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**Article**

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Anna Bjerde

## “Laying Foundations for Building Back Better in Ukraine” – Policy Actions and Principles for a Strong Transition and Recovery Process\*

Russia's invasion of Ukraine is causing massive economic and social repercussions in Ukraine, including a sharp increase in poverty.<sup>1</sup> Ukraine's GDP is estimated to have contracted by about 30 percent in 2022, due to the reduction in economic activity caused by the destruction of productive capacity, damage to arable land, and reduced labor supply. Poverty is estimated to have increased from 5.5 percent in 2021 to 25 percent in 2022 with income below US\$6.5 per day<sup>2</sup> and headline inflation hit 26.6 percent in December 2022, with food price inflation hurting the poor. As of January 3, 2023, 17,994 civilian casualties were recorded. The invasion of Ukraine has also triggered the largest human displacement crisis in the world at present: since the onset of the war, approximately 5.4 million people have been displaced within Ukraine and over 8.1 million have moved to neighboring countries (UNHCR).

Damages to infrastructure and services are mounting daily with persisting and intensified attacks. The recovery and reconstruction needs are immense, estimated at approximately US\$349 billion—more than 1.6 times Ukraine's 2021 GDP—as of June 2022. The ensuing destruction over the following months has pushed up this already high estimate. The scale of the damage is best exemplified by the energy sector where targeted attacks on energy infrastructure had damaged over 60 percent of Ukraine's power infrastructure by the end of December 2022—causing destruction estimated at over US\$10 billion. Similarly, damage to housing increased 35 percent between June 1, 2022<sup>3</sup> and the end of 2022 to reach an estimated US\$54 billion.

EU candidacy is a key driver for reconstruction efforts. After Ukraine was granted candidate status in June 2022, the country's future is expected to involve eventual membership of the European Union. This means that the process of reconstruction will need to be closely aligned with EU accession process requirements. Despite the war, Ukraine has continued to advance toward gradual alignment with the

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<sup>1</sup> All statistics in this and subsequent sections are estimates by World Bank Staff based on official statistics of Ukraine's public authorities and do not reflect the status at the time of publication.

<sup>2</sup> In 2017 PPP.

<sup>3</sup> Based on the ongoing damages assessment under second Rapid Damage and Needs Assessment. Final results are expected in April and may differ from the current estimations presented.

### KEY MESSAGES

- **Russia's invasion of Ukraine is causing massive social and economic repercussions with a devastating loss of human lives, millions of displaced people, and a sharp increase of poverty**
- **Ukraine will need to balance the need to sustain the war economy today and create the necessary conditions for a sustainable economic recovery in future**
- **Ukraine's reconstruction and progress toward EU standards will demand more from its institutions and will be a key driver for reforms and plans to build back better**
- **External support, especially from the private sector, remains key to expand the available and necessary pool of resources exponentially**
- **Ukraine would need to build a strong foundation to accelerate reconstruction by focusing on a set of policies that catalyze external financing, enhance implementation capacity, and ensure recovery actions do not impede progress on long term commitments and accession requirements (including the green transition)**

EU acquis—a process that began in 2014—and to implement its economic reform agenda aimed at addressing structural impediments to (i) attract greater investment, (ii) better allocate capital, and (iii) take full advantage of the opportunities offered by its agriculture sector. Alignment with the EU also entails improving institutional governance, integrating climate change mitigation and adaptation in recovery and reconstruction efforts, and reconfiguring the country's development objectives towards carbon neutrality.

Ukraine's reconstruction and progress toward EU standards will demand more from its institutions. The country's remarkable capacity to carry out basic governmental functions during the terrible events of the past 12 months can be attributed in large part to the extensive reforms implemented in public administration, financial, healthcare, and agriculture sectors over the past



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half-decade, along with the establishment of anti-corruption institutions. Ukraine provided a convincing roadmap to meet the EU accession criteria in 2022, following the start of the war. However, the momentum on many reforms has stalled during the war, due to weakened institutional capacities and a shift in priorities to cater to wartime needs.

While the Government of Ukraine (GoU) is expected to lead recovery and reconstruction efforts, the country cannot finance the magnitude of the needs by itself. Efforts to contain the high fiscal financing requirements—consisting of the deficit (excluding grants) and debt repayments—are ongoing. Donor support has somewhat alleviated the severe fiscal strain,<sup>4</sup> with an estimated US\$3 billion to US\$4 billion per month required in 2023 to maintain essential services, including government operations, health, education, and social protection.<sup>5</sup> Additionally, Ukraine's capital absorption capacity, at around US\$8 billion in 2023,<sup>6</sup> is limited in relation to its needs—only amounting to less than one tenth of the direct damages as of June 1, 2022. To enhance the pool of resources available for both short-term needs and long-term focused investments, the Government needs to foster private sector financing and bolster donor support.

#### **KEY CHALLENGES: BALANCING PRESENT NEEDS WITH BUILDING FOR A SUSTAINABLE FUTURE**

Ukraine will need to balance the need (i) to sustain the war economy today, and (ii) to create the necessary conditions for a sustainable economic recovery in the future. The authorities have deployed resources to sustain essential public services (including social transfers) while maintaining broadly sound macroeconomic policies to avert the most immediate fiscal, monetary, and financial sector risks of the wartime economy. Yet, the Government is faced with difficult decisions on how to fund other activities (including emergency restoration of critical infrastructure) given the cost of the war and of providing essential social services, wages and pensions. Additional compression of social expenditures could risk breaking the social contract, already stretched to the limit amidst rising poverty and joblessness. At the same time, a successful transition towards a sustainable economic recovery will hinge on a combination of targeted pub-

lic investments to restore critical assets and policy interventions that control wartime rent seeking and reduce risks so that the private sector can invest. If Ukraine's productive capacity cannot be sustained or even boosted during the war, it risks settling into a situation of low or no growth and facing huge social challenges once the war ends.

Maintaining a broadly adequate macroeconomic policy framework during a protracted conflict is another key challenge. Specifically, adequate policies are needed to maintain macroeconomic stability and limit adverse distributional impacts for households and damage to productive sectors of the economy while the war is ongoing. A return to less trying conditions after the war will mark a divergence between current and anticipated future income streams, accompanied by a revival of domestic demand, including for reconstruction, that exceeds output capacity. In practice, this translates into tightening budget constraints on public spending and limited resources to support economic recovery. Management of these policy tensions requires a strong macroeconomic framework that encourages private investment and maintains overall market confidence.

Thus far, large donor inflows have helped to mitigate macroeconomic risks by helping the Government to mobilize much-needed financial resources. Most of these inflows have been used to honor bare-bones social expenditures, limit irrevocable damage to Ukrainians' living standards, and rehabilitate personal incomes. Donor inflows, however, could be limited in the medium term. If Ukraine's imbalances persistently exceed external support, deficits will need to be increasingly offset by domestic resources through increased monetization and financial repression, and further compression of private investment and consumption through borrowing or taxation.

Experience from other post-conflict situations highlights the central role of Government and its institutions in managing resource allocation and ensuring vertical and horizontal coordination among different levels of government during the reconstruction process. The public sector, and its key institutions, will likely play an important role in providing guarantees and other de-risking instruments (particularly insurance) to enable private sector participation. Public intervention may also be needed to restore private assets, including housing. Productive sectors such as agriculture may require additional public financing for recovery and the banking and financial sector may need capitalization to offset losses incurred during the war.

However, Ukraine's track record has also shown that the Government's strong role may overburden state capacity, exacerbate existing problems (rent-seeking), and encourage (untaxed) informal market activities. Centralization and the introduction of Martial Law during the war have given the central Government unparalleled powers to mobilize

<sup>4</sup> Since February 2022, tax revenue collection has plummeted due to the GoU's strategic decision to reduce the tax burden on the population and, particularly because of a war-related decline in economic activity (including due to out-migration) and the inability to collect taxes in conflict. On the other hand, public expenditure has increased sharply to maintain key public services during wartime.

<sup>5</sup> The World Bank Group has been working with international partners to mobilize fast-disbursing funds that help the GoU sustain essential public service delivery under the "Public Expenditures for Administrative Capacity Endurance (PEACE)" project. Government programs supported through PEACE-mobilized financing include wages for hospital workers, pensions for the elderly, social programs for the vulnerable, social assistance for utility bill payments, grants to internally displaced persons and wages to State Emergency Service staff.

<sup>6</sup> Based on extrapolations of the 2021 budget plan and considering inflation for 2022 and 2023.

resources and manage the wartime economy. A post-war Government may face different challenges that require a more decentralized approach to decision making. Hence, it may have neither the resources nor the capacity to rebuild the economy, and this may become a key binding constraint.

By contrast, the domestic and external private sector has both the resources and the ability to act as a permanent engine of growth in the aftermath of the war. The role of public policy – in particular, ensuring fair competition and regulatory policies that limit market concentration and capture – will be to ensure that the private sector has the incentives and environment needed to grow. These market conditions will be facilitated by rapid trade, fiscal, and regulatory integration with the EU. EU integration also offers an opportunity to access global markets.

### **BUILDING STRONG FOUNDATIONS TO CATALYZE TRANSITION AND ACCELERATE THE RECONSTRUCTION OF UKRAINE**

Given the scope and range of needs and the limited resources, the GoU needs to carefully prioritize its recovery agenda, focusing first on building strong foundations. The evolution of the war cannot be predicted, and this uncertainty makes precise assessments and long-term planning difficult. Urgent repair projects must be implemented simultaneously with continued support for basic services, but this too is affected by evolving conditions on the frontline. Given ongoing efforts to balance short-term needs with long-term goals, Ukraine must focus first on policies that catalyze external financing, enhance internal implementation capacity, and ensure that short-term emergency and recovery actions do not impede progress on long term commitments and accession requirements—including the green transition. For Ukraine, this would entail focusing on key actions centered around three pillars.

#### **Building Trust, Accountability, and Implementation Capacity**

- a. *Rebuilding with integrity in a competitive environment.* Ukraine's anticorruption architecture is beginning to demonstrate its capacity to uphold accountability. This architecture needs to be strengthened further to support reconstruction. Justice reform is on track, but not finalized, and should therefore remain a priority to ensure the rule of law and independence of the judiciary system. Law enforcement alone cannot safeguard the integrity of the massive reconstruction process to come. Preventive measures will be key. Finally, without implementing robust anti-trust measures, reconstruction might benefit only a few in the private sector, with negative impact on Ukrainian consumers and the broader economy.
- b. *Reforming public institutions for greater accountability, transparency, and efficiency.* For the private sector and donors to play a prominent role in the recovery and reconstruction, governance systems need to be transparent and accountable to all stakeholders, including to the people of Ukraine. This requires concerted efforts to strengthen overall public investment management systems by embedding reliable checks and balances and fast-tracking essential institutional and regulatory reforms in line with international good practice—including for procurement, public financial management, and state-owned enterprise (SOE) reforms—and enhancing processes for regular performance monitoring and strengthening parliamentary oversight.
- c. *Building strong institutions and modalities focused on facilitating effective and efficient reconstruction planning and works.* Global experience suggests the success of large-scale recovery and reconstruction efforts, like those needed in Ukraine, relies on leadership from a legally empowered agency, set up under a central authority to coordinate all stakeholders, mobilize resources and set up monitoring systems. Recently the State Agency for Reconstruction and Development of Ukraine was set up under the Ministry of Communities, Territories and Infrastructure Development for driving recovery and reconstruction. To meet its mandate, the agency would need to optimize processes including coordination and planning, absorption of funds, and facilitation of streamlined and agile implementation — all of which are key factors underpinning effective reconstruction. Additionally, the agency would not only need to be responsible for the formulation of regulations vital to recovery and reconstruction and for strategic planning for long-term reconstruction and rehabilitation, but it would also need to establish the necessary architecture for financial devolution and implementation independence.
- d. *Enhancing the agency and capacity of local governments through the completion of decentralization reforms.* Decentralization reforms were ongoing at the war onset and critical areas remained contentious, such as demarcation of administrative boundaries and mechanisms to help local governments implement regional development strategies. Progress has stalled with the war and the burden on local governments has grown exponentially as they are expected to implement emergency recovery works, create conditions for resilience, and develop urban recovery plans for coordinated recovery at the local level. Given current capacity and the lack of clarity on administrative boundaries, roles and responsibilities, transfer mechanisms and local finance regula-

tions, local governments will be hard-pressed to deliver. Without an integrated place-based approach and implementation capacity at the local level, much needed recovery and reconstruction efforts in urban areas will stall.

- e. *Strengthening land and property rights and registration to enable the private sector and residential (re)construction.* With recovery, new businesses will need to find premises and established businesses may need to scale up, scale down or move to a different location, reflecting market changes caused by the war. Similarly, households will need to repair, rebuild or move, depending on multiple factors including the changing location of jobs and opportunities. Prior to the war, the cadaster was comparatively underdeveloped. Deficiencies were especially acute in urban areas where coverage was low and accuracy was uncertain. Typically, in Fragile, Conflict and Violence contexts confiscations, expropriations, fraudulent transactions, transactions conducted under duress, land grabbing and land speculation during war further weaken property rights and limit reconstruction and recovery for both households and businesses by making legitimate ownership more difficult to determine. Strengthening land/property rights would include comprehensive registration, including apartments, and a dispute resolution process. Cadasters depend on local government boundaries, which have not yet been legally agreed due to recent local government reforms. Boundary delimitation is another priority area, required for both cadaster and master plans.

### Ensuring Macro Stability Supported by the Rehabilitation and Rethinking of Key Sectors

- f. *Restoring macro stability and mobilizing private finance.* Stable exchange and interest rates, overall price stability and a conducive risk-return ratio for investments are key to any private sector-led economic growth strategy. Authorities are committed to maintaining sound macroeconomic policies to avert the most immediate fiscal, monetary, and financial sector risks. At the start of the war, the authorities managed to preserve financial and exchange rate stability and fiscal policy was swiftly adjusted to maintain spending on critical social needs and increase defense expenditures. More recently, the authorities have made progress in *reducing sizable drains on foreign currency assets*. Just as a full restoration of macroeconomic stability would require cessation of military activity, the mobilization of private finance will require progress in addressing long-lasting structural impediments. Specifically, an *improvement in conditions for private sector investment* would require further deregulating the business environment, improving government effectiveness, and strengthening con-

nectivity and trade to support integration with the EU and reducing state capture through SOEs. In addition, policy actions are needed to *improve allocation of capital* and increase access to finance, such as enhancing the financial sector's contribution to addressing private sector needs including through provision of credit guarantees, export financing and credit insurance mechanisms, measures to stimulate bank lending and diversification of the financial system as well as strengthening of digital financial services. During the war, a significant share of banking system liquidity remains frozen in non-performing loans or idling in Central Bank deposits.

- g. *Reforming, rehabilitating, rebuilding, and modernizing infrastructure sectors and services, with a focus on energy.* The energy sector will play a pivotal role in the recovery and reconstruction phases. Energy policy decisions made during recovery could impact long-term economic and climate objectives. Before the war, reforms were initiated in the energy sector to improve efficiencies, establish a wholesale electricity market, and introduce private sector participation in generation and distribution, although challenges remained on underpricing and robust governance. The post-war context will present an opportunity to rethink energy sector priorities in Ukraine. Physical and market integration with the European energy system should be a key priority to ensure energy security. However, emergency measures such as the introduction of public service obligations (PSOs) and other legal changes under martial law could delay compliance with European energy commitments and hinder the economic integration process. During reconstruction, Ukraine will need to adopt a building back better approach with policies to align its energy model with the European energy strategy.<sup>7</sup> These policies will also help attract support from donors, financiers, and investors to accelerate the restoration and reconstruction. In the transport sector, improved multi-modal planning will be needed to optimize the logistics network, which will be important to enhance connectivity, and for territorial cohesion and economic activity after the war. Finally, reconstruction should take advantage of opportunities and synergies to decarbonize and digitalize the energy and transport sectors, building on significant advances in digital development before and during the war.<sup>8</sup>

<sup>7</sup> (i) Transposition of the Clean Energy Package with support from the Energy Community Secretariat, correcting institutional and market-related breaches; (ii) diversification of gas supply and promotion of green gases and promoting electrification when economically feasible; (iii) Acceleration of decarbonization of the power sector and implementation of a just transition roadmap out of coal and toward renewable energy generation; (iv) boosting energy efficiency in demand sectors (housing, industrial, transport).

<sup>8</sup> The comprehensive legislative framework in cybersecurity and its implementation strategy helped protect Ukrainian systems during the war. Ukrainian energy facilities suffer continuous cyberattacks.



h. *Rebuilding the agri-food sector for accelerated climate resilience, diversified growth and enhanced global food and nutrition security.* In 2021, the agri-food sector, with input supply and agricultural trade, generated 20 percent of GDP – making the sector a backbone of the Ukrainian economy. In addition to direct war damage, the sector has lost billions of dollars due to depressed farmgate prices, reduced exports, and decreased agricultural production. Rebuilding the agri-food sector is a daunting task, made more difficult by landmines and ordnance on agricultural land and inland waterways. In the short run, the agri-food sector will require much liquidity in the form of credit softening, credit lines, and grants for smaller farms and food processors to recover agricultural production. Public support will also be required to demine agricultural fields and recover damaged assets. Lack of support to this sector would have severe negative implications for Ukraine's economy and global food and nutrition security. In the medium term, the completion of land and irrigation reforms is essential. Attention must also be paid to building institutions and programs that accelerate climate resilience through climate smart agriculture adaptation, incentivize the diversification of agricultural production and food processing, and support improvements in food safety, phytosanitary and sanitary measures, digitalization and agri-logistics to reduce the cost of private sector investments.

#### **Adopting a People-centered Approach with Careful Sequencing**

i. *Investing in recovery of social infrastructure and services, especially at the local level, as well as real sectors.* By the end of January 2023, 6 percent of health facilities and 10 percent of schools had been damaged or destroyed. Bomb shelters are required for schools to re-open. Restoring access to safe and modern health and education services is essential for the well-being of the Ukrainian people and their potential to contribute productively to the recovery. As territories become safe, the provision of key social services will encourage Ukrainian refugees and internally displaced people (IDPs) to return to home communities.

j. *Addressing new needs that have arisen directly as a consequence of the war.* These include an increased need for mental health services, physical rehabilitation of the injured, and services for veterans, among others. With 2.4 million jobs lost by October 31, 2022, equal to 15.5 percent of pre-war employment,<sup>9</sup> job creation will be important and opportunities to match the need for investment in recovery with job needs could

be explored through the introduction of public works programs or better labor market activation services. Such programs are also likely to hasten integration of IDPs in host communities and the reintegration of returnees in home communities.

k. *Sequencing and phasing designed around evolving demographic profile and needs.* The war has resulted in large scale displacement. As the country transitions to the recovery and reconstruction phases, Ukraine's population and its spatial distribution is unlikely to resemble its pre-war status. While some territorial communities have retained only a fraction of their population, other cities have become IDP hubs and increased in size. The war has also altered the age and gender aspects of the demographic profile. Considering limited resources, the planning, sequencing and phasing of investments for short, medium and long timeframes at both local and national levels must be based on a realistic outlook of population flows and their associated needs. "Reconstruction" should therefore not aim to actually reconstruct all damaged assets and replicate pre-war status, but rather reflect the current context and anticipate future needs with investments that are both justified and feasible.<sup>10</sup>

#### **POLICY CONCLUSION**

Although the path to recovery and reconstruction for Ukraine is challenging, it presents an opportunity for building a modernized, better Ukraine. At present, Ukraine is at an important juncture: on the one hand, the country is grappling with continued attacks and aggression while catering to the wartime economy; on the other hand, driven by EU candidacy, it is actively planning for recovery and reconstruction based on building back better principles. Given financing limitations, this entails balancing short-term needs and securing future sustainability and productivity. External support, especially from the private sector, remains key to exponentially expand the available and necessary pool of resources. While articulating a roadmap for reconstruction is important, Ukraine must first focus on key actions that (i) resolve constraints for private sector and donors; (ii) strengthen the rule of law, incentivize and catalyze external support, and bolster implementation efficacy; and (iii) maintain macro-stability while continuing to prioritize the well-being of people. Ultimately, the pace and trajectory toward EU accession and modernization will be determined by actions rooted in strong foundations.

<sup>10</sup> This could play out in various ways such as focusing on the expansion of transport and energy networks and services to some cities while in others downsizing and leveraging more compact planning; ceasing all recovery and reconstruction work and planning in certain areas due to the presence of explosive hazards; building communal and social infrastructure for an ageing populous and reducing assets catering to children due to significant current and anticipated changes in age profile.

<sup>9</sup> [https://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/---publ/documents/briefingnote/wcms\\_859255.pdf](https://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/---publ/documents/briefingnote/wcms_859255.pdf).