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INSIDE UKRAINE

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The International Center for Policy Studies (ICPS) restores issuing analytic paper «Inside Ukraine», the last issue of which was prepared in September 2010.

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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1. The Government Policy

Relocation of gunmen to large cities bears a number of risks and challenges for the government. On one hand, it may lead to long-lasting military confrontation with intensive urban warfare. On the other hand, ATO progress is likely to become a breakthrough in the operation and result in final suppression of separatists. At the same time the government task is to restore infrastructure in liberated towns and to carry out informational work with local population whose pro-Ukrainian position becomes more articulate.

Though Donbas events have been defining informational agenda for several months, topic of Crimea annexation should not be concealed as it will legitimize the fact of the peninsula joining Russia on the international level. Crimean Tatars, who are the most consistent opponents to Crimea annexation, require support of the Ukrainian government in their confrontation with the Russian authorities.

1.1. Significant changes in ATO

Terrorists' retreat from northern Donetsk region to cities of Donetsk and Lugansk demonstrates change in the gunmen's tactics and a better coordination of Ukrainian troops after ten-day ceasefire. Deterioration of separatists' morale and decrease of their support among local population may be used for prompt suppression of terrorists. If the gunmen receive time to recover and strengthen their positions in Donetsk, with its 1 million population, Petro Poroshenko will be entangled in long-lasting military conflict with intensive house-to-house combats.

Major advantage in ATO changes is decrease in territory controlled by separatists and opportunity for the Ukrainian army to better encircle the gunmen.

On the other hand, armed confrontation on a smaller territory is likely to become more intensive and lengthy. Although thousands of internally displaced persons (IDP) from Slovyansk and Kramatorsk at last will get an opportunity to return home, their experience may be shared by dozens of thousands of people from Donetsk and Lugansk. It will have serious humanitarian consequences.

After changes in ATO the major risks for the Ukrainian army are the following:

- 1) Large concentration of gunmen with heavy armaments in Donetsk and Lugansk;
- 2) Separatists' connection with Russia through porous border in Lugansk region;
- 3) Though major separatist forces retreated from Slovyansk and Kramatorsk, many local gunmen remained in these towns and they may be used for terrorist attacks and sabotage.

1.2. Challenges of civil administration in liberated towns

Ukrainian government has a task to quickly restore infrastructure in liberated towns and to carry out informational work with local population, aimed at their re-integration in all-Ukrainian processes.

Donbas people live in the world of destroyed political coordinates, caused by long-lasting influence of Russian media on their conscience. At

Terrorists' retreat proves change in gunmen's tactics

Increase of IDP numbers will have serious humanitarian consequences

The government task is to quickly restore infrastructure in the towns

first they were frightened with the image of Kyiv coup d'état and ultra-right parties coming to power. They were afraid of deterioration in relations with Russia as industry in these towns is closely connected with Russian market. Russian media formed public opinion that separatists had come to defend local people and that Kyiv government was an enemy.

However, destruction and terror were the only thing pro-Russian gunmen have brought to these towns. After their escape local people feel that they were betrayed twice: first – by Kyiv, and second – by pro-Russian gunmen. A sign of political disorientation is that many local people have difficulties defining who “their guy” is. They greet Ukrainian authorities returning to liberated towns while they have some sense of affiliation to the separatists who have escaped.

The government policy is to be aimed at some psychological rehabilitation of local residents who have lived through several months of actual war. They need to feel that central government does as much as it can to solve their problems and that the myths imposed by Russian propaganda are a lie. Strengthening of pro-Ukrainian disposition in Donbas will become the best means to prevent destabilization scenarios and to decrease separatists' support.

It will also help to change civilization mindset in Donbas. Nowadays support of Russia and personally Vladimir Putin among local population in the region significantly decreases. In case of successful information campaign the Ukrainian government may use this time to transform once blatantly pro-Russian region into a more moderate one.

Ukrainian government gets a better understanding of the importance informational front plays in fight against the aggressor. As an example, on July 7 Petro Poroshenko suggested a special broadcasting program for the region as “Donbas people lack true information about Ukraine”.

However, informational campaign is not enough to transform Donbas. One needs positive results which would have positive effect on the people's lives. In particular, it concerns restoration of destroyed infrastructure, which will require significant funds.

Ukraine needs support of international donors, yet it is equally important to engage Ukrainian businessmen who have assets in the region. Every large plant is not only industrial facilities, but also social infrastructure which has not seen investments for decades. Instead, billions of dollars have been pumped out from these plants.

For many times Rinat Akhmetov stressed that Donbas should be heard. He has resources to actually hear Donbas needs and to help local people to return to normal lifestyle.

At the same time, involvement of businessmen cannot be an excuse for Kyiv distancing itself from local residents' problems. Thus, it is important to combine the efforts of international donors, Ukrainian government and Ukrainian big business.

1.3. Repression of Crimean Tatars by Russian authorities

Crimean Tatars remain one of the most active and consistent opponents to Russian occupation of Crimea. Realizing this threat, Russian authorities try to isolate leaders of Crimean Tatars and to split Majlis. The task for Ukrainian government is to actively support pro-Ukrainian forces in Crimea, at least in informational field and during international negotiations.

Shift of informational focus revealed in domination of fight against

Influence of Russian media destroyed political paradigm in the conscience of local residents

Stronger pro-Ukrainian sentiment in Donbas will prevent from destabilization scenarios

Ukrainian businessmen should get involved in reconstruction of the region

Russia tries to isolate leaders of Crimean Tatars

terrorism in Donbas topic provides silent legitimization to the peninsula annexation on the international level. So far activities of the Ukrainian officials have not gone further than flag-waving declarations that “victory parade will be celebrated in Ukrainian Sevastopol”.

On July 4-5, Majlis session took place beyond the peninsula as in April 2014 Mustafa Dzhemilev, leader of Crimean Tatars, was forbidden to cross the Crimean border. After the session Refat Chubarov, head of Majlis, became another victim of Russian entry restriction. Such policy deprives representative body of Crimean Tatars on the peninsula from its leadership. As a reply, Majlis officially recalled its representatives from executive bodies in Crimea.

Russian government tries to influence political position of Crimean Tatars. Ban for Crimean Tatars’ leaders to enter the peninsula is one of the steps to weaken their movement for national and territorial autonomy. It is indicative that for many times Mustafa Dzhemilev stressed that he sees this autonomy only within Ukraine.

Among other steps there may be promotion of split among Crimean Tatars and an attempt to promote Majlis representatives, loyal to Russian government, at the congress scheduled for September 2014. If these scenarios do not work, it may end up with the ban on the Majlis activities. Natalia Poklonska, Prosecutor-General of self-proclaimed Crimean Republic, said about the possibility of such ban in early May. For Russia it is not the first time when its government tries to limit democratic rights and freedoms of Crimean Tatars.

Ukrainian government should support Crimean Tatars in their fight for democratic rights and freedoms. At the international level one should insist that processes taking place in Ukraine are properly called. Crimea annexation is a direct aggression of Russia against Ukraine. Restriction of Crimean Tatars’ rights for assembly and not allowing their leaders to return home is a violation of democratic principles, which repeats repressive policy of the Soviet Union against this people.

If the Ukrainian government has recognized so called Luhansk People’s Republic and Donetsk People’s Republic as terrorist organizations, it is necessary to fix this formulation at the international level. Then any support to gunmen, either official or unofficial, will fall under the category of “terrorism financing”, and the party which would provide this support will be qualified as “sponsor of terrorism”.

Majlis suspended cooperation with the peninsula administration

Restriction of Crimean Tatars’ rights repeats repressive policy of the Soviet Union against this people

2. Economic Situation

Ukraine wants Russia to halt flights to Crimea and to close Crimean ports. Crimean authorities, in turn, plan to introduce a duty on Ukrainian non-food products.

Parliament adopted a number of important laws on the banking sector, regarding protection of the banking system stability, introduction of linear tax rates on deposits and corporate governance in banks.

The State Treasury of Ukraine has provided new information about the state budget implementation. There is reason to believe that the amount of revenues is lower than it has been actually announced.

The Government is taking steps to strengthen the energy security of Ukraine.

2.1. Ukraine insists on control over the Crimean airspace

Ukraine encouraged the International Civil Aviation Organization (ICAO) to stop the violation of Crimean airspace by Russian airlines and Russia ignoring international law in air navigation control.

The official position of the international regulatory organization on this issue was stated in April 2014 and remains the same: air space over Crimea belongs to Ukraine.

However, the Russian air carriers continue violating airspace over the peninsula. They are increasing the number of flights to the peninsula, with full support of Russian government agencies. Some Russian carriers have even reduced the price of air travel to Crimea. Moreover, Russia is planning to abolish VAT on flights to Crimea and offers subsidy program to the carriers. One of the requirements to participate in the program is to ensure flights to Crimea.

Given the high probability of obtaining sanctions on flights to Europe and America due to its operations in Crimea, Russia has come up with the idea to create a separate airline that will fly from Simferopol and Sevastopol to Russia. It will help to avoid the possible effects of international sanctions.

In addition, Ukraine will officially close international shipping in Crimean ports. This means that any ship that enters ports in the peninsula may face serious problems - fines or imprisonment of the crew.

In turn, Crimean authorities are planning to introduce a tax on Ukrainian non-food products. The main justification is the possibility of duty-free supplies of Ukrainian products to the territory of Russia. At the same time, a new tax will not be applied to food. Obviously, this is due to the fact that introduction of taxes on food can negatively influence purchasing power of Crimean residents. It should be noted that in January-May 2014 inflation in Crimea has reached 17%. The main reasons for price growth are increase of transportation costs and problems with delivery of products from continental Ukraine, which resulted in speculative pricing.

2.2. Verkhovna Rada has approved a number of laws on banking sector

The Parliament approved a law on protection of banking system stability, which foresees:

- Easier procedures for bank capitalization and sale of delinquent banks;
- Increase in minimal authorized capital from UAH 120 mln. to

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food products*

UAH 500 mln.;

- Introduction of liability for FX rate manipulation and stricter punishment of bank owners;
- A longer list of criteria to recognize banks as delinquent or insolvent, for instance, when negatively classified assets of the bank exceed 35% of all assets;
- Deposit guarantee system will not cover deposits in banking metals as well as deposits used to secure other liabilities towards this bank;
- Deposit guarantee fund gets permission to issue financial bills and bonds with maturity over five years.

The law is agreed upon with the World Bank. Its approval was actually one of the requirements for the state budget to get USD 1 bln. by the end of year.

Verkhovna Rada adopted the law on corporate management in banks based on the principles of corporate management by Basel committee on banking supervision and international practice of corporate management.

In particular, the law foresees:

- Amendments to the law on banks, which defines “conflict of interests” and introduces requirements to avoid it in the bank;
- More authorities to the Council in bank management;
- The NBU getting a right to demand replacement of the council member in case of undue fulfillment of job.

The law will improve overall management level in corporate banks, which ameliorates trust of legal entities and individuals as well as potential investors to the banking system.

The Parliament also reviewed tax rate on deposit income. Instead of progressive scale, linear rate on passive income is set at the level of 15%. Taxation of royalty, investment income and dividends will return to the level it used to be before July 1: for royalty and investment income – 15%, dividends – 5%; a single rate for taxation of other passive income is set at the level of 15%. Banks, but not individuals will administer the tax. The tax will be paid by deposit owners regardless of deposit volume.

Taking into account active discussion taxation of deposit income caused, replacement of progressive scale with linear one will have a milder effect on the banking sector. However, the very idea of a new tax is doubtful especially after government declared decrease of tax number and lower tax pressure.

2.3. The State Treasury of Ukraine reported on budget fulfillment

According to the State Treasury of Ukraine, the state budget received UAH 175.8 bln. in January-June 2014, which is 8.1% more than in the same period of 2013. However, this information is doubtful due to decline in economic activity of enterprises, particularly in the East. There is a high probability that the state budget received a lot of advance payments in January-June 2014. Another factor that influenced fulfillment of the state budget was the reduction in VAT refund compared to 2013. The amount of VAT refund was UAH 20.4 billion in January-June 2014 that is 25.8% less comparing to the previous year.

Conventional practice of forced advance payments negatively impacts state budget. It increases the tax burden on business. One of the problems for Ukraine in budget sphere is to determine the effective

Verkhovna Rada tries to improve stability of banking system

The law on corporate management in banks is adopted

Rate for deposit income tax will make up 15%

Government reports on increase in budget proceedings

statistical mechanism for reporting on budget implementation based on actual indicators without artificial revenues.

Taking into account political and economic situation, there is a possibility that the budget cut will take place in September-October 2014. In the previous period the cut concerned expenditures on the state apparatus and centralized social spending. Therefore, this time intergovernmental transfers and expenditures on the state apparatus are likely to be reviewed.

2.4. Steps to improve energy security of Ukraine

Ukrainian Ministry of Finance, in cooperation with relevant ministries and agencies, has developed the following eight variants for substitution of imported natural gas: biofuels, synthesis gas, domestic natural gas production increase, water-coal fuel, night electricity usage for heat storage, LNG terminal, synthesis gas SG, synthetic natural gas SNG.

In foreseeable future, the demand for the energy resource can be met by using liquefied gas, which requires construction of marine terminal. Due to the high cost of LNG infrastructure construction, implementation of these options may be possible in case of feasibility study on the project as well as formation of competitive prices for such energy resources. Partial substitution of natural gas consumed by households may be provided by biofuels. However, this kind of production process may impact soil depletion, so the production must be carried out on non-agricultural lands.

The usage of synthesis gas, synthesis gas SG, synthetic natural gas SNG is another prospective variant to substitute a share of natural gas import. It may be received through coal gasification (conversion). Although the certification of gasification plants in Ukraine is not available today, in the long term development of such energy resources may positively impact coal industry and lead to cost reduce in gas production.

In case of relevant technologies introduction, we may replace some share of imported natural gas with domestic production using deep drilling technologies. However, taking into consideration the high cost of such production, it is necessary to develop an economic incentives mechanism for producers.

In addition to these diversification measures, according to the results of «Open Season» procedure for reverse gas supplies to Ukraine via Slovakia, about twenty European gas suppliers are interested in Ukrainian energy consumer market. It is expected that gas supply through this direction will provide 8 bcm per year since September with the prospect to increase supply in this area to 30 bcm annually through the usage of one of four gas pipelines which do not yet work to their full capacity.

Besides, recently the Parliament of Ukraine passed the first reading of a draft law “On amending some laws of Ukraine on reforming management of Ukrainian gas transportation system”. This draft law will support the Ukrainian government initiative to transfer the EU admission point for Russian gas from the western to the eastern border of Ukraine. According to the draft law, functions of the gas transportation system operator can be assigned to a company which is founded and owned by a state only or government (owning at least 51% of corporate rights) and legal entities, which are owned and controlled by residents of the European Union, USA or the European Energy Community. The operator functions for underground gas storage system can be separated and assigned to another company – the underground gas storage facility operator.

Eight options to substitute imported natural gas

Imported gas may be partially replaced with domestic production using deep drilling technologies

Gas transportation system operator may be founded by Ukrainian government (not less than 51%) and foreign legal entities

The quality of this draft law raises a number of questions, especially regarding possible operator shareholders (it is important that European and U.S. companies, but not Russian ones receive a share). Another controversial aspect is the technical coordination of two operators within a single integrated infrastructure - the gas transportation system and underground gas storage facilities network. However, this would create a legal framework for the improvement of the existing energy infrastructure by attracting foreign companies' investments.

In case this draft law is implemented and the initiative to move Russian gas intake point to the eastern border of Ukraine is realized, Europe will be able to use the Ukrainian system of underground gas storage facilities. On the other hand, Ukraine will have the opportunity to buy gas from the European companies. It would also lead to changes in the transit arrangements format as Ukraine will be responsible towards the European Union for the reliability and security of gas supply.

3. Political competition

It gets harder and harder for the President to mobilize MPs to support his decisions. A number of political players are interested in snap parliamentary election; therefore this issue may be solved within next weeks.

First polls aimed to show potential support of political parties at the elections are the first sign that the electoral campaign has started. Their results show considerable level of support for Radical Party of Oleh Lyashko who has not stopped his public activities after the presidential elections. Sociological ratings may become one of major tools in this campaign. Efficiency of this tool was proved at the last presidential elections.

3.1. Discordance between the President and the Parliament aggravates

Last week voting in the Parliament shows that tension between Verkhovna Rada and the President increases. Lack of his own faction in the Parliament significantly limits actions of Petro Poroshenko. Parliamentary factions and groups tend to better realize their influence on state policy under parliamentary-presidential republic. Therefore, every time the President will ask them to support his initiatives, they will insist on consideration of their own interests.

Presidential variant of constitutional amendments caused severe critics on part of “Batkivshchyna” and “Svoboda”. Though the item was included in the agenda, both factions denied to support it as a basic draft law and are going to prepare the alternative texts.

Presidential candidate for the position of Minister of Defense received fewer positive votes – 260 – than it was two weeks ago when head of the National Bank (320 votes), Prosecutor-General (329) and Minister of Foreign Affairs (335) were appointed. It shows that it becomes harder for the President to mobilize MPs to support his appointments or decisions.

Meanwhile, possibilities for changes in the government are actively discussed. The government was formed by “Svoboda” and “Batkivshchyna” representatives, while the third coalition faction – UDAR – did not fill its ministerial quotas. While Yatseniuk’s government was formed, Vitali Klitschko’s party insisted on the cabinet of technocrats and deliberately tried to avoid negative impact from unpopular governmental decisions during the election campaign. Nowadays Petro Poroshenko may use UDAR quotas to delegate his representatives to the government. Changes may affect six-seven ministries, among the others being Ministry of Economy and Ministry of Finance. Thus, Petro Poroshenko will get more tools to influence state policy in various spheres.

3.2. Opponents and supporters of snap parliamentary elections

Last week Arseniy Yatseniuk also mentioned the possibility of the government dissolution unless the Parliament supported the Cabinet initiatives in energy sector. Such step may be a ground for snap parliamentary elections necessity of which was mentioned in Petro Poroshenko’s addresses. However, this idea is opposed by some parliamentary factions.

At the present UDAR is Poroshenko’s direct ally in the matter of snap elections. The President also actively works with independent MPs. Some of them may end up in Poroshenko’s political project so they are

Tension between Verkhovna Rada and the President increases

Possibilities for changes in the government are actively discussed

UDAR is Poroshenko’s direct ally as regards snap elections

personally interested in this initiative.

Ihor Kolomoisky, as well, is interested in early parliamentary election. Head of Dnipropetrovsk regional state administration will support “Strong Ukraine” of Serhiy Tyhyhko and he may lead his own political project which would include MPs who were elected under FPTP system. Ihor Kolomoisky is assumed to have influence on “Economic Development” parliamentary group headed by Vitali Khomutynnik. If “Economic Development”, together with UDAR and independent MPs, leave the coalition, it may become a reason for early parliamentary elections.

The elections also match the interests of Serhiy Lyovochkin who may lead his own political project and get potential allies in “Party of Development of Ukraine”. Besides, journalists claim that Serhiy Lyovochkin is related to Radical party of Oleh Lyashko, who keeps building up his political rating.

Though officially “Batkivshchyna” and “Svoboda” support the idea of early parliamentary elections, they will use every means to postpone the date. It is caused by overall drop in support of these political forces in the society. Representatives of party of the Regions and Communist party of Ukraine are also against early parliamentary elections as they have scarce chances to make it to the next Parliament unless they change the way they position themselves.

Last week former deputies of the Party of the Regions created another parliamentary group called “For Peace and Stability”. It is assumed that the group is financed by representatives of so called “Family”. Obviously, this group will also be against snap elections as its MPs are unlikely to be re-elected.

3.3. Electoral prospects of Radical Party of Oleh Lyashko

Rather unexpectedly, at the presidential elections Oleh Lyashko received high third place, which strengthened positions of his party project. Unlike other presidential candidates, after the elections he did not disappear from media. Moreover, he increases his presence on TV. He takes an active part in TV shows, visits ATO zone and carries out meetings in the regions. Besides, he conducts successful PR-events such as raid on illegal casino in Kyiv.

Oleh Lyashko has drawn conclusions from Petro Poroshenko’s electoral campaign the cornerstone of which was skillful use of polls. Last week Kyiv International Institute of Sociology (KIIS) published the results of its recent sociological survey according to which Radical Party receives the highest level of people’s support at the national level.

These results are to show upward trend for the politician’s rating. Besides, they check how society will respond to these results. As well, it creates informational ground for further surveys.

Sociological surveys are likely to become one of the most efficient campaign instruments. Political players who will learn how to use this tool effectively and in time, have high chances to significantly improve their standing before the elections.

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