IPS

ECONOMY AND ECOLOGY 21.06.2023 | Luke Cooper

Insourcing the Ukrainian war-effort

Ukraine's dependence on its partners remains a key vulnerability. The country must become the main coordinator of its wartime economy

Russia’s destruction of the Kakhovka dam is a war crime that has unleashed a catastrophe on Ukrainian civilians. The immediate international response has been to consolidate support for Ukraine. But going forward, the country’s dependence on its partners remains a key vulnerability – especially in the context of economic turbulences at home.

The current round of US funding will run out this summer and may not receive a like-for-like extension. Aid from Ukraine’s other allies has also been modest compared to other wars – and not only those of distant historical memory. Ukraine has even been forced to undertake another IMF programme with its high interest, non-discretionary loan terms.

All this creates significant challenges for Ukraine, which is trying to begin reconstruction and fund its war-effort simultaneously. A critical question now is how Ukraine retains sovereignty over its goals in the war.

A double crisis of and demand

All-out-wars tend to have the effect of ‘seizing-up’ the normal functioning of markets due to the fundamental lack of security for private economic activity. The Ukraine Recovery Conference in London, with its focus on private sector-led reconstruction, is at risk of being a missed opportunity unless this is recognised. State intervention needs to substitute for the collapse in private sector demand. With physical and human resources directed on a very large scale to the military and productive output falling due to physical destruction or the risk of it, wars also tend to generate shortages that are favourable to inflation and war-profiteering. These features mean wars generate, simultaneously, supply and demand crises.

In Ukraine, the supply crisis has hit the labour market with the loss of millions of refugees and the military draft. The effect of the mobilisation campaign has been especially felt in sectors that are key to the reconstruction; Trade unionists estimate that at least a quarter of all construction workers are serving in the armed forces.

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This double crisis of supply and demand means that while Ukraine is basically winning the war, it remains acutely vulnerable at the 'home front' – i.e., its domestic productive economy, where the recession and social crisis risk unbearable hardship for the population, driving dislocation and destabilising the war-effort. Ukraine's unemployment rate for 2022 was 21.1 per cent, with no significant relief expected for 2023. There is an on-going cost of living crisis with real wages falling by 11.4 per cent in 2022. While now gradually receding, inflation in 2022 was 30.6 per cent and GDP fell by 29.1 per cent. Making up this lost ground could take a generation.

Ukraine can rebuild itself

So far, Ukraine has not introduced similar state planning mechanisms as were adopted by the Allies in World War 2. Instead, the government has been experimenting with a mix of measures, combining labour market and business deregulation, and privatisation with modest centralisation policies (selected oligarch and Russian asset seizures). There has been little appetite for tax increases – wealth remains largely untaxed, while income is taxed at flat rates that are low by international standards. Informality and corruption, the grey economy and systemic evasion plague the collection of business and workplace taxes. In the 2023 budget, taxation is expected to account for well under half of expenditure, making Ukraine heavily dependent on international donors to fund its war effort.

As markets have collapsed in the course of the war, the state has predictably become the central coordinator of economic activity – even though this has not been the policy of the government. But the state still lacks the fiscal and administrative capacity to grow and direct the war-economy. But it is also important to emphasise that there is not an 'all or nothing' choice between state planning or total non-intervention. Any steps towards greater state coordination should be welcomed.

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Overall, this means that the Ukrainian state – and, consequently, its war-effort – is heavily exposed to any decrease of international donor support. Such a reduction would very likely trigger a serious balance of payments crisis. Offsetting the risks of external dependency requires maximising the output of Ukraine's productive economy. Ukraine continues to operate in a fairly open international trading environment and foreign competitors may gain an unfair advantage in the domestic market simply by operating in peace conditions 'at home'. With the promise of significant funds for reconstruction, foreign companies are looking to maximise their share of public procurement and logistics contracts in Ukraine. But embracing such 'assistance' could have a counterproductive impact. As Ukrainian production struggles, external debt obligations would be racked up only for the money to flow back overseas through increased imports, supporting employment abroad rather than in the home market, where it is so desperately needed.

To offset this danger, the Government of Ukraine should adopt a policy of prioritising its domestic manufacturers and construction firms for infrastructure and procurement contracts. Ukraine's domestic market can rise to the challenge of reconstruction – and is in desperate need of more business due to the crisis in the economy. An enterprise survey published by US AID Economic Resilience Activity and Ukraine Industry Expertise identifies a severe problem of underutilisation with Ukrainian industry operating at '25 to 35 per cent of their production capacity'. Indeed, the geographic spread of the construction material sector across Ukraine means that war-related damage has been limited and it could provide up to 90 per cent of the resources needed for reconstruction. Senior Ukrainian officials have begun to signal strong support for a policy shift that would give explicit priority to Ukrainian firms. While very welcome, the state still lacks the fiscal capacity to play an effective coordination role in the economy due to its weak levels of tax mobilisation.

A chance to break the vicious cycle of low taxes

The mistaken belief that the path to increased tax revenue runs through further tax cuts is still the stated viewpoint of the Ukrainian Ministry of Economy. With such ideas in steep decline globally, this position goes against IMF guidance that recommends middle income countries move from flat tax to progressive systems to raise funds for public investment. Indeed, Ukraine's own IMF deal commits the government to avoid 'new measures that might erode tax revenues'. Research of the LSE International Growth Centre has shown that in low and middle income countries both high and low tax rates can go alongside poor revenue mobilisation. Enforcement and building quasi-voluntary compliance among citizens are the critical factors when it comes to increasing the tax base. The latter links tax collection to providing public goods. For Ukraine, the 'public good' is, naturally, straightforward: securing victory in the war, protecting the well-being of Ukrainians, and upholding the country's democratic institutions.

The tremendous support for the war-effort provides a chance to break the vicious cycle of low taxes, low faith in public authority and weak state capacity. There are signs of this happening with taxation revenues falling by half the rate of GDP in 2022 – a fact that has been interpreted as 'patriotic Ukrainians... rushing to pay their taxes'.

Ukrainians would, however, be wise to prepare for the worst-case scenarios.

In the most hopeful scenario, Ukraine's economic vulnerability on the 'home front' may not prove to be damaging to its impressive resistance. Ukraine has extraordinary civil society institutions and networks that continue to underpin its war-effort – a profound democratic culture that contrasts sharply to the fragility of Russian authoritarianism. Indeed, the war crime at Kakhovka may have been an act of desperation – and there are reports of turmoil on the Russian front as it struggles to maintain its defensive line against the Ukrainian counteroffensive. There may also be no significant reduction in long-term Western military and economic support for Ukraine.

Ukrainians would, however, be wise to prepare for the worst-case scenarios. Above all, the war could become protracted, further challenging Ukraine's capacity to fund its military and reconstruction while testing allied support. So, Ukraine should take steps now to dramatically improve the state's institutional capacity by raising taxation revenue and directing labour and capital to the demands of the liberation war.

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