Why Russia must pay for the damage it has done to Ukraine – and how to ensure it does

by Timothy Ash and Ian Bond, 19 June 2023

Western taxpayers and Ukraine itself will cover some of the costs of post-war reconstruction, but it is unrealistic to expect the private sector to fund everything else. Russia broke it; Russia must pay for it.

Western governments have already poured billions of dollars, euros and pounds into military, humanitarian and financial assistance for Ukraine. They are hoping to pass the baton to the private sector for the next stage, reconstruction, but they are likely to be disappointed. Before they ask their own taxpayers to stump up again, they should put the responsibility where it belongs: on the Russian state.

The Ukraine Recovery Conference (URC23) convenes in London on June 21st. An important element of the conference is the 'Business Compact', described as giving "leading international businesses a platform to show their support for Ukraine's recovery". Companies are invited to sign up with a view to seeking "opportunities, when the time is right, to engage in trade and investment, peer-to-peer expertise sharing, pro bono work and business activities". Just in case the message is not clear, the website stresses "the URC23 will place emphasis on the role of the private sector – and the reforms required to drive investment – as essential components of Ukraine's long-term recovery".

The scale of the challenge donors and investors are being asked to face is enormous. Tens of thousands of Ukrainians have been killed, maimed or kidnapped; millions have been internally displaced. Ukraine will have to entice back, and in some cases rehouse, the 8-10 million Ukrainians who migrated abroad to escape the war. And it will have the long-term responsibility of looking after perhaps as many as 1 million demobilised troops. The veterans will be hailed as war heroes, but praise will not solve the complex physical and psychological needs that many will have, or find jobs for the rest. Nor will it pay their pensions. The experience of Croatia after the wars of Yugoslav succession was that the heavy weight of war pensions took decades to resolve – entitlements were generous and imposed a fiscal drag on the economy for many years.

The economic cost of the war in terms of lost output and productive potential, and destroyed assets, may already run into the hundreds of billions of dollars – perhaps as much as a trillion – and continues to rise with every attack on a new target in Ukraine. Even if one takes the World Bank's conservative estimate of March 2023 that the cost of reconstruction and recovery would be $411 billion, that would still be more than twice Ukraine's pre-war GDP of about $200 billion. The destruction of the Kakhovka dam will add even more to the bill. That has resulted in many towns and villages being flooded, infrastructure, such as water treatment plants, being damaged or destroyed, and agriculture in one of Ukraine's most fertile areas being disrupted for years to come. Assuming that reconstruction might take ten years, that would mean spending over $40 billion per year.

Ukraine would be unable to manage that on its own: it suffered a near 30 per cent loss in real GDP in 2022. Unlike the end of the Cold War, however, when Western governments were able to offer significant help to countries emerging from communism, this time the West's economic position is significantly different. Then, the West had the benefit of the peace dividend that came from the collapse of first the Warsaw Pact and then the Soviet Union itself. This time the West faces headwinds from an aggressive Russia and an increasingly challenging China. In the early 1990s, with the US emerging as the world's single remaining superpower, Europe looked secure (the wars in former Yugoslavia, though awful, never threatened the comfort of most other European countries). Now, by contrast, there are doubts in Europe about the staying power of the Western alliance: the Biden administration has done more than any other Western government to support Ukraine, but its National Security Strategy makes clear that it sees China as a higher priority; and there is obvious concern about what a win for Trump (or another isolationist Republican) in the US presidential elections in 2024 would mean for NATO, given Trump's disdain for the alliance in his first term in office.

In the face of these challenges, the message from Western governments ahead of the London conference seems to be that Ukraine's recovery and reconstruction is a top priority – but the heavy lifting in terms of funding it will have to be done by the private sector. It is true that Western governments have already spent a lot on Ukraine – more than €150 billion euros in the first year of the war, according to the Kiel Institute for the World Economy's Ukraine Support Tracker. In an age of populism, perhaps they doubt that there is popular backing to commit to spending another $40 billion a year on Ukraine over the next decade – even though it would amount to about 0.1 per cent of combined Western GDP of over $40 trillion, or about a 0.05 percentage point increase in the basic tax rate. If Western governments fear that their taxpayers will reject the idea of spending even that much, however, it is unrealistic for them to assume that the private sector will just stump up the full amount for Ukraine's reconstruction, and certainly not in the early years that will be most critical to success.

There are several reasons for this: first, depending on how the war ends, it will be hard to persuade investors that Russia will not be back for another go in a few years. After its annexation of Crimea and intervention in the Donbas in 2014, 'peace' (of a sort) was re-established by the Minsk agreements, brokered by France and Germany in 2014 and 2015. Putin, however, wanted more. Perhaps investors would see Ukraine as a safer place to invest if it were a NATO member, or had "solid security guarantees", as Emmanuel Macron suggested recently.

Second, it will take time for investors to be convinced that Ukraine's investment climate has changed from the pre-war norm, when it was blighted by corruption and poor governance. It will be hard enough to persuade investors to overcome their fear of another Russian invasion, but their worries could to some extent be mitigated by offering insurance backed by national export credit agencies or the EU – if those bodies are willing to accept the potential cost. Investor concerns over the rule of law will be even harder to deal with. In Transparency International's 2022 Corruption Perceptions Index, Ukraine was 116th out of

180 countries – worse than any other country aspiring to EU membership. With that track record, perhaps the private sector might invest a few billion dollars or euros, but to attract significantly more Ukraine will have to show real improvements over a sustained period. Then it might see incremental increases in foreign direct investment (FDI) inflows as confidence grows. Ukraine has a vocal group of anti-corruption civil society organisations on its side, as well as an increasingly well-developed set of state and law-enforcement institutions for fighting corruption. And, thanks to the war, Ukrainian citizens are less tolerant of corruption and the old ways of kleptocracy and oligarchy.

Third, even if there was no risk of fighting, and corruption miraculously vanished, the amount of investment Ukraine needs is far beyond what other EU aspirants with better starting conditions, have been able to attract from the private sector. It would help if at the end of this year the EU could say that Ukraine had met the seven criteria for moving to the next stage in its candidacy, agree to open accession negotiations and give Ukraine a credible accession timeline – ideally, with a realistic target date of accession in, say, a decade, subject to meeting further benchmarks. But the prospect of membership on its own would not be a panacea: in the case of Turkey, even when optimism about the likelihood of accession was at its peak in 2007-2008, its record inflow of FDI was $28 billion – which has sagged to $5-6 billion per year as the prospect of EU membership has receded. Even for EU accession 'stars' in the run-up to accession in 2004, such as Poland and Hungary, FDI gross inflows have totalled only 2-3 per cent of GDP per year over the past 20 years, which would be the equivalent of $3-4 billion a year for Ukraine based on its current, reduced GDP. Before the war, Ukraine was only attracting 0.5-1 per cent of GDP in annual FDI flows, and most of that was Ukrainian money returning from Cyprus and other offshore financial centres.

But if neither Western taxpayers Plan A) nor the private sector (Plan B) are willing to provide enough money in time to meet the strategic imperative of making Ukraine economically strong quickly, then without a Plan C Ukraine's reconstruction is at risk of failing. One version of Plan C would involve turning to major investors outside the West; but China and the Gulf states have thus far had a limited and chequered track record of investments into Ukraine, and their friendship with Russia would likely make Ukraine nervous of becoming too reliant on financing from these sources.

Another version would throw more responsibility onto the international financial institutions – the World Bank and the European Bank for Reconstruction and Development, with more shareholders than just the countries of the West. The West would still end up paying the lion's share of the costs, but they would be spread more widely. But precisely because many of their shareholders are non-Western, these institutions may not be so invested in Ukraine's success. Their priorities and interests may not align with those of Kyiv and its partners, for whom Ukraine's reconstruction is a national security issue.

Fortunately, another Plan C is available: the West should make it possible for Ukraine to use frozen Russian assets which are now held in Western jurisdictions – $330 billion in Russian central bank assets and perhaps (who knows?) $70-100 billion more in yachts, villas and the bank accounts of oligarchs and sanctioned Russian companies. The CER has previously written about the ways in which this could be done, and some of the obstacles.

From a moral perspective, Russia should clearly be held accountable for its own actions: why should Ukraine or Western taxpayers pay for the human and physical damage caused by Putin's genocidal war? Russia is not a poor country. Before the war its per capita GDP was more than two and a half times that of Ukraine, it has $600 billion in sovereign assets (including those frozen in the West), a low debt ratio (less than 20 per cent of GDP, so it could easily borrow to fund reparations to Ukraine if it were forced to do so as part of a peace deal – at which point it would probably be allowed back onto international capital markets) and $250 billion in annual energy export earnings.

Some European countries are uncomfortable about the legality of confiscating assets, as opposed to freezing them, however. Germany (with an eye to the history of the Third Reich) is wary of taking the assets of Russian oligarchs or businesses when they have not been found guilty of any crime by a court, though the finance minister, Christian Lindner, has been more open to taking Russian central bank assets. Others are more worried about the precedent set by confiscating central bank assets – traditionally regarded as sovereign assets and immune from seizure. In November 2022 the European Commission presented EU member-states with options for using these assets to help Ukraine, though little progress seems to have been made in deciding what to do. A report suggesting that the idea of confiscating central bank assets has been dropped was premature, however: the Commission still seems to be looking for ways around the problems, and a feasibility study is underway.

It is important that the West lives up to its own standards when it comes to respecting the rule of law, including international law. If outright confiscation is rejected on legal grounds, there might be more creative ways to use Russian state assets to Ukraine's benefit. For example, Ukraine could issue 'Restitution Bonds' to the value of the frozen assets. Western governments could then use frozen Russian central bank assets to buy these, so Russia would still own an asset with an equivalent value, as though it had invested in US Treasuries. It would be politically difficult for Ukraine to accept that Russia would benefit financially from the arrangement, but any interest payments could be held in escrow until reconstruction was completed or, indeed, paid to Ukraine as a contribution to the reconstruction process. And whether Ukraine opted to pay back or restructure the debt could depend on future peace talks and negotiations with Russia over reparations – not that these would be easy to extract from Moscow, even if Russia forces were defeated and driven out of Ukrainian territory. But Ukraine would get the cash now for rebuilding and defending itself. Disbursement could be done incrementally, and managed by a new reconstruction institution for Ukraine. To ensure good governance, the institution could be set up with joint G7/Ukrainian ownership for perhaps ten years, before being transferred fully to Ukraine, while retaining an international governing body and executive. It would plan the recovery, co-ordinate finance, and borrow and invest to deliver Ukraine's reconstruction on a sustainable basis.

The issue of using frozen Russian assets for Ukraine's reconstruction should be on the agenda for URC23 – it is a more realistic approach to funding Ukraine's reconstruction than praying for the private sector to spare Western governments' blushes. The governments and international institutions that could make it happen will be there, and there have been encouraging signs from both Commission Executive Vice President Valdis Dombrovskis and US Treasury Secretary Janet Yellen recently that they still want to ensure that Russia pays for what it has done, even if they are vague about how. A bipartisan US congressional effort to draft legislation enabling the administration to confiscate Russian assets and use them for reconstruction in Ukraine may add to the momentum.

Western governments have a big stake in what happens next in Ukraine. Ukraine's victory and recovery are the most important strategic and development project the West has faced since the fall of communism in Europe in 1989-1991. Ukraine is fighting in defence of Western values and protecting Europe from further Russian aggression and expansion. If Russia wins then the rest of Europe's security is at risk. Given a chance, Putin will not stop in Ukraine – he and former president Dmitri Medvedev have hinted in the past that Russia's ambitions may stretch to other parts of its former empire, from the Baltic states to northern Kazakhstan.

But even if Ukraine succeeds in stopping Russia's advance and pushes its troops back into Russia, the threat to Ukraine and the West will remain. Ukraine will need help to be economically strong enough to sustain its own defence – protecting its Western neighbours in the process. The project of enabling Ukraine to win the war and the peace is a strategic priority and a public good for the West. Failure to fund Ukraine's reconstruction would mean economic, social and political instability in a country with Europe's largest army; the prospect of millions more Ukrainian migrants in Europe; and the need for Western governments to increase defence spending massively in the face of a newly confident and even more aggressive Russia. The West has no choice but to rebuild Ukraine, however it funds the work. But if Putin has to pay for it, so much the better.

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