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# Inside Ukraine

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# Content

<b>The Government Policy</b> .....	<b>1</b>
Debaltseve is a critical point on the conflict map .....	1
The reforms require effective communication .....	3
<b>Economic Situation</b> .....	<b>5</b>
Tax innovations in 2015 .....	5
Coal background .....	6
<b>Political competition</b> .....	<b>8</b>
Decentralization as a new field for political competition .....	8
“Batkivshchyna” is a weak element in the coalition .....	9

# The Government Policy

The Kremlin is striving for the revision of the Minsk Protocol and is provoking a further escalation of the conflict in Donbas in order to make the Ukrainian government more compliant at the negotiations table. If Ukrainian troops manage to hold the frontline and prevent the pocket near Debaltseve, Ukraine will improve its position on the international level and the Minsk Protocol will not be revised. Otherwise, Ukraine will have to play according to the Russian scenario and make a deal with the separatists. Such a scenario is a threat to the current government, as the latter will be unable to explain the repetition of the “Ilovaisk tragedy” to the society.

The defensive capacity of Ukraine may be improved through changes in HR policy regarding the army command, the fight against corruption, a transparent mobilization procedure, which should concern mostly experienced military personnel, the promotion of military service through infor-

mational campaigns and a reliable social benefits package and basic military training to citizens who will not be mobilized.

Although the presence of foreigners in the Ukrainian government has not brought about any specific results yet, there is a qualitative difference between them and their Ukrainian colleagues in terms of communication on reforms. In January 2015, several active PR-campaigns have been launched to explain some aspects of the justice and police reforms as well as the fight against corruption. Foreigners who are either members of the government or consult it are key speakers in these campaigns. Meanwhile, Ukrainian politicians have yet to understand that a year full of general declarations, which do not actually explain the reform mechanics, serves to discredit the notion of changes in the country and no reforms are possible without popular support. The simulation of reforms undermines the people’s trust in the government.

## Debaltseve is a critical point on the conflict map



Pro-Russian gunmen systematically test the whole frontline in Donbas, trying to find the weakest points. The destruction of the Donetsk airport, a plan to surround Ukrainian troops near Krymske, the constant shelling of Mari-

**Gunmen are looking for the weakest points in Ukrainian defense**

upol, Stanytsia Luhanska and Shchastya and the attempt to create a pocket near Debaltseve are aimed to exhaust the Ukrainian defense and increase the number of Ukrainian losses enough to make the Ukrainian government agree to Minsk-2 under Russia’s terms.

The tactical success of separatists in some parts of the frontline prove that the Ukrainian govern-

ment have not use properly decrease in hostilities after signing the Minsk agreements.

For almost six months, Ukrainian authorities have not followed through on necessary work with local populations in the towns that are close to the frontline. Though a separate Ministry of Information was created, informational campaigns have not been launched. It is these campaigns that play a crucial role in hybrid wars, in which it is necessary to win both “hearts and minds” of local residents. Russian and “separatist” media remain the only source of information for populations in Avdiyivka, Maryinka and Debaltseve, which are under Ukrainian control.

Ministry of Information does not counteract Russian propaganda in ATO zone

A number of towns and villages, which had been controlled by the Ukrainian army for over six months, were relatively easily taken by separatists after they started their offensive.

Volunteers are still more efficient and prompt in providing soldiers with the necessary equipment than the Ministry of Defense.

Though there are quite a significant number of Ukrainian troops in the ATO area, they are dispersed and sometimes ill-coordinated. Battalions from the same brigade are located in different ATO sectors and are often managed by the General Staff, but not by the brigade commander. In comparison to April-May 2014, the army management system has become more complicated.

Meanwhile, the Kremlin understood that the Minsk Protocol does not serve Moscow’s interests and used autumn and early winter to accumulate weapons, train gunmen and launch a centralization project of the separatist republics through the elimination of uncontrolled chiefs. At the same time, separatists have continue to shell residential areas in the cities under their control in order to incite hatred of Ukrainian soldiers among local residents.

The Kremlin used so called ceasefire to prepare separatists for offensive

The situation near Debaltseve remains the most difficult at the frontline and has the potential for further aggravation. Up to 4,000 gunmen with heavy weapons and tanks are attacking the whole perimeter of the Debaltseve beachhead, whereas a

highway to Artemivsk is the only logistic connection for Ukrainian troops.

In order to win in this confrontation, the Ukrainian government needs to focus on improving the defensive capacity of the country.

First of all, the President cannot turn a blind eye on army appointments. Several failed operations with significant losses on the Ukrainian part caused a wave of criticism against Viktor Muzhenko, head of General Staff. For over nine months of the ATO, many middle-rank officers showed an outstanding performance and may become the new faces of the army’s leadership.

Secondly, mobilization will be more efficient if it concerns experienced specialists, not youth without any experience. According to some data, in Ukraine there are 400,000 professional military men who participated in peacekeeping missions, and 800,000 people are veterans of the marines and special task forces.

Defense capacity may be improved through revision of HR policy in the army and mobilization approaches

Further, there are 300,000 employees in the Ministry of the Interior, many of whom are under threat of dismissal during the course of the police reform. Encouraging police officers to sign a contract with the army will solve the issue of their employment after the MOI reform and provide the army with specialists who at least know how to deal with guns.

In order to attract former military and current police officers to the army, the mobilization campaign should be preceded by an informational one. Potential army recruits should understand the level of their financial remuneration as well as the social packages offered to their families if the they should get wounded or die.

An efficient mobilization is based on positive stimuli, not repressive methods. The declarations of the Defense Ministry that people subject to military service are limited in their right to go abroad or even across the country cause social discontent and do not facilitate the necessary mobilization.

Young people may be trained on the basics of military service even without mobilization: through training camps, a greater emphasis on military training at school and more active work of defense support

Basics of military training may be taught even without mobilization

societies. In their turn, enterprises and institutions may be encouraged to send their employees for week-long training camps — a similar approach is used in Switzerland where all the men under 50 have to undergo a three-week military training once a year.

Another way to improve the defensive capacity of the country is to eradicate corruption in the Ministry. This will ensure a better technical provision of units and more transparent mobilization.

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# The reforms require effective communication

Effective communication with the public is one of the prerequisites for successful reform implementation. Two months of the government in place demonstrated a new trend for Ukraine — the “legionaries” (foreigners in the government) began to explain which stages reforms will have, what principles they will be based on and how much time they may take. Society finally has started to obtain information about changes which the Ministry of Justice will undergo, when the patrol police will be formed and why the Anti-Corruption Bureau creation has slowed down.

Society needs detailed information about reforms: their principles, risks and deadlines

Eka Zguladze, Deputy Minister of the Interior, is the most active in reform promotion. She oversees the formation of patrol police in Kyiv, which will pass through a few stages. Until February 6, 2015, candidates may apply for the competition. Following the results of a general skills and psychological profile assessment, selected recruits will go through a three-month training (in Georgia, due to the rapid pace of reforms initially set by officials, training was reduced to three weeks). Once 3,000 new police officers have completed their training (June 2015), the Kyiv State Motor Vehicle Inspectorate will disband and patrol police will start working. Public attention to MOI reform resulted in 27,000 people having applied for the competition. 72% of them are university graduates.

Public attention to the MIA reformation increased a number of applicants

At the end of January 2015, the Ministry of Justice presented its reform, in which Georgians Jaba Ebanoidze, Gia Getsadze and Khatia Shelia became key speakers. Private bailiffs will replace the State Bailiff Service, which may accelerate the implemen-

tation of court decisions due to competition. The State Registration Service functions will be delegated to local authorities, although Jaba Ebanoidze stresses the flaws of such an approach because of the local authorities’ opportunity to slow down the registration process and to demand additional funds. The fundamental principle of the reform is the institution’s division into the front office (receiving documents) and the back office (registration). Such separation of the offices will help stop corruption due to the minimized physical contact between applicants and registration officers.

The difference between Ukrainian officials and their colleagues of foreign origin concerning their approaches to communication also lies in corruption counteraction. Having adopted the anti-corruption package in October 2014, Ukrainian politicians spoke very little about specific mechanisms to combat corruption, such as delineating which investigations will be pursued by the Anti-Corruption Bureau and which by the State Bureau of Investigations, etc. Instead, they focused more on the particular importance of the Anti-Corruption Bureau, the issue of its accountability and the procedure under which its head will be selected.

Giorgi Vashadzhe, former Deputy Minister of Justice in Georgia and current adviser to the Ukrainian government, was probably the first to provide a comprehensive explanation to what is going on with anti-corruption reform. He stated that, according to the October law on the Anti-Corruption Bureau, the new agency did not have all the necessary tools for operation. That is why the Anti-Corruption Committee of the Verkhovna Rada has prepared draft amendments to the law, which sim-

It is not enough to form the Anti-Corruption Bureau; it is essential to provide all necessary tools for its activity

plify the procedure of the confiscation of property acquired through corruption and a collaboration mechanism for accomplices who help investigation.

The functioning of the Anti-Corruption Bureau will be outlined before the appointment of its head and after public consultations with civil society organizations, the business community and journalists. This vital step will facilitate the consideration of all stakeholders' positions, not only the political players' interests.

A detailed explanation of reform initiatives, public consultations and attempts to speak coherently, without hiding behind general declarations

and long lists of reforms, clearly set foreigners apart in the Ukrainian government, although it is too early to discuss specific results of their presence in the government. It was expected that such a proactive position and sense of competition would spur Ukrainian officials onto action. However, the lack of explanations for judicial, energy and national security reforms from Ukrainian authorities signals that reform simulation continues, which will inevitably result in a lower public trust in the government.

Reform imitation will lower public trust to the government

# Economic Situation

Approved at the end of 2014, tax changes will offer many innovations for entrepreneurs in 2015. Though the government promised to simplify the tax administration system, businesses will not get the expected tax relief.

The government proposal of coal industry re-

forms has stirred miners to protest recently. The shutdown and temporary closure of mines, a delay with salaries, as well as the increasing fiscal burden on miners' pensions and salaries caused mass protests among miners. Authorities' disregard for this problem may end up with further civil disturbances.

## Tax innovations in 2015



Issues such as budget revenue, the deteriorating investment climate, a decline in currency reserves and the absence of trust-based relationships between state authorities and businesses are major economic challenges that Ukraine is facing. Throughout 2014, there was an incessant debate between state authorities, businesses and the expert community concerning future tax reform. At the end of 2014, this debate resulted in draft amendments to the Tax and Budget Codes. However, there will be no reduction in the tax burden for businesses in 2015.

**Business will not get expected tax relief**

The main changes in tax legislation will be as follows:

1) Though the government promised to reduce the number of taxes and levies from 22 to 11, in fact they will be absorbed into existing taxes and levies.

2) Individual income tax. Since January 1, 2015, tax rates have increased from 17% to 20% for the

monthly taxable income exceeding ten minimum wages; the minimum taxable pension will reach the equivalent of three minimum wages (UAH 3,654); passive income tax rates will increase from 15 to 20%; a military duty will be charged throughout 2015; a progressive scale of taxation for individual income will be introduced, which is a common practice worldwide. However, any innovations concerning the individual income tax are doomed to fail due to the sluggish development of the financial market, in the first place, as regards non-state pension insurance and the lack of pension reform.

3) VAT. Beginning in the first reporting period in 2015, tax declarations will be submitted solely in electronic form. The threshold for obligatory registration/cancellation of a VAT taxpayer increases from UAH 300,000 to 1 million. On February 1, 2015, a VAT electronic management system will be introduced. However, the introduction of VAT-invoices does not correspond to the coalition agree-

ment. Further, many representatives of the business and expert communities view such an initiative rather negatively.

4) Income tax. A basic income tax rate is 18%. There will be obligatory advance payments for companies with an income exceeding UAH 20 million (for the reporting period). The time frame for filing a tax report will be changed.

5) Rent pay for natural gas (which is not intended for domestic consumers) extracted from the deposits above 5 km in depth increases from 28% to 55%. Rent pay for natural gas extracted from the deposits below the 5 km line increases from 15% to 20%. As regards the so-called agreements on joint activity, there is a gradual increase in rent irrespective of the depth: 1 quarter — 60%, 2 quarter — 65%, 3 quarter — 70%.

6) Simplified tax system. There is an increase in the maximum amount of income for all groups (1st group — from UAH 150,000 to 300,000, 2nd — from UAH 1 million to UAH 1.5 million, 3rd group — from UAH 3 million to 20 million). Transaction registers do not apply to the 1st group; as for the 2nd group, they will start to apply on January 1, 2016; and for the 3rd group, transaction registers are due as late as July 1, 2015.

Since 2015, there will be four groups of single tax taxpayers instead of six.

Business will not get expected tax relief

7) Immovable property tax. Since 2016, apartments with a total area of 60 square meters will be taxed at a rate of 2% of the minimum wage, whereas buildings with the total area exceeding 120 square meters will be taxed at a rate of up to 1% of the minimum wage. Collected immovable property taxes will go to local budgets.

8) Excise tax. The list of goods subject to excise tax has been increased due to the introduction of an excise tax on tobacco and alcohol retail trade as well as an excise tax on electrical power. It should be noted that the Tax Code already provides for an excise tax on manufactured and imported products, subject to excise tax. That being said, the excise tax imposed on the retail trade will only lead to double taxation, which violates the main principles of taxation as well as EU directives, which Ukraine has to implement under the EU-Ukraine Association Agreement. Another problem is that the introduction of this excise tax will create unfair conditions for street kiosks and large sales outlets. The coalition agreement does not contain any provisions regarding the introduction of the aforementioned excise tax. An excise tax on electrical power corresponds to the EU directives, which Ukraine must implement.

9) Extra import duty. The introduction of an extra import duty totalling 5% and 10% for specific goods corresponds to the GATT in case Ukraine's balance of payments deteriorates. However, the introduction of an extra import duty will worsen the purchasing power of consumers.

Extra import duty will worsen the purchasing power of consumers

Taking into account the current economic recession, the armed conflict in Ukraine's east, the destroyed infrastructure in Donbas, the trade war with Russia, the devaluation of the national currency and, as a result, the general deterioration of the social and economic situation, almost all proposed changes are of a fiscal nature and have nothing to do with the reduction of the tax burden, as was promised by the government.

## Coal background

The Ministry of Energy and Coal Industry is now actively working on coal industry reform, which will encompass:

- 1) Identification of potential coal mines, subject to privatization and pre-privatization activities in the course of the current year;
- 2) Suspension of state subsidies to domestic coal producers;
- 3) Drawing up a list of coal companies that are unprofitable and are thus subject to shutdown

- or temporary closure
- 4) Revision of miners' social protection standards.

The reforming of the coal industry: will be there winners?

The 2015 budget provides for the allocation of UAH 1.2 billion for the purpose of the audit and liquidation of 32 mines in the Donetsk region and the temporary closure of 27 mines in the Lviv, Luhansk and Donetsk regions. According to the Ministry of Energy and Coal Industry, out of 90 state



mines in the Donetsk region, 37 mines are located on the territory controlled by Kyiv, while only 24 of them are functioning. In the Lviv-Volyn Basin, only 13 mines are functioning. These mines produce “G” grade coal (gas coal), which Ukrainian thermal power stations use in rather small quantities.

Ukraine inherited the Soviet-era thermal and power generating infrastructure. Since the breakup of the Soviet Union, no modernization or enhancements have been made in this area. Today, more than 80% of thermal power stations in Ukraine run on coal of grade “A”, which is extracted in the Luhansk and Donetsk regions. The coal of grade “G” (coking coal, or the so-called gas coal) is extracted in the Lviv and Volyn regions in small quantities. Moreover, as of today, there is an overproduction of gas coal, the surplus of which is used for the creation of the so-called “coal mix”, i.e. the mixture of “G” and “A” coal. Still, much of the extracted gas coal remains in state coal storage facilities.

According to the Ministry of Energy and Coal Industry, the payroll in state mines in 2013 amounted to UAH 450-470 million. The profit of state mines totalled UAH 300 million. This is precisely why the state subsidized the coal industry, with the subsidies worth around UAH 350 million, in order to ensure social and working standards for mines. Paradoxically enough, such a situation has recurred for many years. That being said, the shutdown of unprofitable mines seems a reasonable state decision.

However, the closing of mines will lead to civil disturbances. As many as 60,000 miners will lose their jobs. Taking into account the issue of infrastructure (logistics firms, service companies, schools, etc.), as many as 300,000 people may lose their jobs. Further, the closing of mines in the Donetsk region will have far-reaching social and political repercussions for the region. The “Opposition Bloc” is now publicly accusing the government of adding to the high unemployment rate among people living in the ATO zone, thus adding a political undertone to a purely economic problem.

It is obvious that the state should offer an alternative to miners, for example, by creating new job opportunities or offering compensation. It is worth turning to the experiences of other countries that have managed to avoid significant social disturbances following the radical reforming of their coal

industries and have subsequently created transparent and liquid coal markets.

For example, upon realizing that the mining sector became a “troublemaker” for the Polish economy, the Polish government recently decided to close down four mines and fire as many as 3,000 miners. The process of liquidation of unprofitable mines will last for four years, during which miners will receive an equivalent of USD 35,000 as a single payment or as several equal payments over the course of four years. Compensation will become a propitious condition for starting up or mastering a new profession.

European  
experience  
in coal reforms

The coal industry reform in Germany took place in the 1980s. Firstly, the number of unprofitable mines was reduced from 26 to 17, and as many as 90,000 miners out of 130,000 were fired. Secondly, the government offered compensation payments for job loss for those miners who would give up their jobs on a voluntary basis. Thirdly, the government offered training courses for miners to improve their qualifications. Finally, a “less working hours” scheme was introduced pro rata to the reduction of wages.

State financial  
support should be  
aimed at people,  
not mines

Today, the main task of the coal industry is to step onto a losses-free path and avoid grave social implications. For this purpose, a top priority for the government concerning energy reform is to strike a balance between coal production and coal consumption, which should be competitive. It is necessary to elaborate a set of measures to modernize and streamline the energy infrastructure, with energy efficiency and energy equilibrium as an absolute priority (no energy resource should account for more than a third of the energy balance of the country). With the government’s support, it is necessary to introduce an online coal exchange. Such an initiative can level the domestic coal market by balancing demand and supply. State subsidies to mines should be abolished. Instead, state financial support should be aimed at people, i.e. creating conditions for their professional re-training and new job opportunities.

# Political competition

Decentralization is an urgent issue in the agenda of the main political players. It will determine the parameters of the political competition, especially at the regional level. The party and business elites in the regions expect that decentralization will bring about unlimited financial resources and greater freedom of action. On the other hand, the President is trying to postpone the process of power transfer, as his local support is not strong enough. Only after the local election, it will become clear which format of decentralization is more advantageous for the President.

For Yulia Tymoshenko, it is important to demonstrate her influence on political processes, as further passivity can lead to her complete marginalization. The “Batkivshchyna” party criticizes its coalition colleagues and is gradually distancing itself from the government. For “Batkivshchyna”, the lack of reforms could become a formal pretext for leaving the coalition. This will lead to the resignation of Arseniy Yatseniuk’s government and the formation of new situational alliances. A potential demarche of Yulia Tymoshenko may lead to a new round of the parliamentary crisis.

## Decentralization as a new field for political competition



The transfer of powers to the regions, especially in the public finance sector, creates a new phase of confrontation between regional groups of interests and the President. The local party and business elites demand that the President and the parliamentary majority provide fiscal autonomy to local communities as soon as possible.

In this regard, Petro Poroshenko and his party are the most disadvantaged. The voters do not understand why the President, who holds a majority in the Parliament, cannot implement the necessary reforms and fulfil his campaign promises.

On the other hand, decentralization may deprive the President of influence on regional policy formation, a fact which he is aware of. A number of regions can turn into separate fiefdoms with one financial-industrial group or clan dominating in each.

Therefore, the presidential administration is trying to postpone the decentralization, arguing that the necessary amendments should be made to the

The format of decentralization will lead to a deepening conflict between central and local elites

Constitution first. In fact, the President risks losing political and financial control over the regions.

Currently, heads of local state administrations who represent executive power are the only mechanisms of presidential influence. However, the functions and opportunities of state representatives and prefects (even if they are appointed by the President) will be much smaller than those of administration heads, who were always responsible for election campaigns.

The President does not have actual regional support, as “Petro Poroshenko’s Block” does not have its factions at local councils. Under these circumstances, the transfer of

True decentralization will start only after local elections

authority to the local level will obviously take place only after local elections. Therefore, the format of decentralization is unknown yet, whether it be financial or political.

If the officials at the national level are ready to lose administrative influence in the regions, the situation with finances is much more difficult. The aggravation of political competition between central and regional powers may be expected, as the latter will exert pressure on both Parliament and the President in order to get their electoral promises fulfilled.

Therefore, the results of local elections will define not only the configuration of political players in the regions, but also the format of decentralization.

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## “Batkivshchyna” is a weak element in the coalition

After the Euromaidan, the positions and political influence of Yulia Tymoshenko gradually became weaker. Defeat at the presidential elections, a number of party functionaries and sponsors leaving her team and the loss of influence over some regional party organizations has marginalized the political party of Yulia Tymoshenko. One of the major parties, which controlled over 200 MPs in the times of Viktor Yushchenko, ended up at the sidewalks of political processes, having barely surpassed the 5% threshold.

Having signed the coalition agreement, the “Batkivshchyna” faction did not get a golden share in the parliament. Yulia Tymoshenko’s protégés have not received politically influential offices in the government. The loss of political weight resulted in the dismissal of district administration heads who were appointed under the “Batkivshchyna” quota. Thus, the party is gradually taking the niche of “internal” opposition.

Yulia Tymoshenko distances herself from public politics, delegating representative functions to experienced functionaries and young MPs. The media presence of the politician increases whenever the Prime Minister’s or President’s team makes a mistake in domestic or foreign policies. Tension and latent conflicts between Arseniy Yatseniuk and

“Batkivshchyna” is taking the niche of internal opposition in the coalition

Petro Poroshenko provide Yulia Tymoshenko with a space for political maneuvers. As an experienced politician, she tries to distance herself from government failures, while remaining a coalition member.

For instance, after the military tragedy at Ilovaik, Tymoshenko criticized Minister of Defense Valeriy Heletey. Valeria Hontaryeva, Head of the National Bank, was guilty of the drastic depreciation of the hryvnia and the growth of the shadow financial market. Minister of Foreign Affairs Pavlo Klimkin faced criticism for his inability to protect the national interests of Ukraine at the international level. Nowadays, a major point of criticism against the parliamentary majority is its failure to fulfill the coalition agreement, especially regarding reforms of local government and decentralization.

Thus, the escalation of political conflicts may be expected as early as this spring. The lack of reforms may become an official reason for leaving the coalition. For Yulia Tymoshenko, it may keep the party brand and her own reputation as an influential political player.

Yulia Tymoshenko is looking for the next behavior model to improve her image

Lack of reforms may become an official reason for leaving the coalition

The aim of the publication is to provide objective information on current political events in Ukraine and thorough analysis of major tendencies in domestic politics. Such analysis will assist in setting priorities in the process of implementing reforms in Ukraine and in evaluating quality of state decisions from the viewpoint of their impact and sustainability. Special attention is paid to evaluation of political competition in Ukraine and ability of key political players to address challenges.

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