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BULLETIN

Ukraine Facility: EU Takes Up New Carrot-and-Stick Instrument

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The European Commission (EC) has proposed a new financial instrument for Ukraine for 2024-2027 that will partially cover its current economic needs and reconstruction. The EC will introduce conditions for the implementation of reforms related to its accession to the EU as well as enhanced spending controls. This has the advantage of predictability in the disbursement of fund tranches, but one of the challenges will be encouraging business to commit to investment.

The EU is the largest donor of economic aid to Ukraine. Between February 2022 and May this year, it provided around €38 billion (including €7.8 billion in support from Member States) mainly in the form of low-interest loans and grants from the Neighbourhood, Development and International Cooperation Instrument. To support Ukraine's reconstruction, in the scope of the mid-term review of the EU budget, the EC proposed on 20 June to introduce a new Ukraine Facility (UF) for the period 2024-2027. The regulation will be adopted together with two related pieces of legislation on the revision of the Multiannual Financial Framework and the creation of a Strategic Technology Platform for Europe. It is currently being negotiated under the ordinary legislative procedure.

Instrument Assumptions. The aim of the UF, with a budget of €50 billion over four years, is to meet Ukraine's short- and medium-term reconstruction needs, stabilise its macroeconomic situation, and support reforms related to the EU accession process. Each year, the EU would provide €12.5 billion in quarterly tranches to Ukraine, including €8.25 billion in loans and €4.25 billion in non-repayable funds, or so-called grants. The UF would integrate existing bilateral aid, loans, and pre-accession support, thus increasing the possibilities for redeployment of funds and flexibility in spending.

The UF will consist of three pillars. The first, with a budget of €39 billion (€33 billion in loans, €6 billion in grants), is expected to cover the cost of implementing reforms and Ukraine's ongoing financing needs (e.g., social spending, repair of critical infrastructure) between 2024 and 2027. The EC declares it will finance around 50% of the ongoing needs, the total amount of which has been estimated by the International Monetary Fund (IMF) at €75.1 billion over this period. These funds will be transferred directly to Ukraine's budget. The second pillar will include assistance for the development of public and private investment in Ukraine (€8 billion in grants). These will mainly be guarantees from the EU budget to cover the risks of financing and investment operations, for instance loans, including in local currency. For example, covering a loan with an EU guarantee means that if the borrower defaults, the EU covers the missing funds up to a certain ceiling. The provisioning rate of the guarantee will be 70%, and the EC will be able to modify this rate as the situation in Ukraine develops. The EC estimates that the proposed solution will generate investments of around €20 billion. The third pillar (€3 billion in grants) will include financial assistance to build the capacity of the Ukrainian administration to implement reforms and to strengthen local governments and NGOs, among others. Funds will be provided on the basis of, among others, competitions for grant recipients and intermediary institutions for their disbursement.

Strengthened Conditionality and Control. The Ukrainian authorities, in cooperation with the EC, are to develop a reconstruction and reforms plan, which is to include qualitative and quantitative indicators for the implementation of planned measures. The Council will approve the plan by means of an implementing decision. Based on that, the EC will condition the transfer of funds from the first pillar of the UF on, among others, Ukraine ensuring macro-financial stability, effective fiscal surveillance and public financial management, and the implementation of sectoral and structural reforms. The Commission will be regularly assessing the implementation of the plan. If the conditions are not met, the EC may deduct from payments an amount proportionally corresponding to these requirements. Up to one year after the original deadline, it can withhold these funds or disburse them if the conditions are met. In addition, in the event of a lowering of democratic standards in Ukraine, the EU could suspend all financial assistance from the first pillar of the UF. Conversely, if hostilities escalate and the Ukrainian authorities' ability to implement reforms is limited, the EU could waive conditionality of the assistance and funds would be transferred to cover Ukraine's immediate needs.

The EC has proposed mechanisms for enhanced control over the disbursement of funds to counter fraud and corruption. Ukraine will have to ensure that the EC, the European Anti-Fraud Office (OLAF), the European Court of Auditors and, where appropriate, the European Public Prosecutor's Office have adequate access to data on the use of funds. For example, twice a year, Ukraine will be obliged to publish data on individuals and entities receiving amounts of funding in excess of €500,000 in aid received from the first pillar. The EC and OLAF will be able to carry out on-the-spot disbursement checks, and the EC can be an observer in the project selection and procurement procedure. The EC will enclose conditions in the UF agreement, including for Ukraine to reform its audit system and it will appoint a board of independent auditors to monitor possible irregularities in the management of funds.

Assessment of the EC Proposal. The advantage of the UF is the predictability of the disbursement of aid tranches on a quarterly basis and the flexibility to change its financing structure. Together with IMF loans and U.S. support, the new instrument will serve mainly to cover Ukraine's current economic needs, for instance related to healthcare or energy sectors. The funds will be insufficient, though, to co-finance the costs of implementing structural reforms in Ukraine. The EC has also proposed a small amount of funding for the development of Ukraine's administration, local governments, and NGOs. It will be important for other aid donors to fill this gap. In such a situation, the EC will have to properly calibrate the conditions with the Ukrainian authorities' capacity to undertake economic reforms.

Making aid conditional on the state of the rule of law will be beneficial for Ukraine's transition. The Union's setting of specific requirements in this area to open accession negotiations is already yielding results. Despite the war, the Ukrainian authorities are fulfilling most of them. However, the effectiveness of the UF in this area will depend on the extent to which the conditions in the EU-Ukraine UF agreement are adequate and detailed. It will be crucial to involve, among others, representatives of the Ukrainian non-governmental sector in the process of drafting them and to make them public in order to allow public pressure on the implementation of reforms by the authorities. A limitation could be the potential that some Member States may block the approval of the Ukraine plan for reconstruction and reforms in order to negotiate other European policy issues. The proposed expenditure control mechanisms will strengthen the transparency of funding, but the EU should also build up control mechanisms on the ground. It could, for example, increase funding for NGOs and investigative journalists to monitor corruption.

The challenge will be to increase private sector participation in the use of EU funds for investment. The entry of foreign investors into the Ukrainian market will depend on the improvement of the security situation in Ukraine. Moreover, the European Investment Bank, responsible for financing hard infrastructure projects in third countries, as a public institution, so far has mainly worked with the public sector and banks and corporations with state guarantees. The EC did not present any new mechanisms for the development of private sector investments.

Perspectives. The Council and the European Parliament (EP) want to adopt the regulation by the end of this year in order to launch the UF in January 2024. In order to speed up the procedures, the EC together with the Ukrainian authorities are already developing a plan for reconstruction and reforms. However, the negotiations may be prolonged due to other issues involved in the EU budget revision, such as the establishment of additional funds in the field of migration or a new thematic instrument for EU reconstruction. Clarification of the provisions on EU conditionality and expenditure control may also be a flashpoint. The EP is demanding the strengthening of these mechanisms and its role in the implementation of EU aid in Ukraine. For Poland, it will be important to actively engage in consultations of the reconstruction and reforms plan, and at a later stage to partially coordinate its bilateral assistance to Ukraine with the priorities of the plan. Poland can, for example, support Ukraine to a greater extent by advising the government administration and local governments on reconstruction planning.