remains to be done?



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- Guarantee and respect the independence of NBU
- Privatization of SOBs
- Privatization of SOEs
- The introduction of the land market
- Reform of tax and customs administration
- Strengthen the fight against corruption and the rule of law
- Complete decentralisation and further reform public administration
- Demonopolisation and opening regulated and closed sectors such as the energy sector and railway transport