

# Ukraine: The Path to a Post-War Prosperity

According to the basic economic theory, there are four sources of GDP growth: three of them (land, labor and capital) are exogenous and one (total factor productivity) is endogenous. The latter can be explained by the four additional factors – innovation, entrepreneurship, education and infrastructure. All eight factors are valuable; however, innovation and entrepreneurship will serve as the driving force behind Ukraine’s recovery and thriving economy.

## Economic Growth Model



**Land** is such an outdated economic input in the Information Age, that modern economists shy away from mentioning it. But so is Russia’s continuous land grab in Ukraine. Thus, not only should we consider land as a factor, under current conditions we are forced to start with it. Ukraine has lost 20% of its GDP because of annexation of Crimea and occupation of parts of Donbas by Russia<sup>1</sup>. How much Ukraine loses (or gains, in the case of the successful war) is decided now on the battlefield. Defense security and international security guarantees are thus paramount for any future growth. The standard Central European defense solution of joining NATO is not an option now, whilst the current defense ideas brought by Ukraine are seen as amateurish<sup>2</sup>. This results in high demand for new creative ideas regarding defense security and its support.

Ukraine’s **Labor** situation was grim even before the war. A global investor and bestselling author, Ruchir Sharma, writes that “increases in population have accounted for roughly half of economic growth. A 1% decline in the working-age population growth rate will shave about 1% point off economic growth”.<sup>3</sup> Because of the lowest birth rate in 10 years<sup>4</sup> and emigration, Ukraine’s population went from 52mIn in 1993 to 44mIn officially (and 37mIn unofficially, the figure endorsed by the former Ukraine Cabinet Minister<sup>5</sup>) in 2019. More than 5 million have left for neighbouring countries, since the beginning of the war. More than 3.5 million have applied for temporary residence in another country, while 7 million people are still thought to be displaced inside Ukraine itself.<sup>6</sup> However, hundreds of thousands of refugees have returned to their home country - especially to cities like Kyiv. Whether this will continue depends not only on the war, but also on the economic freedom to start new businesses and hire people in Ukraine, which is problematic at the moment. Meanwhile, NYT projects the number of

refugees to go up to 10mln<sup>7</sup>. Ukraine's Labor Code dates from 1971. The attempts to liberalize labor legislation were not successful. Ukraine also needs creative ideas regarding its immigration policy.

Aforementioned Sharma writes that “growth picks up as investment accelerates. So any emerging country is generally in a strong position to grow rapidly when investment is high—roughly between 25 and 35% of GDP—and rising. On the other hand, economies face weak prospects when investment is low, roughly 20% of GDP or less—and falling”.<sup>8</sup> Gross Fixed **Capital** Formation (as an indicator of Investment) went down from 18% to 12% of GDP in Ukraine during 2018-20, while it is up around 25% in the Czech Republic (and incidentally, 42% in China)<sup>9</sup>. Aging population, depressed entrepreneurship and low gross savings rate (12% of GDP in Ukraine, while 29% in Czech Republic and 44% in China)<sup>10</sup> are the main culprits. Ease of doing business, pension, education and healthcare reforms will increase savings and thus investment.

Productivity of the exogenous factors - land, labor and capital - (called **Total Factor Productivity**) is another important driver of growth. As T. Kvasha from the Institute for Economics and Forecasting of the National Academy of Sciences of Ukraine notes, “The TFP dynamics in Ukraine is characterised by high growth rates by 2012, a sharp fall in 2013-2015, and a return to the growth path in 2016-2017, but, as in the whole world, by very moderate pace.”<sup>11,12</sup> There is a consensus that **education and infrastructure** are the primary ways to raise productivity. Nobel Prize winner in Economics Amartya Sen notes that “there is by now a fairly agreed general list of ‘helpful policies’”, which include openness to competition, the use of international markets, a high level of literacy and school education, successful land reforms, public provision of incentives for investment, exporting and industrialisation.<sup>13</sup> The Ukrainian education system has suffered a triple blow of underinvestment, pandemic and now - war. The current war damage to the infrastructure was estimated at \$95bn by Kyiv School of Economics as of June 13th.<sup>14</sup>

Institutional infrastructure needs further development as well, which will be facilitated by the accession to the EU. “Ukraine's struggles with reforms over the past 30 years relate significantly to not having a clear EU accession anchor. Herein if you look at countries like Poland, Hungary, the Baltics states et al, they only really reformed apace when the EU set a clear blue print for accession and reform. Hopefully EU candidate member status will provide the required blueprint for reform which will now accelerate.” - writes Timothy Ash<sup>15</sup>. “Times are calling for extraordinary measures and recognition of Ukraine's sacrifice and its importance to European security,” says Dr Marcin Zaborowski at GLOBSEC<sup>16</sup>. I would add that times are calling for the extraordinary measures on both sides, foremost in Ukraine. On top of these measures would be fully adopting the EU competition and anti-corruption legislation, institutions and procedures, which will deliver the final blow to the notorious Ukrainian oligarch system.

While exogenous factors (occupied land, fleeing or dying labor and insufficient capital) paint a pessimistic picture in Ukraine, there is still light at the end of the tunnel. Harvard University and London School of Economics Professor Philippe Aghion states that “existing paradigms have proved inadequate to explain major trends and to solve the enigmas of growth and the wealth of nations.”<sup>17</sup> Thus, other paradigms are needed. Another Nobel Prize winner in Economics Edmund Phelps adds in this regard that “the most striking, perhaps, was Schumpeter's 1911 book<sup>18</sup> going beyond the classical view of a nation's development as simply its capital formation—investment and saving—to its **innovation and entrepreneurship**.”<sup>19</sup> Incidentally, a great economist Joseph Schumpeter, who was born in a modern day Czech Republic, wrote this book in Chernivtsi, modern day Ukraine. Econometric research supported his finding: Stanford economist Abramovitz found that “capital and labor accounted for roughly 15% of the growth. Productivity or what is now called technology, innovation, or technical innovation, accounted for the remaining 85%”<sup>20</sup>.

It is this innovation and entrepreneurship that drives the Ukrainian IT sector, including its public extensions: the Prozorro Procurement System and the Diia app from the Ministry of Digitization.<sup>21</sup>

In many ways, innovation and entrepreneurship is how the outmanned, outgunned Ukrainian military has fought the Russians to a standstill: “The Ukrainian military has proved not only motivated and well led but also tactically skilled, integrating light infantry with anti-tank weapons, drones, and artillery fire

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to repeatedly defeat much larger Russian military formations. The Ukrainians are not merely defending their strong points in urban areas but maneuvering from and between them, following the Clausewitzian dictum that the best defense is a shield of well-directed blows”, concludes Eliot Cohen, a professor at Johns Hopkins University<sup>22</sup>. “A senior US defense official said that Ukraine had been ‘very creative’ in how it used its defenses, and the country’s forces were staging a much fiercer resistance than Russian intelligence expected. “They [Ukrainians] are putting resources where they’re most needed [and] they’re doing it quickly. They are being adaptive and nimble... in almost a sort of a hit-and-run kind of style,” reports the FT<sup>23</sup>

Timothy Ash makes an important bridge between the Ukrainian war strategy and the path to its post-war prosperity: “The way that Ukraine has conducted the war, with bravery, intellect, innovation, and real skill/honor/grace, suggests that this nation can be truly successful - drawing the comparison to the State of Israel how, when faced with huge external threats and challenges, it has risen to the challenge as a nation and innovated to survive, because it had to.”<sup>24</sup>

The war is shifting the **societal values**. In his argument about what makes nations prosper, Phelps argues that the wellspring of the mass flourishing were modern values such as “trust, the willingness to take initiative, the desire to achieve on the job, create, explore, and meet challenges, teaching children to be independent, acceptance of competition, and economic freedom, all of which contribute positively to innovation.”<sup>25</sup> These values fueled the grassroots dynamism that was necessary for widespread, indigenous innovation. Most innovation wasn’t driven by a few isolated visionaries like Henry Ford or Steve Jobs. Rather, it was driven by millions of people empowered to think of, develop, and market innumerable new products and processes, and improvements to existing ones.<sup>26</sup>

The right level to promote entrepreneurship with its small and medium business is the local one. That is where entrepreneurs really communicate and support each other, where they find the most loyal customers and suppliers. In a large, yet decentralized country like Ukraine, local good governance and local economic development become extremely important catalysts of national prosperity. It is heart-warming to see the West-Ukrainian city mayors outcompeting each other, attracting and embracing business that relocates from the eastern part of the country, endangered by war. I really hope that the local tax offices and other local government agencies join mayors in their business friendliness.

However on the national level, **economic freedom**, as the driver of innovation and economic growth, continues to be problematic. The Heritage Foundation ranks Ukraine’s economy as the second least free in Europe. It is currently #130 in the world and during the last year in went not up, but down by 3 spots. Czech Republic in #21, Slovak Republic is #36, Poland is #39, Hungary is #48.<sup>27</sup> So after ensuring national freedom on the battlefield, Ukrainians finally need to ensure economic freedom. Visegrad countries experience may be very helpful in this regard.

The innovative and formidable Ukrainian defense, active civil society, and global voluntary force that was not expected by many, both in the West and North-East, **pull in** much needed resources into the country: from armory to sympathy. This is the primary model for the future post-war development and prosperity. Late Harvard Business School professor Clayton Christensen summarized it well: “Every year we spend billions of dollars in an attempt to help low- and middle-income countries develop. These funds are primarily used to push resources into poor countries in order to help them begin their march toward prosperity. But even after pushing trillions of dollars’ worth of resources, too many countries are still poor, with some even poorer today. Why is development so hard to attain and then sustain? We believe that many of these attempts are missing a critical component for development: innovation. Development and prosperity take root when we develop innovations that **pull in** necessary resources a society requires. This, we believe, is essential for long-term and sustainable prosperity.”<sup>28</sup>

This is exactly where I see GLOBSEC’s **differentiation** from other think tanks - focusing not only on government-driven variables like international aid, sanctions, and security, but also on private sector-driven variables like entrepreneurship, innovation, which pull in the essential resources. GLOBSEC can and should offer effective Central European-tested policy advice.

## Endnotes

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