Economic Council Paper #1

Financing Democracy: Why and How Partners Should Support Ukraine

The Economic Policy Advisory Council

https://kse.ua/economic-policy-advisory-council/

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The Economic Policy Advisory Council, a working group of independent, international experts, has been convened to recommend economic policies and measures. Our goal is to provide critical recommendations for Ukraine's economic recovery and development, offering strategic advice to the government.

While acknowledging the positive steps, such as the launch of the Ukraine Facility and multi-agency Donor Coordination Platform, we express concerns about the timing and commitments from other partners. In this paper, we propose a “financing democracy” deal and a framework for cooperation with donors, aiming to streamline efforts and support Ukraine effectively.

As members, we engage in individual capacities, aiming to produce a consensus document and offer a comprehensive menu of possible measures. Not all members agree on every specific policy, but we share a common commitment to supporting Ukraine in its struggle for survival and the principles of European democracy.

We concentrate on offering recommendations to assist Ukraine in addressing its economic and security challenges, emphasizing that supporting Ukraine is not an act of charity but a dedication to international principles and security.

1. Meeting The Challenge of War and Reconstruction

After almost two years of full-scale war, the outcome is not yet clear. On the one hand, Ukraine has preserved its statehood and a working government, regained a large part of the territory occupied in 2022, materially degraded the Russian navy in the Black Sea, and is operating the seaborne shipping corridor without Russia's goodwill. Furthermore, Ukraine's economy has been resilient: inflation is in single digits, the banking system operates normally, and many businesses have resumed operations. In addition, Ukrainians continue to be extraordinarily united in their desire to defeat Russian aggression: for instance, more than 80% of Ukrainians donate to support the army, and tens of thousands of volunteers help source and provide critical army supplies. On the other hand, the war of attrition is taking a heavy toll. Without a doubt, Ukraine would not be able to resist for so long without the military, humanitarian, and financial aid of other governments and international organizations. But while continued support is vital for Ukraine to prevail, it currently looks at risk, with some saying that spending on Ukraine is not a priority and further US support held up in Congress.

We argue that supporting Ukraine is not charity, since Ukraine's existential war for its own survival is also a war to defend the international rule of law, European democracy and security. In short, we see two critical reasons why democratic countries should support the defence and reconstruction of Ukraine.[1] First, values. Ukraine is a liberal democracy, which aims to embed these values – respect for human rights and freedom in a democratic society governed by the rule of law – in its institutions, in particular by becoming a member of the European Union. If Russia is not defeated, Putin and other autocrats and dictators will be emboldened, and the global threat to democracy – in retreat for the last 18 years according to Freedom House – is likely to intensify. Second, security. Russia under Putin poses the main security threat to Europe, with a revisionist doctrine justifying aggression, a proven willingness to subvert and attack its neighbours and no respect for the norms of diplomacy or war. Ukraine is holding this threat at bay and has materially weakened Russia's capabilities, at the modest cost of 3% of total NATO defence expenditure. But the risk remains acute. If Russia is not defeated and the war drags on or becomes frozen, Europe faces the prospect of a zone of instability in the East. The occupied territories will be exploited by Russians and various malicious actors to fuel ongoing inflows of refugees, arms, and contraband and driving higher security and defence spending.[2] Further, Russia's influence over critical resources, notably global food supply, would be enhanced, giving it additional leverage which it might seek to weaponise.

[1] This paper focuses on proposals to improve the Ukraine-donor relationship in the context of discussions on the 2024 budget and Ukraine's EU membership. It is intended to supplement previous CEPR papers, including A Blueprint for the Reconstruction of Ukraine (CEPR, April 2022, Becker et al), Post-War Macroeconomic Framework for Ukraine (CEPR, July 2023, Becker et al), Financing Ukraine's Victory (CEPR, September 2022, Nell et al) and the papers in Rebuilding Ukraine: Principles and policies (CEPR, November 2022, ed. Gorodnichenko et al.), notably Chapter 14 on How to organise aid by Eichengreen and Rashkovan.

[2] During the Cold War, defence spending for NATO Allies (even putting the United States aside) routinely averaged more than 3% of GDP —compared to the current 1.3% EU-27 average (as of 2021). See

Beyond this, Ukraine has a clear pathway to independence from external budget support. Put bluntly, the more aid Ukraine receives today, the faster it will win the war and start the recovery. Unlike Iraq or Afghanistan, Ukraine has a legitimate and effective government, which is committed to a Ukraine able to stand on its own feet and pay its own way. Moreover, Ukraine has committed to a credible trajectory for achieving this result through integration with Europe – a formula which worked for core Europe in the 1950-60s, in southern Europe in the 1970s-90s and in eastern Europe in the 2000-20s.

Defending and rebuilding Ukraine demands an outsized military and a large reconstruction programme. Financing a much larger military has broadly doubled Ukraine's public spending, while estimates of reconstruction costs range as high as 1tn USD, or five times the size of the pre-war economy. In short, Ukraine needs help with extraordinary financing needs – we estimate it to be at least $400 bn over a decade.

In this paper, we make two proposals to strengthen Ukraine's partnership with its allies and maximise the chances of success in defence and reconstruction.

First, we propose a "financing democracy" deal with donors, where Ukraine commits to key outcomes on democracy, defence and fiscal self-reliance when the war and reconstruction is over in return for sustained support until then. Why do we propose a new deal with allies, when Ukraine already has an ongoing IMF program and EU support coming through the Ukraine Financing Facility (UFF)? We think a broader political agreement with partners is needed since Ukraine's democratic and security ambitions are political goals that go beyond the technical remit of the IMF and which should encompass all the world's leading democracies, including the US, UK, and Japan, as well as the European Union. It also reflects the scale and duration of the financing challenge: for instance, on current plans, net 2024 financing from the IMF will be $3bn, while the EU's UFF will possibly provide $18bn - combined less than half of Ukraine's 2024 financing gap.

Second, we propose a framework of cooperation with donors to manage the inevitable tensions that will arise over the extended period of extraordinary needs. With input and oversight from partners, Ukraine should be trusted to draw up, implement and report on a credible reconstruction plan. Partners should provide ongoing oversight alongside the promised support while aligning their efforts with each other and their demands with the reconstruction plan.

2. Key Features of Ukrainian Reconstruction

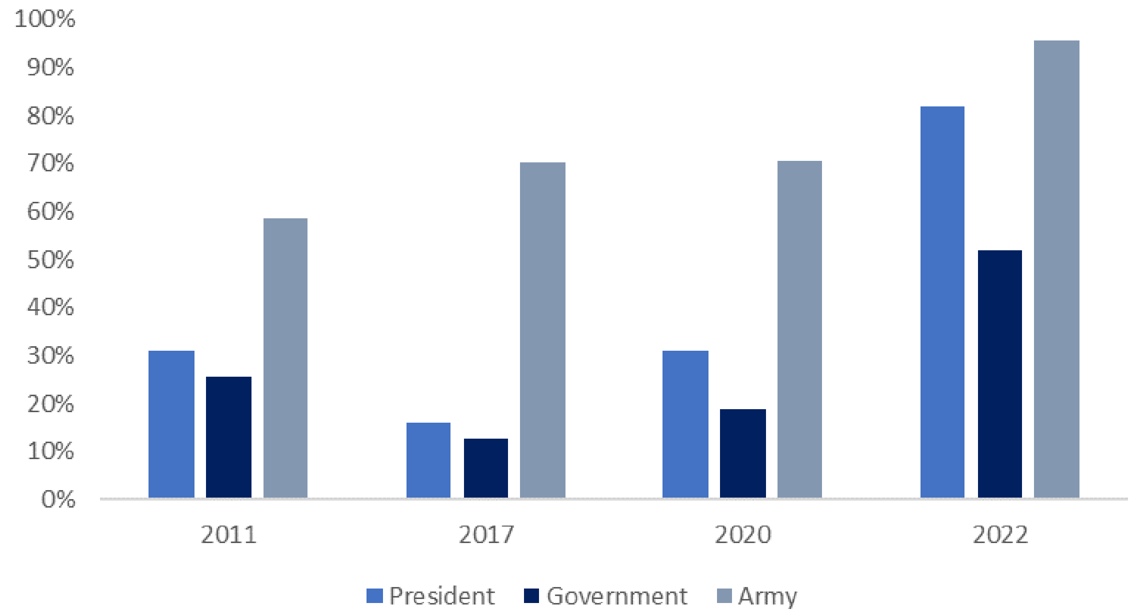
We see several distinct features of Ukraine's situation which we believe an effective strategy should take into account:

First, Ukraine has a government. With strong popular support, the Ukrainian government has successfully prosecuted a national war of defence against a larger adversary, stabilised the currency and economy after the initial shock from the invasion, and implemented substantial reforms while building an international coalition of support. In some recent post-conflict situations, such as in Iraq and Afghanistan, there was no legitimate government after the war,

https://www.nato.int/docu/review/articles/2023/07/03/defence-spending-sustaining-the-effort-in-the-long-term/index.html.

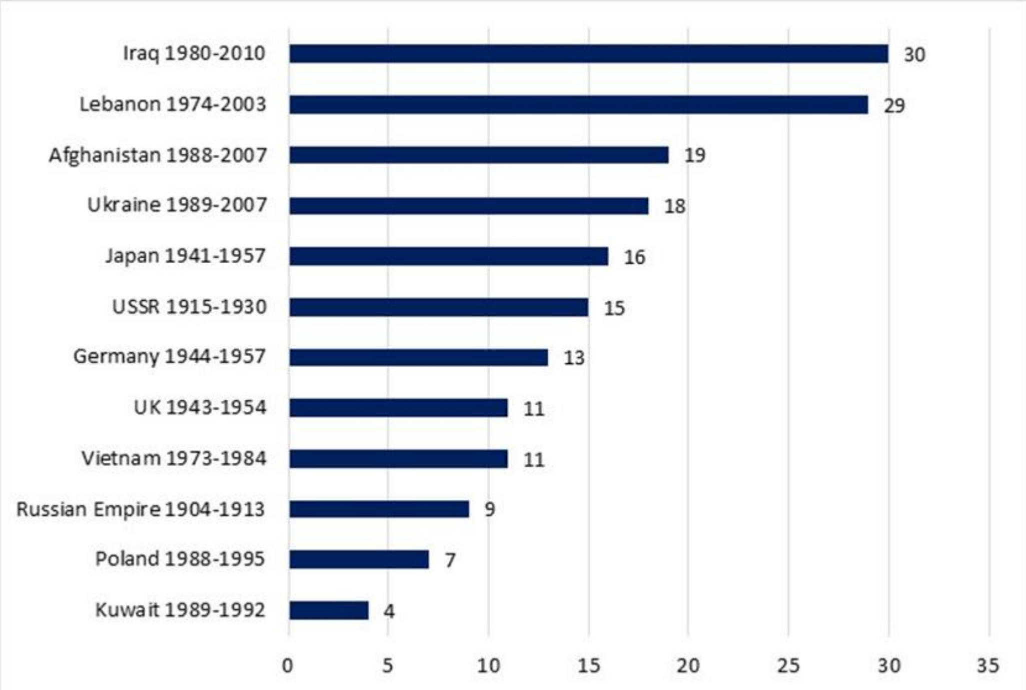
and the central political problem donors faced was how to foster the emergence of a legitimate functioning government. By contrast, Ukraine has a legitimate, effective and popular government in place, which we believe should play the central role in the design and implementation of Ukrainian defence and reconstruction, building capacity in Ukrainian institutions rather than in parallel structures.

Chart 1: *Increased support for president, government, and army since Russia's invasion*



Source: [Razumkov centre] + "[Slovo i dilo]" (info about presidents' trust level for 2011 & 2017).

Chart 2: Years to recover the pre-shock level of real GDP per capita, selected countries



Source: Maddison World tables 2020

Second, there is clarity on who the aggressor is (Russia) and who the victim is (Ukraine). This clarity is central not only for mobilising resources during the war but also thinking about post-war developments. Perhaps the closest comparison is with Kuwait after Iraq's 1990 invasion. Just like Russia today, Iraq's aggression was unprovoked and Iraq had significant income and assets associated with the energy sector. These assets and income were used to compensate Kuwait for damages and other losses. It remains to be seen if and how a similar arrangement can be made but there are indications that some Russian resources will be transferred to Ukraine. For example, on November 22, 2023, the General Assembly of the United Nations adopted a resolution stating that Russia "must bear the legal consequences of all of its internationally wrongful acts, including making reparation for the injury, including any damage, caused by such acts." In October 2023, the Belgian government decided to transfer to Ukraine ~€1.7bn raised from a tax on the interest income of frozen Russian assets held in Belgium, while Estonia has proposed to transfer seized Russian assets to Ukraine. A Russian contribution to Ukrainian reconstruction from the transfer of assets or levies on Russian exports to western markets could materially reduce the cost to partners of supporting Ukraine.

Third, as with the CEE countries through their transition from communism, Ukraine has made the achievement of EU membership the central goal of policy, providing a credible anchor for institutional reform. Poland and other peers provide concrete examples. Indeed, the transformation seen in Poland post-EU accession—once (in the early 1990s) on a par with Ukraine economically, now significantly more prosperous—demonstrates the potential impact of such integration.

Comparisons with recent reconstruction and transition experiences suggest that with a functioning and legitimate government, external financing, and the objective of EU membership a rapid recovery in Ukraine is achievable – in line with the four years required for Kuwait to recover from Saddam Hussein's 1990 invasion rather than the three decades which it took Lebanon to recover from its civil war in the 1970s. However, it will not be easy since Russia's invasion continues. In short, a realistic plan must be based on an assumption that Ukraine will face extraordinary financing needs – beyond its own capacity to finance – for years to come.

3. Financing Democracy: the Ukraine-Partners Deal

The estimated amount of Ukraine's financing needs over the next decade ranges from \$400bn to \$1tn, depending on the duration and outcome of the war, and future decisions on how to rebuild. This suggests that the lower bound of credible estimates of the required additional funding is around \$40bn per year for 10 years. Ukraine does not have the internal capacity to finance this cost.

Box 1: Main Parameters of Ukrainian Budget 2024

On November 9, 2023, the Ukrainian parliament approved the budget for 2024. It is based on the assumption that the Ukrainian economy will grow 4.6% in 2024 (4.9% in 2023) and inflation will increase by 9.7% (5.8%). Thus, nominal GDP in 2024 is expected to reach UAH 7.6tn. The main budget parameters for 2024 are presented in the following table

Ukraine's financing needs and a few key figures

	UAH bn	*USD bn*
Revenues	*1 768*	*43.4*
Expenditures	*3309*	*81.3*
of which defence spending	*1668*	*41*
Deficit	*1 571*	*38.6*
Debt repayment and service	*1 047 (mostly internal but extension of external debt will be needed)*	*25.7*
Gross public borrowing	*2194, of which external 1668 and domestic 526*	*54, of which 41 external and 13 domestic*

In 2022 and 2023 Ukraine spent almost all of its domestic revenue on defence, which amounted to approximately 50% of the total government budget.

The Ukrainian Ministry of Finance defined the external financing need for 2024 at $41bn. For comparison, in 2022 Ukraine received $31bn in external economic aid while seigniorage revenue from printing money amounted to almost $12bn; and in 2023 Ukraine expects to receive $43bn of aid while avoiding monetary financing/printing money. Of the requested $41bn for 2024, $5.4bn is expected from the IMF, $8.5bn from the USA and $18bn from the EU. However, the Minister of Finance admits that $29bn in financing for 2024 is not yet confirmed. While the war and Russia's aggression continues, we do not think it is reasonable to expect Ukraine's financial need to decline.

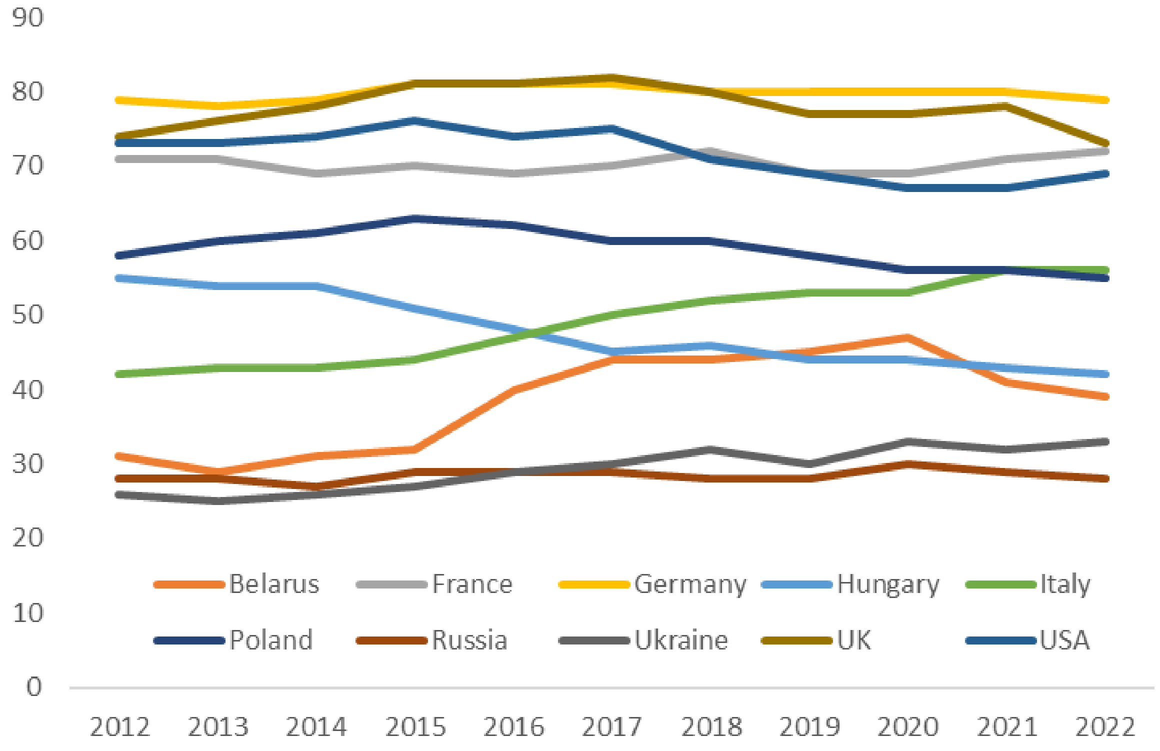
There are four potential sources of financing to cover this gap: Russia, Ukraine, partner governments, and the private sector. During the war, given the risks, we expect the private sector will not play a major role. We believe Ukraine can and should make a contribution, but it cannot cover this gap. We see use of Russian assets as a possibility, but it also depends on donors' decisions, and for now, cannot be relied on. This leaves donors as the critical source of finance for 2024, and likely for longer. And donors face other calls for their attention and resources. If donor resolve falters and donor financing is not forthcoming, Ukraine's defence and recovery will be at risk. To mitigate this risk and bolster Ukraine's relationship with its partners, we propose a broad "financing democracy" deal.

On the Ukraine side, we propose three big upfront political commitments to a) democratic constitutional order and elimination of corruption ("rule of the people and rule of law"), b) defence ("standing on our own two feet"), c) self-reliance ("paying our way") when the war and reconstruction are over.

Democracy. Ukraine is fighting for its freedom – to be a sovereign democracy, which makes its own choices. We believe that Ukraine is fundamentally democratic: it has healthy public debate and multiple parties that participate in competitive elections which lead to changes in government. But it still has a challenge with corruption, which can undermine the rule of law, and democratic processes and institutions, in the democratic constitutional order. In Ukraine's neighbors, leaders who came to power through elections in relatively open political systems, such as Putin and Orban, subsequently undermined critical checks and balances, appointed loyalists to capture the media and the judiciary, and in the process shifted their countries toward autocracy and a one-party state. Ukraine itself faced a similar risk during the Yanukovych presidency. Encouragingly, we see progress on corruption, including several recent dismissals of senior officials who failed to tackle corruption robustly, including a supreme court judge and the defence minister, and the President's insistence on reinstating declarations of income and wealth for officials. However, to combat this insidious threat to Ukrainian democracy – highlighted by Ukraine's score on Transparency International's Corruption Perceptions Index, which puts Ukraine on a level with Russia and Belarus, and far below Hungary, the lowest-ranked EU member state – we propose Ukraine implement a comprehensive programme of action on the demand and supply side of corruption, as well as continuing to adopt EU standards.

On the demand side, much of the corruption in Eastern Europe since the fall of the Soviet Union has been fuelled by businessmen who captured control over key assets – typically in a legal vacuum and without paying fair value – in the transition from communism, and then used their disproportionate resources to influence legal and political decisions, undermining the rule of law. In recognition of their influence over politics and law, they were often called oligarchs. We see it as critical to restrict the political role of business through a consistent set of policies, including measures to: 1) increase competition and reduce monopoly rents across the economy; 2) increase transparency of beneficial ownership, and introduce security vetting in sensitive sectors, particularly for media assets ; 3) reduce incentives for political parties to seek funding from oligarchs (e.g., more state funding for public administration and parties, a cap on political donations, transparency in funding and reporting for political parties, transparency of lobbying); 4) provide process direct transparent transfers to industry, if warranted by policy, and avoid hidden or open-ended subsidies; 5) strong corporate governance standards for state owned enterprises that cannot be privatised; 6) transparent public procurement on recovery projects funded by the state budget and donors; 7) consistent implementation of the law, with effective sanctions to deter corrupt behaviour.

Chart 3: *Ukraine's ranking on the Corruption Perceptions Index (Score changes 2012 - 2022)*



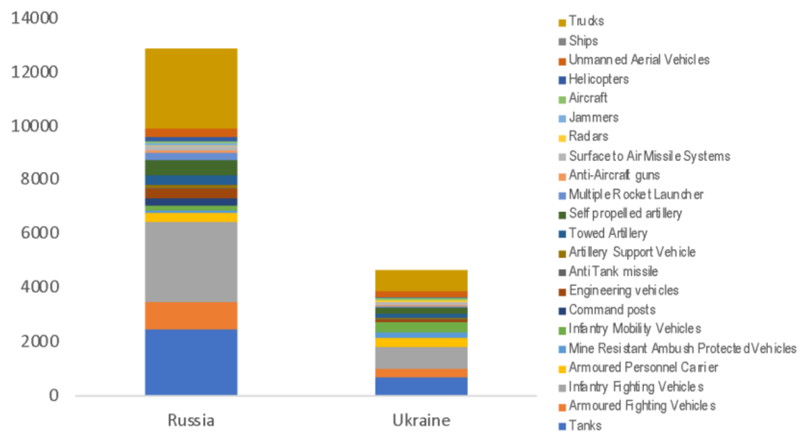
Source: Transparency International

On the supply side, we similarly propose to restrict the "provision of corrupt services" by increasing the cost and risk of providing them. Specifically, we propose a "higher standards for higher reward" deal for officials. On the standards side, this should continue to include publicly available tax returns and annual declarations of wealth and income for all senior Ukrainian officials as well as competitive selection of senior officials, with increased training in ethics and managing conflicts of interest. On the reward side, we propose that pay for senior government officials should be benchmarked to the market to ensure that skill and competence are adequately rewarded and attracted to the public sector. In the near term, as a practical matter, partners may need to fund a special unit in the Ukrainian government to attract employees with the right skills to help plan and manage reconstruction and interface with funders.

Defence. Ukraine's armed forces have successfully defended the country and materially weakened Russia's military capability - the main threat to European security. In security, Ukraine offers defence at very low cost for the West: no allied soldiers are fighting, and much of the supplies have been of surplus stock. Indeed, Western armies and defence industries may even benefit from orders for and supply of new weapons, as their stockpiles of older weapons are transferred to Ukraine. Overall the total cost of the war in Ukraine is set to be much lower than the post-9/11 wars. For instance, the US Department of defence reports spending $758bn in Iraq, while third party estimates of the aggregate fiscal cost of the post-9/11 conflicts run as high as $8tn. Second, the results have been spectacular, providing value for money. The Ukrainians have destroyed over 13,000 pieces of Russian military equipment, taking out around 3 Russian pieces of equipment for every Ukrainian piece of equipment lost, according to open-source intelligence. The evidence shows that a strong Ukraine can be Europe's bulwark against Russian aggression. By contrast, while the wars after 9/11 did remove Saddam Hussein and undermine Al-Qaeda, the security threat from Western enemies in the region continues to be material, with e.g. the Taliban back in Afghanistan and Iran's position across the region stronger than before the 2003 Iraq invasion.

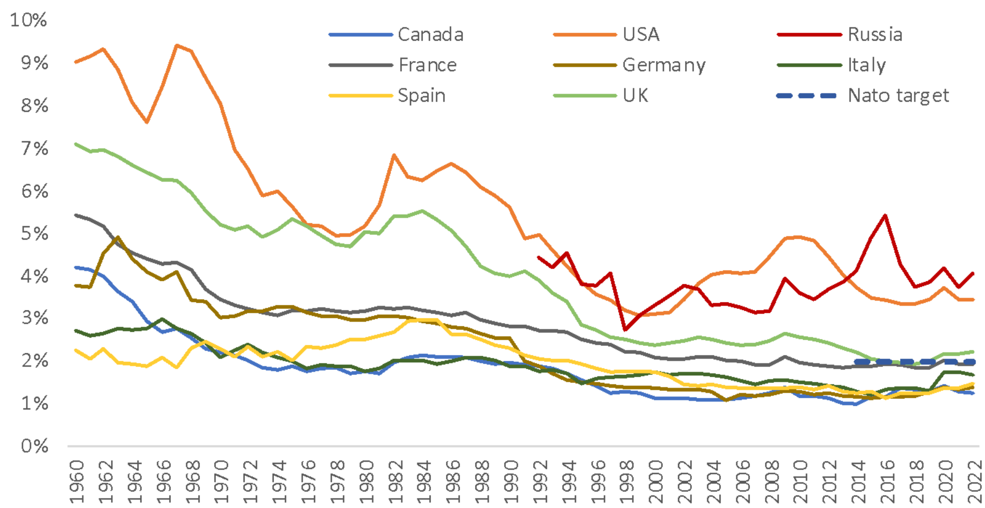
At the same time, we note that many European countries have been underspending the 2% of GDP NATO target for defence spending for years – and that the cost of financing Ukraine's needs is far less than the increased defence spending needed for the European defence laggards to meet the 2% of GDP target (see Becker, 2023 for further discussion).

Chart 4: *Military equipment lost during Russia's invasion of Ukraine*



Source: Oryx

Chart 5: *Defence spending in Europe still far below cold war levels and the NATO 2% of GDP target*



Source: SIPRI

Self-Reliance. Self-Reliance. Ukraine needs extraordinary support now – which we see as justified on pragmatic grounds, given Russia's threat to international order and the efficiency of Ukraine's armed forces. But Ukraine cannot expect partners to finance its deficit indefinitely - there are domestic political constraints in the US, the EU and elsewhere that can delay or limit the amount of aid. And the partners will expect a final date after the war and recovery after which Ukraine will not require additional financial aid. Thus, we have to recognize and address the fiscal vulnerabilities of Ukraine. There are at least three areas that may challenge the long-term sustainability of Ukraine's public finances – weak fiscal capacity, pension and social support system, and energy subsidies. To limit its vulnerability to variation in international financial support during and post war and strengthen its ability to be financially independent after the war is over, Ukraine can commit to long-term objectives to be implemented through the war and reconstruction, which will allow Ukraine after the war to finance its current spending from current receipts. The Government of Ukraine has already started planning such measures as a part of the National Revenue Strategy (to be adopted in December-January). Many of the expected measures below are likely to be in line with this strategy. There will be reforms of the tax administration and customs office to deliver improved tax enforcement, alongside tax policy reforms to broaden the tax bases, with elimination of special schemes and reduction in tax expenditures. The rates on some major taxes can be raised: taxes on higher incomes and luxury consumption. One possible approach is to levy an income tax surcharge on higher incomes, similar to the solidarity surcharge on higher incomes in Germany used to fund reunification. Over time the excise taxes on fuel, alcohol, and tobacco will be increased to reach minimum EU rates. There is also a difference between Ukrainian and European rates of VAT and the VAT rate might have to be aligned with those of the EU. It would also be impossible to achieve fiscal self-reliance without changes to the pension and social support system. Furthermore, in the process of accession to the EU, Ukrainian retirement age will be progressively aligned with retirement ages in the EU and the pension system is expected to move to "notional defined contribution", and Ukraine will be expected to set energy tariffs that fully recover costs, including pricing carbon in line with the European carbon price (currently around €80/tonne).

In return for ambitious commitments on democracy, defence and self-reliance, and delivery of material first steps towards the objectives, partners should agree to finance the 2024 budget deficit and commit to support Ukraine's defence and reconstruction in future years.

4. Framework for cooperation

In addition to the "financing democracy" deal, we propose a framework for cooperation between Ukraine and partners to resolve issues.

On Ukraine's side, we believe that its tasks should include:

- Drawing up a deliverable reconstruction plan. Building on the programme proposed for the EU's Ukraine Finance Facility, Ukraine's government should set the priorities and timeline for defence and reconstruction, consistent with the available resources, including economic and fiscal capacity, and take into account the views and input of donors.

- Effective implementation. Ukraine should implement the reconstruction plan, including structural measures to improve the competitiveness and capability of the economy. The focus in reconstruction should be i) on rapid action to minimise scarring, and ii) on effective use of resources through procurement which builds capacity and a competitive supply chain.

- Transparency and accountability. Ukraine should provide accountable reporting on the use of resources to ensure transparency and allow Ukrainian society and partners to hold the government to account for the delivery of the plan, including through a partner-led supervisory board. Ukraine should demonstrate steady progress in fighting corruption.

On the partner side, these should include:

- Delivery of committed resources. Partners should provide financial support as agreed in amount and timing, including facilitating the provision of financial support from Russian sources.

- Agreement on appropriate conditionality. While partners will require certain actions in return for funding, this conditionality should meet criteria. We propose that the conditions be aligned with delivery of the agreed reconstruction plan, be appropriate for the stage of reconstruction, and avoid making competing or contradictory demands. Further, we propose that adequate warning should be provided and due process followed when adjustments in conditionality are proposed;

- Partner coordination and oversight. Partners should coordinate their activity, and establish mechanisms to streamline discussions with the Ukrainian authorities, to report on the use of aid, and ensure efficient cooperation between donors and with their Ukrainian counterparts at the working level.

- Grant-centred funding. Until recovery has been completed, Ukraine's ability to service debt is limited. It has already agreed a debt standstill with debtors, and we believe that a substantial debt write-off will be appropriate. Given Ukraine's major needs and limited financing and debt capacity, we believe that partners should commit to immediate post-war funding in the form of grants. Over time, as Ukraine's financial position improves, loans can play a larger role.

- Front-loaded funding. Allow Ukraine to borrow against future tranches of aid. The arrangement could be similar to the International Finance Facility for Immunization that was used to raise funds to pay for COVID-19 vaccines.

We believe that Ukraine faces an extended period when it will require additional financing for a deficit – to finance the war and reconstruction – of at least $40 bn USD per annum. Ukraine should contribute through fiscal self-help, and partners should explore what contribution Russian and private sources can make - but for 2024 at least partners remain the only credible source to finance most of this gap.

5. Ukrainian commitments

5.1. Drawing up a deliverable plan. Unlike many post-conflict and transitional countries, Ukraine has a functioning, legitimate and popular government, with strong leadership, so Ukraine can take the lead in designing and implementing the plan, with partner input and oversight.

We propose that economic policy be divided into two phases:

A. Rapid Return to Potential. Through the war and up until Ukraine's economy has returned to around its potential level of output, economic policy should be expansionary, led by large fiscal and external deficits. In war and the immediate post-war period, the high level of risk will likely deter the private sector and banks, so the government needs to take the lead in the economy.

Among other elements, we suggest this involves:

Sustained high public investment, focused in particular on military needs and infrastructure during the war, and until the infrastructure, borders and capabilities to defend against future Russian aggression are in place. In this phase, while the needs of the war and civilian defence have priority, we would also emphasise targeted elements of reconstruction, including expansion of infrastructure linking Ukraine to Europe for wartime supply and resilience and for peacetime trade, demining in liberated areas, to reduce mine risk and support agricultural recovery, and reconstruction of essential housing and infrastructure.

Robust public finances require higher revenues, which we propose should be targeted on non-essential imports, non-essential consumption, and on higher earners, who have greater ability to pay.

At the same time, key structural reforms to the pension system and to energy tariffs and subsidies will be required over time to put Ukrainian public finances on a sustainable longer-term basis.

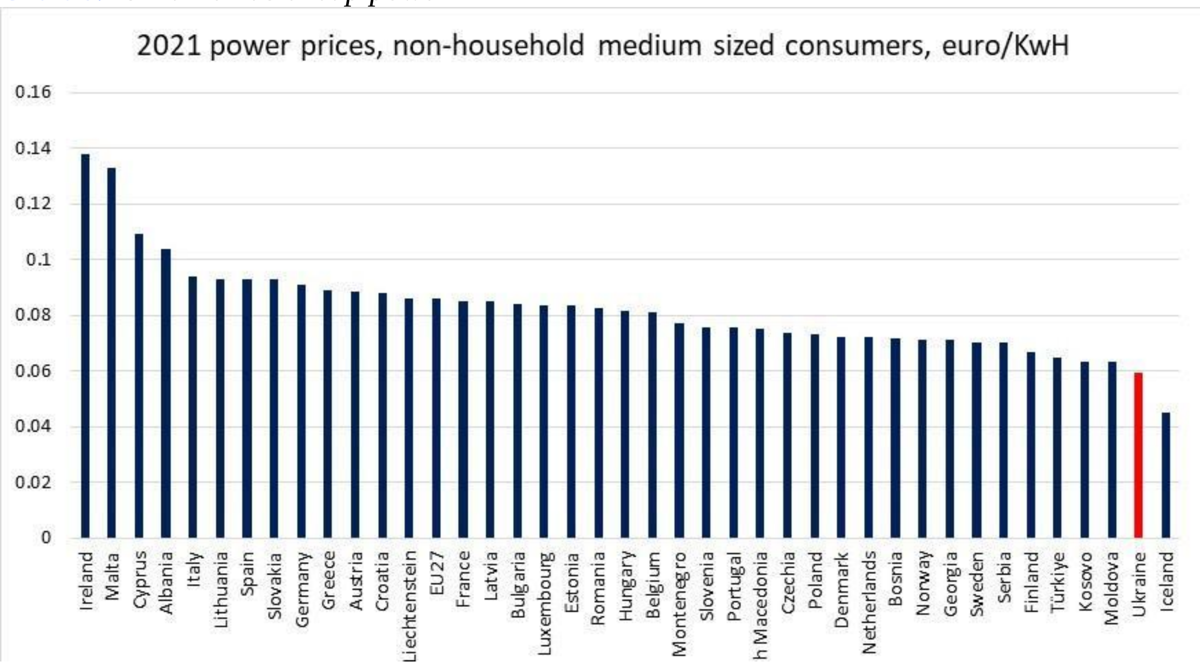
"Year zero" institutional reforms to strengthen the foundation of Ukraine's European democracy, including by using competition policy to break up monopolies, and by strengthening the independent institutions (media, courts, parties, reporting requirements) which provide the checks and balances to reassure Ukrainian society and partners that funds are being used for their intended purposes – and thereby serve the larger purpose of underpinning the rule of law, and protecting against oligarchy or autocracy.

B. Convergence with Europe. Once the economy has returned to potential, and the post-war military stance has been implemented, the strategy should shift , as the private sector returns to playing a more central role. In this phase, action should focus on leveraging trade and investment with Europe, to which Ukraine will have privileged market access as a candidate county, with a focus on attracting investors into sectors where Ukraine has a competitive advantage, including power, agricultural products, metals and critical minerals, military technology and know-how, software, and tourism.

Significant adjustments will also be required by Europe as Ukraine becomes an EU member, including changes to EU decision-making and finances, and adjustments in many sectors, including agriculture, energy and industry. Over time, Ukraine's accession can boost real wages and living standards across Europe, thanks to Ukraine's cheaper energy. For instance, Ukraine has some of the cheapest electricity in Europe, backed by low-cost nuclear and hydropower. To help manage Ukraine's economic integration with the EU, we propose that full market access be achieved gradually, with extended derogation periods, and transitional funding for losers. Further, to strengthen trade links and ensure mutual gains from trade, we propose Ukraine develop infrastructure and trade action plans with each of its European neighbours – as well as with the Commission at the European level – to agree priority cross-border projects and mitigations where adverse impacts are identified.

Since Ukraine's reconstruction will occur simultaneously with EU integration, there is room for increased cooperation between Ukrainian and EU institutions. For example, these can be long-term secondment programs where some EU officials work for several years inside Ukrainian ministries, and conversely, Ukrainian officials work for several years at EU institutions. This setup would allow better understanding and closer working contacts, as well as support faster development of Ukrainian institutions. A natural place to pilot these secondments would be a government agency responsible for reconstruction.

Chart 6: *Ukraine has cheap power*



Source: Eurostat for power, using the latest available data (1H-2021). Even after the June 2023 60% hike in tariffs, Ukrainian power is cheap – reflecting a low-cost generation mix with nuclear and hydro.

5.2. Implementing the plan. Since Ukraine has a functioning government, the implementation of reconstruction should be done wherever possible through the Ukraine government, whether through existing ministries or a special agency, rather than some parallel partner-led process. It should be subject to internationally standard procurement rules and reporting arrangements, with partners agreeing on one standard reporting standard or template across the Ukrainian government, reinforced by additional reporting and monitoring from a partner-led supervisory board. At the same time, we recognise that speed is critical to minimise scarring, and in some cases it may not be appropriate to wait for a better system of procurement or reporting to be in place before acting. We propose a twin track approach:

- Phase 1: Emergency phase. Agree with donors simplified procurement and reporting mechanisms during the war and the initial tranche of reconstruction, where speed is of the essence. For example, the procurement process can focus on framework agreements, pre-screening contractors, and post-project evaluation/audit, alongside open access to reports.

- Phase 2: Core reconstruction. Assign clear responsibilities, in particular between the different ministries and between central and local government, for different reconstruction tasks. Encourage major international contractors and suppliers to set up in Ukraine and establish Ukrainian subsidiaries now so they are in a position to bid for large defence and reconstruction contracts as they are implemented. Support a greater private sector presence in Ukraine by encouraging multilateral institutions such as EBRD and MIGA which can coordinate a large number of donors to provide war risk insurance, which can reduce the risk premium. Agree on a plan of action with donors and international financial institutions such as the World Bank and IMF to provide technical assistance to improve public expenditure management, and to improve the scope, timeliness, and comprehensiveness of fiscal reporting, including on commitments and disbursements, and on fiscal risks, including the governance of state-owned enterprises. Agree a procurement strategy that is directed at creating a competitive market with multiple competing players in key sectors in Ukraine through reconstruction.

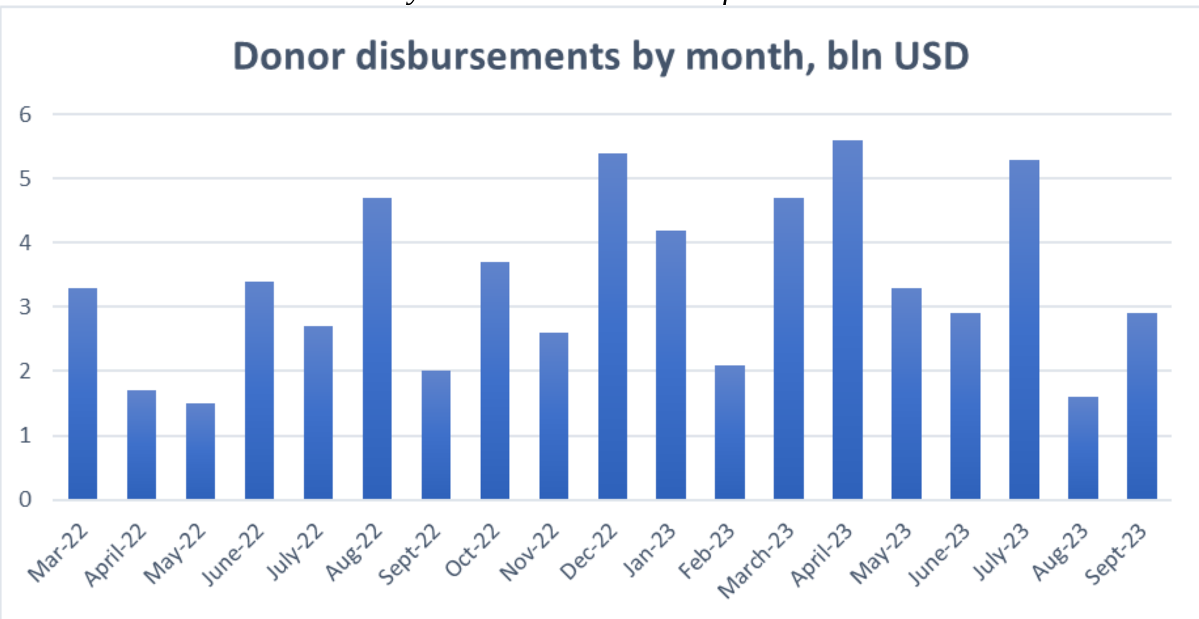
5.3. Transparency and accountability. Partners will rightly require a high level of transparency on spending and procurement, while Ukraine will need to build greater transparency into Ukrainian government processes, as part of moving to European standards of governance in preparation for EU membership. As set out above, we see this demand as going beyond a bureaucratic need to the heart of Ukraine's struggle for democracy and the rule of law, which is based upon a demand for accountability. A board of senior international officials could provide an additional layer of oversight over Ukraine's use of aid.

6. Partner commitments

6.1. Delivery of funding commitments: Partners should provide the resources committed, providing any actions agreed by the Ukraine side have been performed.

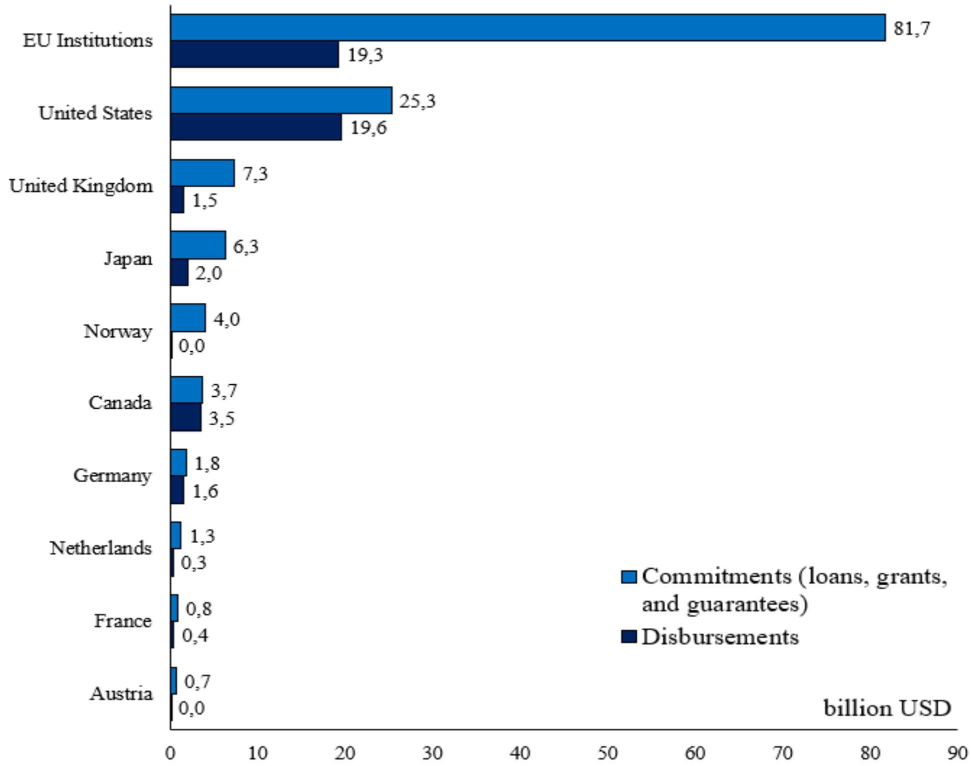
At the moment - although improved - there remains a substantial gap between partner commitments and disbursements, which could put Ukraine's war effort and stability at risk. There is also huge volatility in monthly disbursements. Agreement between partners and Ukraine on the timing and conditions for disbursements can reduce volatility. Ukraine should be able to borrow against future commitments to smooth the flow of funds and ensure funds are available when needed.

Chart 7. *Donor disbursements by month since the start of the war*



Source: Centre for economy strategy

Chart 8. *Top 10 donors, commitments vs disbursements as of July 31, 2023*



Source: Centre for economy strategy and Kiel Institute for the World Economy

6.2. Setting the right conditionality: Every funder has requirements on the purpose for which funding is provided, the actions which are required to unlock it and reporting on the use of funds. This is part of the accountability associated with the use of public funds. However, given the reassurance provided by Ukraine's legitimate and effective government and the overriding commitment to EU membership, we suggest three principles to guide the conditionality associated with Ukrainian reconstruction. First, the reconstruction plan should be primarily owned and developed by the Ukrainian government, with input from and oversight by partners. Second, partner conditionality should be aligned with the reconstruction plan and appropriate for the phase of reconstruction. We see scope for an intelligent distribution of conditionality, with a narrow focus on macro and fiscal conditionality for the initial macro-financial assistance perhaps led by the IMF, alongside a deeper focus on institutional reforms as part of the requirements for EU membership. Third, we propose restrictions on additional requirements, to avoid overloading the Ukrainian government.

6.3. Partner Coordination: Partners have already made major pledges of assistance, and provided tens of billions in macro financial assistance, including through an IMF programme. Further, Ukraine is expected to be awarded candidate status at the December 2023 European Council, putting it officially on the path to EU membership. To mitigate differences between partners - as recently seen with competing US and EU proposals for reform of Ukraine's judiciary - we would urge the main partners to agree on effective arrangements for coordination, noting that the multi-agency Donor Coordination Platform established by the G7 in December 2022 has so far not fulfilled this role effectively.

Clearly, this is a sensitive area, where different agencies will have varying mandates and there will be some duplication and tension. However, we see a strong case for more institutionalized support - notably an agency dedicated to Ukraine's reconstruction with political heavyweights who represent partners appointed to lead the agency. Apart from providing the key interface between partners and Ukraine, so Ukraine does not have to negotiate and interface with multiple partners simultaneously, the agency can aggregate information, mobilize expertise from multiple agencies (e.g., IMF for macroeconomics, World Bank for infrastructure projects, EBRD/IFC for private sector involvement), harmonise requirements, ensure consistency of practice, and provide continuity of staff and institutional memory.

The supervisory board of the agency should comprise senior officials from partner countries who can exercise oversight over Ukraine's use of aid, based on regular reports and backed by the right to audit. Furthermore, appointing credible and respected figures (e.g., Bob Zoellick, the former World Bank President; Mario Draghi, former ECB President) to perform the high-level negotiating and representative roles can help the process. These officials would be responsible for communicating to other international and European partners and taking their concerns and priorities on board so that their discussions with the Ukrainian government become a central locus for donor-Ukraine interaction and programme adjustment.

Summary

Ukraine, with its legitimate and effective government and military and strong support from partners, has good prospects for winning the war and making a rapid recovery from the damage caused by Russia's invasion. However, it will need exceptional financing for an extended period to defend and reconstruct the country.

To support this objective, we propose that Ukraine and its partners agree on a financing democracy deal and a framework of cooperation. On our proposal, Ukraine should commit to democracy, defence, and self-reliance, including major reforms of pensions, energy and taxation which reduce the financing gap. To realise these goals, it should draw up and implement a credible reconstruction plan, with partner input and oversight, and transparently report on progress. On their side, partners should cover the financing gap in 2024 and commit to providing the finance needed during and after the war, including from Russian sources, align their conditionality with the agreed reconstruction plan, and work for improved coordination among Ukraine's partners.

Note: The inclusion of affiliations is for identification purposes only and does not represent an endorsement of shared views with the co-signer.

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