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Insourcing the war-economy: building a resilient Ukraine means maximising its domestic output

Policy Brief

Conflict and Civiness Research Group

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PeaceRep's Ukraine programme

PeaceRep's Ukraine programme is a multi-partner initiative that provides evidence, insight, academic research and policy analysis from Ukraine and the wider region to support Ukrainian sovereignty, territorial integrity and democracy in the face of the Russian invasion. PeaceRep's Ukraine programme is led by the London School of Economics and Political Science (LSE) partnering with the Kyiv School of Economics (KSE) in Ukraine, the Leibniz Institute for East and Southeast European Studies (IOS) in Germany, the Institute of Human Sciences (IWM) in Austria and Jagiellonian University in Poland. Through our collaboration with KSE we work closely with researchers, educationalists and civic activists in Ukraine to ensure that policy solutions are grounded in robust evidence and are calibrated to support democratic outcomes.

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About the Author

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Introduction

PeaceRep's Ukraine programme are extensively involved in providing analysis, evidence and data to prepare discussions at the London Ukraine Recovery Conference, 21st – 22nd June 2023. As part of this work, I recently undertook a study trip to Kyiv. With support and assistance from the [Kyiv Office of the Friedrich Ebert Stiftung](#), the [Kyiv School of Economics](#), [US Aid Economic Resilience Activity](#) and [Ukraine Industry Expertise](#), I met government officials, civil society activists, trade unions, and academics, and made a number of visits to industrial sites in the Kyiv Oblast region to see their challenges up close.

In this policy brief, I argue that the Government of Ukraine should pursue policies that prioritise Ukraine's economic resilience and mitigate against the risk of balance of payments crisis in the event that there is a significant reduction in donor support. The starting point for this analysis is that markets cannot function in wartime. The Ukrainian state therefore needs to embrace its inevitably central role as the coordinator of an integrated war-economy.

The state is critical to Ukraine's economic security

All-out-wars tend to 'seize-up' the normal functioning of markets due to the fundamental lack of security for private sector economic activity. This poses a need for state intervention to substitute for the collapse in private demand. If the state is successful in recalibrating the domestic economy, then wars can facilitate economic growth through war-induced demand.

The expansion of the state has to also grapple with the fundamentally inflationary dangers associated with a war-economy. As physical and human resources are directed on a very large scale to the military, and private sector productive outputs fall or stagnates, either due to physical destruction or the risk of it, wars also tend to generate shortages that are favourable to inflation and war-profiteering. As a result, wars can lead to supply and demand crises at the same time, and these will tend to intensify if the state adopts a non-interventionist policy.

In Ukraine, the destructive economic impact of the full-scale Russian invasion has been enormous. The National Bank of Ukraine estimate that the unemployment rate for 2022 was some 21.1% - up from 9.8% in 2021. They predict that it will remain very high this year at around 18.3%. Real wages fell by 11.4% in 2022. In 2022, the inflation rate was 30.6% and real GDP fell by some 29.1%.¹ The National Bank of Ukraine predicts only a modest return to growth this year. The outlines of Ukraine's 'scissors crisis' can be summarised as follows:

- **Demand crisis.** Falling real incomes and very high levels of unemployment are the markers of a recessionary environment. Given the on-going war – and the security challenge it poses to investment – along with this related demand crisis, the climate for private sector investment will remain volatile for some time. Even if there is a rapid end to the war in Ukraine's favour, the on-going threat from Russia will make for an inopportune environment for business investment, risking a spiral into a long-term depression. This has placed the burden on the state to drive forward economic activity and reconstruction.
- **Supply crisis.** Despite unemployment being very high, businesses in some sectors are experiencing challenges with the supply of labour due to the outflow of refugees, international displacement and the draft. Damage to physical infrastructure and the forced geographical relocation of firms has also had a knock-on effect on the labour supply. Military mobilisation has had a disproportionate impact on the skilled, blue collar, manual workforce, with those working in such jobs tending to be more likely to enlist. For example, a representative of the Construction and Building Materials Workers Union estimates that around 1 in 4 of the 200,000 formally employed workers in the construction sector are currently enlisted with the Ukrainian armed forces.

¹ All figures from National Bank of Ukraine, April 2023 Inflation Report.

These intertwined crises posit the need for direct interventions by the state into supply and demand to drive economic growth. As markets fail and seize-up, the Government of Ukraine should embrace this position as the coordinator of the war-economy. To some degree this is happening by necessity – but not on the level which is required. In one case study of the role of this ‘state substitution’ dynamic at play, which I saw in Kyiv Oblast, an elevator manufacturer told me that 80% of its business is currently with the Ukrainian government. Given this role that the state is already starting play in reconstruction, and the limits that the war places on ‘normal’ market competition, the Agency for Restoration and Infrastructure Development should consider introducing planning mechanisms similar to those adopted by the Allies during World War 2, at least in relation to strategically critical sectors of the economy, where market failure is unacceptable and brings with it increased security risks.²

Importantly, it is not an ‘all or nothing’ choice between non-intervention and planning, and any step towards greater state coordination should be welcomed. However, current growth projections are low. If growth remains stuck at these levels, it may take a generation for the economy to recover lost ground. Innovative strategies must now rise to the scale of the challenge – and a more far-reaching level of state intervention is highly likely to be required.

Ukraine’s dependency on external financial assistance poses a risk to its ability to retain sovereignty over war aims

The challenging economic landscape means that the Ukrainian state – and, consequently, its war-effort – is heavily exposed to any decrease in international donor support. Such a reduction would very likely trigger a serious balance of payments crisis. The Bank of Ukraine hint at this in their April 2023 update, noting that the recovery this year will likely see an increase in imports, carrying balance of payments risks that will be offset by external support:

‘The current account deficit is expected to be large in 2023. Among other things, this will be driven by an increase in imports on the back of a gradual recovery in domestic demand, a large number of migrants from Ukraine spending money abroad, and exports remaining subdued due to lower harvests and limited logistics routes. At the same time, inflows of international assistance will offset these factors.’³

This dependency on external financial flows raises risks for the Ukrainian war-effort over the longer term. Ukraine is vulnerable to any changes in global political alignments that may adversely impact internal flows, e.g., the outcome of the next US presidential election, and therefore has a clear interest in policies that maximise its economic resilience and taxation revenue. This means that the state needs to build the fiscal and administrative capacity to act as the key coordinator of the Ukrainian war-economy. Two key priorities going forward may therefore be ventured; the first, requires maximising the output of Ukraine’s productive economy through measures that recognise the crucial coordinating role of the state; the second, requires sharply increasing taxation revenue to secure the state’s long-term position.

‘Buy Ukrainian’: With the state now central to domestic economic activity, it should prioritise Ukrainian industry

In the run-in to the Ukraine Recovery Conference 2023 and the discussions over private sector engagement in Ukraine’s recovery, it is important to be realistic about the international firms that have a *business case* for orientating to the Ukrainian market. Given that Ukraine was not a major recipient country for foreign direct investment (FDI) prior to the full-scale invasion,

² For a longer form version of this argument, see my December 2022 report: Luke Cooper, [Market economics in an all-out war? Assessing economic risks to the Ukrainian war effort](#), 1st December 2022.

³ Ibid

and that the security environment (despite Ukrainian progress on the battlefield) remains

unfavourable to FDI, those firms orientating to reconstruction will tend to be selling goods and services into the Ukrainian market. Their competition with Ukrainian firms for contracts does not take place on a level playing field – far from it. In fact, foreign firms will have an unfair advantage in the Ukrainian market simply by virtue of operating in peace conditions ‘at home’.

The Government of Ukraine will need to be clear-sighted on these questions and resolutely prioritise their domestic productive economy in the reconstruction process. It is vital that Ukraine avoids a situation that, as domestic production struggles, external debt obligations are racked up only for the money to then be deposited overseas through increased imports, effectively supporting jobs overseas rather than at home where they are desperately needed.

To offset this danger, the **Government of Ukraine should adopt a ‘Buy Ukrainian’ policy of prioritising its domestic manufacturers and construction firms for infrastructure and procurement contracts.** US Aid Economic Resilience Activity and Ukraine Industry Expertise Data shows that 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.⁴ While there is a concern from some global stakeholders that a preferential policy may set backwards de-oligarchisation efforts in Ukraine, this is (a) a question of how the policy is institutionally designed, including in relation to SMEs; and (b) there is no evidence that unfair import competition into the domestic market during an all-out-war would assist de-oligarchisation (indeed, by negatively impacting SMEs it may consolidate oligarchic interests).

A ‘Buy Ukrainian’ policy brings positives for both Ukraine’s global allies and the Government of Ukraine. Partners have an interest in Ukraine maximising its domestic output and creating a resilient economy that overtime reduces its external dependency, while the Government of Ukraine needs to maximise domestic resources to protect its sovereignty over its war aims.

A framework of active support to the domestic economy is not counterposed to deepening Ukraine’s integration into the European single market but represents a type of moderate economic closure and phased integration into global markets that has been historically associated with ‘developmental state’ transitions. Indeed, Ukraine also needs to capitalise on its association agreement with the EU by supporting firms and agencies in the task of aligning with European regulatory standards with a view to improving its external export performance, especially in value added processing. As Western machinery will often be a key part of this process, there will also still be opportunities for exporters in the Ukrainian market.

The relationship between social policy and tax revenue

Weak tax revenue mobilisation represents a key vulnerability to Ukraine’s economic-cum-political security. The budget deficit excluding grants came to 26.5% of GDP in 2022.⁵ Offsetting the risks associated with this requires radically increasing taxation revenue. However, the domestic public policy debate tends towards opposition to tax increases, despite the war. The use of wealth taxes or linking tax rates progressively to income are often held to be taboo in public discussion. This reflects the long-term problem of corruption in the Ukrainian state (and, just as importantly, the *perception of it* among citizens). In addition, the grey economy, informal negotiations between tax collectors and firms, and systemic evasion are common problems when it comes to the collection of business, VAT and workplace taxes.⁶ ‘Fake’ forms of self-employment, for instance among professionals in sectors like education

⁴ Data from US Aid Economic Resilience Activity and Ukraine Industry Expertise, 2023. White Paper: Activating and Strengthening Ukraine’s Reconstruction Capacity. See also the [short form policy brief](#) from the same authors produced for PeaceRep’s Ukraine programme and the London Ukraine Recovery Conference.

⁵ [World Bank Data Overview](#)

⁶ Maryan Zablotsky and Simeon Djankov, ‘[Towards a new tax system in Ukraine](#)’. Centre for Economic Policy Research, 6 April 2023.

that would usually be associated with workplace taxation, are also widespread with workers on these contracts paying an ultra-low rate of 5%.

Social and labour policy are closely connected with tax revenue, the state's debt sustainability and, ultimately, Ukraine's sovereignty over its own war-aims. Presently, Ukraine's social and labour policy appears poorly calibrated to maximising tax revenue for public investment and the war-effort. For example, trade unions argue that the suspension of on-site labour and payroll inspections after the full-scale invasion, has seen an increase in cash-in-hand work on construction sites, even in those undertaking government funded work. Social partnership policies, like those adopted by the Allies during World War 2, which actively seek the buy-in of organised labour for the sacrifices associated with the war through meaningful negotiation over pay, conditions and jobs, have not been pursued. Instead of this a number of employment regulations have been suspended and employer-employee relations are asymmetric, especially in the context of very high levels of unemployment. A new relationship with the trade unions could play an important role in tax revenue mobilisation if workers 'on the ground' are supported by agencies to tackle the problem of the grey economy.

Tax rates are flat, i.e., not weighted to income thresholds, and remain low by international standards. Although the Government of Ukraine's IMF agreement commits the country to not introduce 'new measures that might erode tax revenues',⁷ the public policy discussion around tax mobilisation still tends to see tax reductions as the road to increased revenue. The academic⁸ case for decreasing tax rests on the claim that sharply reducing taxation will incentivise compliance and eliminate the informal economy. But the argument is based on implausibly large estimates for the size of the informal economy. A 2020 study by Ernst and Young undertaken for the National Bank of Ukraine puts the size of the grey economy in Ukraine at 23.8%.⁹ So, even in the hypothetical scenario that this is brought into the formal economy in its entirety, the huge tax cuts proposed under the 10/10/10 policy (10% income, 10% VAT, 10% corporation tax) could not reasonably be expected to lead to increased tax revenue. Aside from the moral objections to huge tax cuts in an all-out-war and cost of living crisis, the proposal also goes against the emerging global consensus in best practice research. IMF research recommends that middle income countries move from flat tax to progressive systems to raise more funds for public investment.¹⁰ Drawing on evidence from the LSE International Growth Centre, Adnan Kahn (currently on secondment to the UK FCDO as Chief Economist) has argued that rates of taxation have a weak relationship to levels of revenue in low and middle-income countries, i.e., states with both high or low rates can still have revenue raising problems when collection processes are poorly designed and vulnerable to corruption.

Rather than tax cuts, the key elements of successful tax reform are effective enforcement and building quasi-voluntary compliance among citizens.¹¹ The latter links tax collection to providing public goods. For Ukraine, the 'public good' is, naturally, straightforward: securing victory in the war, protecting its democratic institutions and the wellbeing of citizens. 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. With taxation revenues falling by less than half the rate of GDP in 2022, there may be signs of this happening as 'patriotic Ukrainians... rush... to pay their taxes'.¹² By contrast, pursuing cuts in an all-out-war, will expose businesses to greater risks, rather than assisting them, and may lead to a backlash among international donors, whose support is currently critical for Ukraine's basic survival.

⁷ [Ukraine-IMF Agreement 2023](#)

⁸ E.g., 'Towards a new tax system in Ukraine'.

⁹ [Shadow Economy in Ukraine](#)

¹⁰ Dora Benedek, Juan Carlos Benítez, and Charles Vellutini, '[Personal Income Tax Has Untapped Potential in Poorer Countries](#)', 24 March 2022.

¹¹ Adnan Kahn, LSE International Growth Centre, 2023. '[Why do tax research and evidence matter for economic growth?](#)', YouTube video.

¹² The Economist, '[Patriotic Ukrainians are rushing to pay their taxes](#)', 27th April 2023.

Summary recommendations

In conclusion, the following recommendations may assist Ukraine's security risk mitigation:

- Recognising market failure in all-out-wars, consider introducing planning mechanisms under the auspices of the Agency for Restoration and Infrastructure Development.
- Restore labour and payroll inspections, and pursue dialogue and partnership policies which give business and labour a common stake in national economic strategy.
- Introduce progressivity in taxation, scope the potential for the introduction of wealth taxes to place the burden of fighting the war on those most able to pay.
- Adopt a 'Buy Ukrainian' policy in state procurement and infrastructure projects to avoid a scenario where debt obligations increase to fund a widening trade deficit.

About PeaceRep

PeaceRep is a research consortium based at The University of Edinburgh. Our research is re-thinking peace and transition processes in the light of changing conflict dynamics, changing demands of inclusion, and changes in patterns of global intervention in conflict and peace/mediation/transition management processes.

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