

## Institutional improvement in Ukraine could lead to growth boom

Following the dramatic events of Ukraine’s 2004 “Orange Revolution,” in which more than a million people gathered in Kiev’s harsh winter weather to overturn a manipulated presidential election, the incoming administration of President Viktor Yushchenko moved quickly to articulate a new policy vision. That vision focused on accelerating Ukraine’s institutional transition toward a modern market economy, with much of the new agenda anchored in a strategy of greater integration with the European Union (EU) and the World Trade Organization.

Implementing that agenda, however, has proved difficult. The orange coalition government was riven by personal and political divisions and suffered a major setback following the March 2006 parliamentary elections. Yushchenko is still president, but there are fears that the new government, led by Yushchenko’s old rival Viktor Yanukovich, will be less than fully committed to pro-market reforms. A recent IMF Working Paper places these developments in context and asks two questions: to what extent have institutional deficiencies hampered Ukraine’s past performance? And what would be the likely payoff if the authorities succeeded in strengthening market-friendly reforms?

These questions, of course, raise some fairly deep economic issues: What do we know about the role of institutions in driving economic growth and income convergence? International variations in income have been found to result mainly from dif-



After his 2004 election, President Yushchenko focused on pro-market reforms.

ferences in *productivity* rather than in *factor accumulation*. The obvious follow-up question, then, is how to account for differences in productivity. As a start, productivity can be broken down into *technology*, representing the sum of available knowledge as to how resources can best be combined; and *efficiency*, representing how effectively that knowledge is put into practice.

Estimates of the relative importance of these two components across a range of developing and emerging market countries all highlight the same message: unless lags in technology are implausibly large, most of the gap between rich and poor countries reflects differences in efficiency rather than in technology. Much of the recent literature on convergence has thus focused on the determinants of efficiency.

The concept of “technology” here is distinct from the techniques that are observed in the workplace. Even with equal access to the same knowledge, different countries may adopt different technologies. Sometimes, this reflects resource differences or comparative advantage. Often, however, it reflects underlying institutional impediments that discourage the implementation of best-practice techniques and prevent new technologies from being used profitably. In this framework, therefore, the presence of suboptimal technologies may not reflect the unavailability of knowledge, but may instead be a symptom of poor efficiency.

### Institutions and efficiency

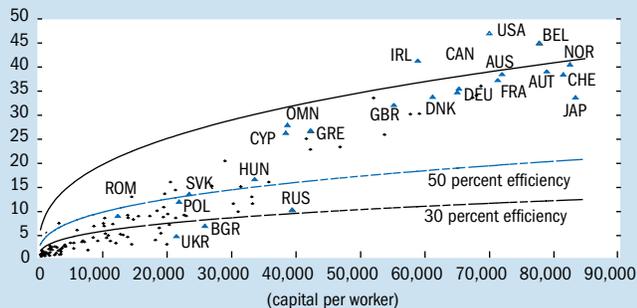
Inefficiency can arise from various sources: unproductive activities (such as stealing, smuggling, rent-seeking behavior, or activity aimed at preventing theft or expropriation), idle resources, and the misallocation of factors across sectors. All of these sources have played a significant role in transition countries, where they are often a legacy of central planning. The study examines the extent to which an absence of market-friendly institutions is responsible for low efficiency in Ukraine and other countries. Although definitions

Chart 1

### Coming up short

Ukraine is significantly less efficient than both the world’s industrial countries and other former centrally planned economies.

(output per worker in 2000; thousands of dollars<sup>1</sup>)



Note: AUS=Australia, AUT=Austria, BEL=Belgium, BGR=Bulgaria, CAN=Canada, CHE=Switzerland, CYP=Cyprus, DNK=Denmark, DEU=Germany, FRA=France, GBR=Great Britain, GRE=Greece, HUN=Hungary, IRL=Ireland, JAP=Japan, NOR=Norway, OMN=Oman, POL=Poland, ROM=Romania, RUS=Russia, SVK=Slovakia, UKR=Ukraine, USA=United States.

<sup>1</sup>1985 prices, purchasing power parity exchange rates.

Data: “How Important Are Capital and Total Factor Productivity for Economic Growth?” Scott L. Baier, Gerald P. Dwyer, Jr., and Robert Tamura, Working Paper 2004-02 (Atlanta: Federal Reserve Bank of Atlanta, 2004); and author’s calculations.

can vary, a market-friendly institutional base is typically characterized by, for example, the rule of law, secure property rights, enforceable contracts, and an evenhanded and transparent government.

To quantify efficiency, the study uses a global panel to estimate a *best-practice frontier*—that is, what a country *could* have produced if it had used all its resources optimally, employing world-class, best-practice techniques. Ukraine’s actual output is then measured against this hypothetical benchmark as a guide to its overall efficiency. Conducting the same exercise for other countries permits an investigation of the relationship between efficiency and domestic institutions. The study’s results suggest that Ukraine is operating significantly within the global frontier and that the economy’s low efficiency is associated with its weak institutional base (see Charts 1 and 2).

### Impact of reform

Efficiency in Ukraine deteriorated significantly during the 1990s, partly because of changes in the best-practice frontier. Before 1990, when Cold War considerations hampered the ability of Eastern bloc countries to acquire technology, Ukraine’s frontier was more limited than that of Western countries. Over the 1990s, however, Eastern bloc countries were deluged with new ideas and techniques, represented by a rapid outward shift of the frontier. For the most part, the countries of the former Soviet Union failed to capitalize on this influx of new technology. Indeed, they experienced a sustained contraction in output—the result of the dismantling of the Soviet state’s central planning apparatus and the fact that, in contrast to more successful countries in Eastern Europe, old institutions were not replaced with a viable alternative. So, rather than move to a more market-oriented system, the countries of the former Soviet Union faced an institutional

vacuum, characterized by mounting uncertainty and pervasive rent-seeking behavior.

Since 2000, output in Ukraine has grown rapidly, owing more to improved efficiency than to higher investment. The recovery reflects a complex combination of factors, including a rebound in neighboring Russia. But Ukraine’s turnaround also reflects the impact of first-generation institutional reforms introduced in 1999–2000. The reforms focused initially on the energy sector and were key in reducing the prevalence of barter payments and arrears. This improvement, in turn, helped foster a more efficient allocation of resources and the beginnings of a working financial system.

### Capitalizing on efficiency

What does all this mean for future policy? The results suggest that lasting improvements in living standards will depend more on increased efficiency than on higher investment rates, which will require, in turn, that Ukraine commit to improving its market-oriented institutions. The IMF’s September 2005 *World Economic Outlook* highlighted the importance of institutions for growth and noted that external anchors have often helped foster institutional change. For transition countries, the prospect of EU accession is a classic example of a successful anchor.

In this light, Yushchenko’s early reform agenda was both timely and appropriate. The agenda was anchored principally in the Ukraine-EU Action Plan and, by harmonizing Ukrainian standards with those of the EU, it aimed to accelerate Ukraine’s progress toward a regionally integrated market-based economy. Although Ukraine’s membership in the EU is somewhat distant and far from guaranteed, the study suggests that the benefits of greater harmonization with EU standards can be substantial and are likely to accrue well before accession.

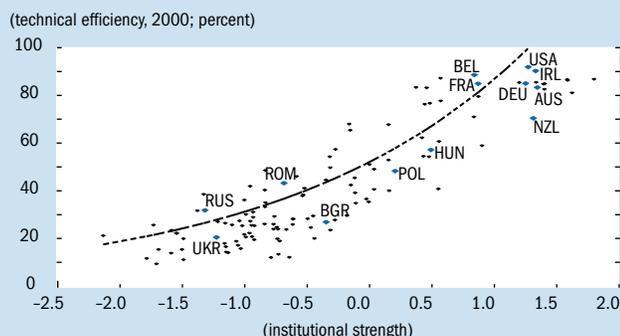
The study also makes it possible to estimate the impact of these reforms on efficiency (and on growth) based on the experiences of other EU candidate countries. The IMF staff’s baseline forecast for Ukraine is consistent with a mild institutional improvement and effectively assumes that, by 2015, Ukraine will have the institutional quality enjoyed by Romania, a current EU candidate. More optimistically, full implementation of an EU-centered agenda might boost Ukraine’s efficiency to that of recently successful accession countries, such as Poland and Hungary. In this case, average annual growth could increase to around 8.5 percent over the coming decade. This would be a remarkable achievement and would place Ukraine alongside recent “growth miracle” countries. ■

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Chart 2

### The institutional difference

A country’s efficiency can be attributed to the strength of its institutions.



Note: Institutional strength is measured by an index ranging from -2.5 to 2.5; the smaller the number, the weaker a country’s institutions. See Chart 1 for country acronyms; NZL=New Zealand.  
Data: World Bank and author’s calculations.

This article is based on IMF Working Paper No. 06/167, “Ukraine: The Cost of Weak Institutions,” by Andrew Tiffin. Copies are available for \$15.00 each from IMF Publication Services; see page 308 for ordering information. The full text is also available on the IMF’s website ([www.imf.org](http://www.imf.org)).