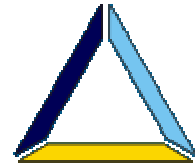


**INSTITUTE FOR ECONOMIC RESEARCH AND
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Working Paper No.15

Anders Åslund

Why Has Ukraine Returned to Economic Growth?

July 2002

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Why Has Ukraine Returned to Economic Growth?

Anders Åslund

1 Introduction

Until 1999, Ukraine stood out as the only postcommunist country that had failed to achieve a single year of economic growth for a whole decade, and it had suffered the greatest registered cumulative decline of all postcommunist countries not been involved in war. The latter might have been a statistical error, but the absence of economic growth was for real (Åslund, 2001a). Ukraine had a particularly large unregistered economy (Johnson et al., 1997).

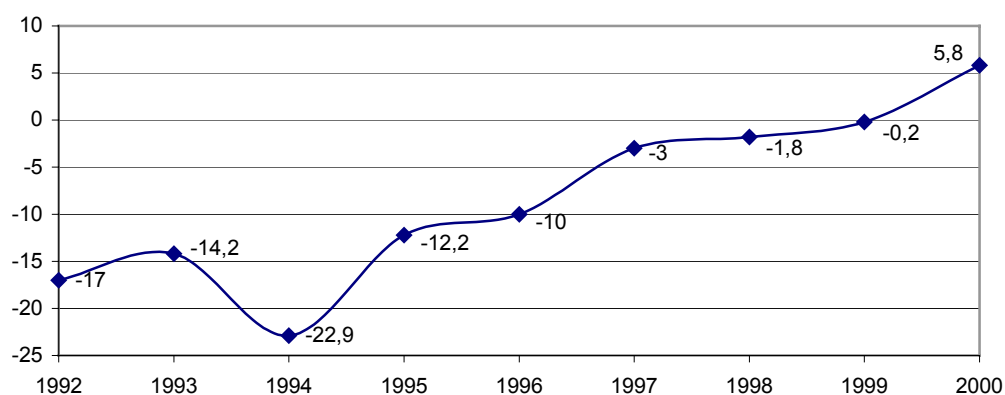
Most features of economic malaise were apparent. Market reforms had generally been tardy and half-done. The budget deficit remained larger than the available financing, persistently becoming slightly bigger than planned. Nonpayments and arrears were notorious, and barter rose till 1998. While the foreign debt was not very large, much of it was caused by nonpayments, especially for gas imported from Russia, and Ukraine lingered on the verge of default from 1998 with currency reserves usually covering less than one month of imports. Its export performance remained poor. The IMF concluded repeated programs with Ukraine, but the government invariably violated them, prompting the IMF to stop disbursements. The social situation was meager, with income differentiation approaching Latin American heights (Åslund, 2000; Milanovic, 1998).

Ukraine had become an oligarchic economy, with a few tycoons or oligarchs dominating both the economy and politics, notably the parliament and the presidential administration, which provided the oligarchs with plenty of tax rebates, subsidies, and regulatory privileges. This was an archetypal rent-seeking society (Hellman, 1998). Ukraine appeared stuck in a severe under-reform trap (Åslund, Boone, and Johnson forthcoming).

But suddenly Ukraine registered a substantial growth of 6 percent in 2000, primarily driven by a growth of industry of 13 percent, of agriculture of 9 percent and a surge in exports of 26 percent (see Graphs 1 and 2 and Table 1). Rather than declining, this expansion has accelerated to 10.5 percent during the first seven months of 2001, likely to exceed 10 percent in 2001, with industrial accelerating by 18 percent and agricultural production skyrocketing by 27 percent, and the growth is spreading to personal consumption and services (ICPS, 2001). A broad-based economic expansion is clearly under way. Even if it would fade, the economic surge is already remarkable, requiring serious analysis. As a previously extreme case of failure, Ukraine is an excellent test case for alternative theories of transition.

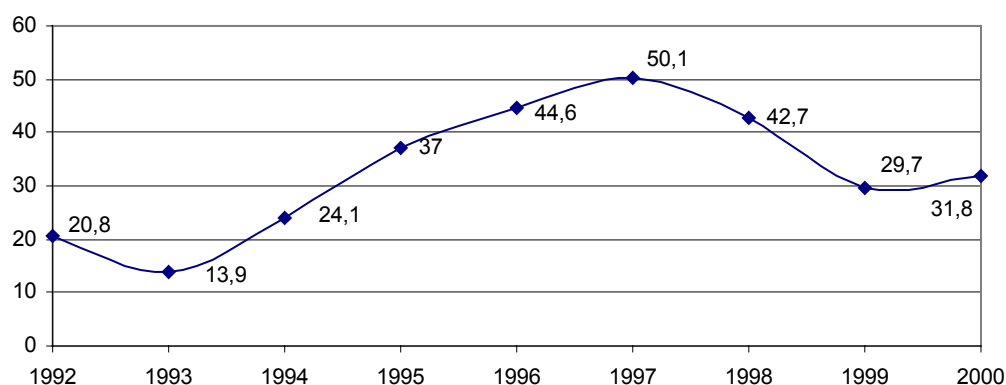


Graph 1
Percentage Annual Change in Ukraine's GDP, 1992-2000



Sources: IMF (website); EBRD (2000); ICPS (2001)

Graph 2
Ukraine's GDP (bn USD), 1992-2000



Sources: IMF (website); EBRD (2000); ICPS (2001)

Table 1
Ukraine's Inflation and Budget, 1992-2000

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Inflation (% end-year)	2,730	10,155	401	182	40	10	20	19	26
Budget deficit (% of GDP)	-25.4	-16.2	-9.1	-7.1	-4.9	-6.8	-2.1	-1.5	0.5
General government revenues (% of GDP)	44	43.7	41.9	37.8	36.7	38	35.2	32.8	...
General government expenditures (% of GDP)	73.3	55.5	50.6	43.9	42.8	43.6	37.9	34	...

Sources: IMF (website); EBRD (2000); ICPS (2001)



Nobody had predicted this sudden boom, which forces us to reconsider the causes of economic growth in postcommunist countries. It is too early for a meaningful quantitative analysis, but the purpose of this paper is to provide a qualitative analysis of Ukraine's sudden and strong recovery. To begin with, we shall look at common explanations of economic growth that have not proven relevant. Next, we shall discuss what concrete economic policy measures appear to have contributed to the generation of growth. Finally, we shall scrutinize how this was politically feasible. A proper understanding of Ukraine's dilemma should help us to understand post-Soviet transformation more broadly and offer clues to how to reform other countries.¹

2 Futile Explanations

The views of causes of postcommunist growth vary greatly, as ordinary growth theory is mixed with the complexities of transition. One school of thought has advocated gradual reform in marketization and privatization. A broad current of gradualist and Keynesian thinking has insisted that the stimulation of demand is vital. A third gradualist argument has focused on disorganization as the problem (Åslund, 2001b).

A popular revisionist idea, spearheaded by Joseph Stiglitz (1999) is that the post-Soviet countries suffered from too radical reforms, and that they should have opted for more gradual reforms. However, until the end of 1999 Ukraine pursued very gradual reforms, leading to a poor economic record. It is difficult to detect any positive result of these slow reforms, as they bred a rent-seeking society (EBRD, 1999).

Deregulation has not been very successful. Ukraine ranks low on all liberalization indices. According to the EBRD structural reform index, Ukraine merely reached the CIS average in 1999. The Heritage Foundation's index of economic freedom puts Ukraine as number 133 out of 161 countries for 2001 (O'Driscoll, Holmes, and Kirkpatrick, 2001). Ukraine tops one statistic, time senior management spent with officials (Kaufmann, 1997). Not surprisingly, on its corruption perception index Transparency International (2000) considers Ukraine the 87th most corrupt of 90 countries.

Similarly, privatization has been slow and directed towards stakeholders, as Stiglitz (1999) has advocated. In 1998, managers owned 17.5 percent of the stocks of privatized industrial enterprises and employees 47 percent, which means much more employee ownership than in Russia. The Ukrainian privatization has not promoted new strong owners endeavoring serious enterprise restructuring but an unclear amalgam of insider ownership. Even in 1999, privatized and state-owned industrial enterprises did not differ significantly in performance (ICPS 1999), and enterprise life has been extremely stagnant. In 1996, the average tenure of an enterprise manager was ten years, as it was virtually impossible to remove a passive,

¹ The policy considerations in this paper is based on repeated interviews with people in the Yuschenko camp.



incompetent or criminal enterprise manager. Many managers had run their companies close to a standstill, but they did not give up or sell off any assets. The Ukrainian stock market has never taken off, as shareholders' rights have been ignored.

The most popular gradual reform idea is that the postcommunist countries suffered from "recession," using the word taken from Western business cycles, which Keynesians thought should be cured with fiscal and monetary stimulation of demand. Few countries have stimulated demand more than postcommunist Ukraine, with huge budget deficits till 1998 and extraordinary monetary emission in 1992 and 1993. Yet, the result was hyperinflation, followed by years of official output decline. Apparently, the problem was not demand but supply. The old communist production was simply not competitive as markets opened up, and output fell because other better goods were demanded. Ukrainian enterprises did not need fiscal stimulation but hard budget constraints or demand barriers, so that they would be forced to adjust to demand. Monetary policy turned restrictive from 1994, but fiscal policy remained lax till 1998 (see Table 2). Growth occurred only after the budget had been balanced, but the budget deficit persisted until Ukraine ran out of both domestic and external financing.

Table 2

Ukraine's External Sector (bn USD), 1992-2000

	1992	1993	1994	1995	1996	1997	1998	1999	2000
Current account	-0.6	-0.8	-1.2	-1.2	-1.1	-1.3	-1.3	0.8	1.5
Trade balance	-0.6	-2.5	-2.6	-2.7	-4.3	-4.2	-2.6	-0.4	-0.8
Exports	11.3	12.8	13.9	14.2	15.5	15.4	13.7	12.5	15.7
Imports	11.9	15.3	16.5	16.9	19.8	19.6	16.3	12.9	14.9

Sources: IMF (website); EBRD (2000); ICPS (2001)

In hindsight, those preoccupied with demand try to explain the Ukrainian recovery with high metal prices and a substantial real devaluation in 1999 after the Russian financial crash, which had depressed Ukrainian exports. As a major energy importer, however, Ukraine suffered from slightly declining terms of trade, although metals, essentially steel, rose to almost half its exports. The devaluation certainly boosted the competitiveness of its emerging food processing and light industry, but it appears more of a catalyst than the whole effect. The fast Russian recovery also helped, as Russia remains Ukraine's main export market.

Another variation of the business cycle argument is that the Ukrainian economy had "bottomed out," and that the huge growth can be explained by the presence of large free capacity and the low initial level. Yet, this argument presumes the existence of a bottom, which the highly varied performance of postcommunist economies contradicts. Nor is there any obvious reason why the upturn would happen after a decade, and not after a couple of years as in Poland, or after several decades as in some unfortunate countries in Africa (Collier and Gunning, 1999). Plenty of



surplus capacity had been available all along, but the systemic question was whether all factors were present to exploit this capacity.

The degree of disorganization has been striking in postcommunist Ukraine. Olivier Blanchard and Michael Kremer have developed a model of disorganization (Blanchard and Kremer, 1997). It argues that under central planning many firms relied on a single supplier for critical inputs, but transition has led to decentralized bargaining between suppliers and buyers. With incomplete contracts, or asymmetric information, bargaining may break down, prompting output to decline sharply, if chains of production link many specialized producers. Blanchard and Kremer (1997) reckoned that this would be a temporary phenomenon until these problems with information and contracts are overcome. Their upshot was (p. 1123): "This raises the question of whether the need to preserve existing production networks provides a justification for gradualism." If this were both true and a dominant effect, we would expect a very gradual reformer such as Ukraine to have experienced a lesser contraction than more radical reformers, but the opposite is the case. Konings and Walsh (1999) and Marin and Schnitzer (1999) have used this model of disorganization to explain the lasting decline in output in Ukraine. As Ukraine has experienced a full decade of steady decline, temporary disorganization cannot be the explanation.

The empirical evidence Blanchard and Kremer (1997) suggest is that firms with more complex supply lines and production have experienced a greater decline in output in various countries. However, the Soviet enterprises with the most complex production were generally the greatest value detractors. Therefore, their production should decline the most as non-competitive. Blanchard and Kremer's (1997), as well as Konings and Walsh's (1999), empirical tests of the effects of disorganization on 300 firms in Ukraine have not measured disorganization but the effect of the market on output.

We can thus dismiss the thesis of Stiglitz and others that radical reform is the cause of post-Soviet economic decline in the case of Ukraine. On the contrary, this country illustrates the dangers of slow and gradual reform. Ukraine's big problem is ubiquitous and arbitrary state intervention. Major business, notably energy trade, was reserved by legal regulations for a few oligarchs. Much of public expenditures was devoted to subsidies to the same people, who also received tax exemptions, rendering competition with them impossible to others. The vast government administration harmed private enterprises without privileges through extortion, often forcing them to close down. The privileges of the oligarchs had to be reduced to make it possible for others to compete, while the state apparatus had to be controlled to make it possible to run independent enterprises. Hence, the economic problem of Ukraine was not demand or disorganization, but the liberalization of supply and the leveling of the playing field (Kaufmann, 1995 and 1997; Hellman, 1998).



3 Ukraine's Reform Drive in 2000

At the end of 1999, Ukraine started a major reform drive under the new Prime Minister Viktor Yushchenko. Admittedly, many reforms had prior roots, and quite a bit had already been accomplished. Macroeconomic stabilization had been attained in 1996, and inflation did not rise above 20 percent a year even in the financial crisis years 1998 and 1999 (Table 2). The economy had been half privatized.

Yet, there was a strong concentration of reforms in 2000, and they were quite radical, comprehensive and profound. Our purpose is to pinpoint what appears most important for the new economic dynamism. Our thesis is that the reduction of rent seeking, the ensuing leveling of the playing field and liberalization of supply provided the foundation of the sudden economic success.

The first reform measure might sound surprising. It was to introduce elementary order in government decision making. Ukraine had been notorious for having no standardized decision-making procedures. The state administration was too centralized and hierarchical, but responsibility was diluted as one decision often required a score of signatures. Top officials could sign hundreds of decisions in a day. No clear division of responsibility existed between the President's Administration, the large Cabinet of Ministers apparatus and the ministries. Everybody could blame somebody else. This extreme collectivism meant that few had time to inform themselves about issues they signed off on, and nobody appeared responsible. At the same time, no gatekeeper barred dubious decisions. The oligarchs, who all were members of parliament, walked the corridors of the President's Administration and the parliament to extract the formal decisions that granted them subsidies and regulatory privileges. The actual reform was exceedingly simple. Under the cabinet, four government commissions were set up, each headed by one of the four deputy prime ministers. Any government decision had to be prepared by one of these commissions, and the respective Deputy Prime Minister was personally responsible. Meanwhile Ukraine introduced regular weekly cabinet meetings, which had previously been held ad hoc and called in the last minute. An effort was also made to reduce the number of signatures needed on each decision and the number of documents senior officials had to sign. The number of state agencies was sharply reduced. Evidently, accountability was raised. In effect, the President accepted that his administration lost operative power.²

The second task was to clean up among government decisions. A large number of government and presidential decrees gave specific enterprises privileges in regulation or taxation, often tax exemptions and subsidies, but sometimes monopoly rights. Another group of decrees and laws contained so-called categorical social benefits, which were primarily social transfers targeted on the Nomenklatura and paid out through the government budget. Over 250 decrees on unjustified privileges for the well-connected were instantly eliminated by the Yushchenko government. This action

² Interviews with First Deputy Prime Minister Yuri Yekhanurov and Cabinet Secretary Viktor Lysytsky.



required little sophistication but a great deal of courage and some energy to find them. The oligarchs, who were the main culprits, were as stunned as furious.³

The third and probably the second most important reform was to put the budget and payments into order. The budget had to be balanced because of the absence of financing, and Ukraine had to be able to service all its international financial commitments. Unjustified subsidies were eliminated, while the government budgeted so that it could honor all its commitments, notably pensions. Taxes were reduced somewhat, as the payroll tax for the Chernobyl Fund of 12 percent of the payroll was abolished, and expenditures had to be adjusted to a lower level of revenue.

The most important fiscal measure, however, was that treasury control started becoming effective, and the government insisted on being paid in real money rather than offsets or promissory notes. Since these instruments usually involved large tax rebates, the playing field was leveled as rents were eliminated. This effect is much greater than nominal budget statistics show, as monetary surrogates are counted at face value, while they usually had a market value of only half.⁴ As a result, barter, which had risen for years till 1998, fell sharply, while monetization proceeded (ICPS, 1999).

Although Ukraine has maintained relatively high state revenues as a share of official GDP, this share has fallen by 11 percent of GDP from 1992 to 1999. Moreover, general government expenditures have plummeted from 73 percent of GDP in 1992, to 34 percent of GDP in 1999 (see Table 2). With less resources, the state and its corruption can no longer be as predominant, and more people, enterprises and organizations will probably break out of the stranglehold of the corrupt state.

The fourth measure undertaken by the Yushchenko government was energy reform. It was as important as unexpected, because all the leading Ukrainian businessmen were primarily commodity traders, and it was considered politically impossible to get them under control. Each year, a handful of leading energy traders shared a few billion dollars in net gains thanks to their enormously privileged positions. Considering that few dared to fight these ruthless giants and even fewer had sufficient insights in their intricate schemes of subsidization, Prime Minister Yushchenko invited one dissident oligarch, Yulia Tymoshenko, to fight her prior competitors as Deputy Prime Minister for energy. She took on her task with great vigor.

The key issue was the imports of natural gas from Russia. In the fall 1998, Ukraine's main gas importer, Ihor Bakai, stated in a newspaper interview: "All rich people in Ukraine made their money on Russian gas" (Tymoshenko, 1998). This business was as nontransparent and monopolistic as anything could be. On the Russian side, the actual producer was the semi-state monopoly Gazprom, but Gazprom sold gas to a private intermediary, Itera, which is widely rumored to be owned by Gazprom managers, for about 4 USD per one thousand cubic meters. Itera, in turn, sold gas for a nominal price of about 80 USD per one thousand cubic meters to Ukraine, but the

³ Interview with Cabinet Secretary Viktor Lysytsky.

⁴ For the corresponding situation in Russia, see Gaddy and Ickes (1998) and Pinto et al. (1999).



real price was considered to be 40-45 USD per one thousand cubic meters (von Hirschhasuen and Vincentz 2000). While the nominal value of Ukraine's gas imports was about bn 5 USD a year, Itera and the Ukrainian gas-importing oligarchs split about bn 4 USD a year between them.

The techniques were many. The most blatant was theft of gas from the main pipeline through Ukraine to Western Europe. Another means was not to pay Russia/Itera/Gazprom, but as Itera happily continued this trade the suspicion lingers that it was paid. Gazprom/Russia demanded that these nonpayments sometimes by private Ukrainian importers should be guaranteed by the Ukrainian state. A third form of rent seeking was barter and offsets, both with Itera and the Ukrainian government, explaining why the real price was considered to be half of the nominal price. The equation was further complicated by Russia paying in kind for the transit through Ukraine, and that benefit disappeared into private accounts. Altogether, a few Ukrainian oligarchs made a net of some bn 2 USD a year on this dubious gas trade.

Having been a major gas trader herself, Timoshenko knew all the tricks and she made her utmost to clean up. By importing gas from Turkmenistan instead of Russia, she brought down the nominal price and enhanced transparency. She tried to eliminate barter as payments for the imports with support from Russia. She insisted on tax payments in money rather than through offsets, and she tried to reinforce discipline to stop the oligarchs' theft of gas from the pipeline. She ended up in a vicious conflict with Bakai and the other major gas traders, but she managed to have Bakai sacked from his post as President of the Naftogaz Ukrainy, the state wholesale monopoly importer of gas.⁵

Another major source of rents was electricity. This scheme was much simpler. State-owned generators produced electricity, which was distributed by regional monopoly distributors, one-quarter of which were owned by Grigory Surkis, another oligarch. While the distributors extracted payments from the final customers, they only paid 6-7 percent of the electricity they "bought" and even less taxes. Timoshenko insisted on full payment both of electricity and taxes in real money, and she assessed that she forced the distributors to pay bn 1.8 USD more for electricity and in taxes in one year. This reform was promulgated as a law in Parliament, which should make it more difficult to reverse.⁶

A third minor source of energy rents arose in oil. One oligarch, Olexander Volkov, had the exclusive right to import oil for one price and sell it for the double price because of tax exemptions. The government took away Volkov's privilege easily, as the scheme was so primitive, and the oil market was leveled, while Volkov went out of business. The coal industry received direct government subsidies of hundreds of millions of dollars. Before Timoshenko took on the powerful coal industry, primarily in Donetsk, she was ousted after a year in office, and she blamed the Donetsk coal industry for her fall.⁷

⁵ Based primarily on an interview with Yulia Timoshenko, May 2001.

⁶ Ibid.

⁷ Ibid.



The total energy rents that were eliminated probably amounted to some bn 4 USD or about 13 percent of official GDP. The bulk of these losses hit Bakai, Surkis, and Volkov, though also Viktor Pinchuk, the metallurgical oligarch in charge of gas trade in the important Dnepropetrovsk region. The limitation of energy rents had many positive economic effects. Payment discipline and tax revenues improved; Ukraine's energy consumption and costs of energy imports fell sharply, when enterprises actually had to pay real money for the energy; and, as the playing field had been leveled, foreign companies entered both the oil and electricity industry in Ukraine.

Fifth, a comprehensive land reform was executed in early 2000. Its essence was that state and collective farms were formally disbanded, and the land distributed to the people on the farms. In effect, most land was leased back to the old managers of the state and collective farms, but much went to private plots, private farms, and large commercial holdings. Agricultural land ownership became highly varied, and the mixed ownership granted the full deregulation of agricultural trade that eluded the country for so long. While little could happen during the redistribution of land, a major supply response appears to have occurred in 2001. Big new businessmen are going into agriculture with a vengeance, and commercial banks are happy to provide loans to farms, as they perceive this as profitable and secure business.⁸

A sixth reform has been under way for a long time. The long-time World Bank representative in Ukraine Daniel Kaufmann (1997) noted that Ukraine suffered from an incredible amount of state inspections, and he found in comparative research that it was the highest in the world, or at least required more management time than anywhere else in the world (Hellman, 2000ab). In a survey of new medium-size entrepreneurs in Poland, Slovakia, Romania, Ukraine and Russia in 1997, Simon Johnson, John McMillan, and Christopher Woodruff (2000) found, that, in comparison with Central Europeans, Ukrainian entrepreneurs paid 50 percent more taxes as a share of their turnover and 75 percent more unofficial payments to officials. A large and intrusive state inspection apparatus of numerous competing agencies indulged in overgrazing of the same companies. Partly the revenues went to underfunded public programs, partly to corrupt inspectors (Shleifer and Treisman, 1999; Kravchuk, 1999). Increasingly, the main scourges became law enforcement itself, the Ministry of Interior, the Ministry of Security, and the Tax Service.

Ukraine was the first postcommunist country where these regulatory hazards were well analyzed, and from 1997 a substantial reform agenda was gradually elaborated. From the top of the government, agencies were reduced and streamlined, while a special entity for the support of enterprise was instituted; licensing was reduced and simplified; inspections were registered and became subject to oversight; underfunded public mandates were either reduced or funded. Initially, little came out of changes such as the simplification of licensing and the control of inspections, as the fundamental problems of underfunded mandates and almighty corrupt inspectors persisted (Akimova, 2001). The tightening of

⁸ Interview with Peter Sochan, an agricultural expert in Kiev in October 2000.



public finance in 2000, however, seems to have brought about real success, as inspections fell off sharply that year.⁹

Another effective measure was the proliferation of low, simplified taxes for small entrepreneurs. Since 1986, Ukraine had fixed lump-sum taxes for individual entrepreneurs on the books, but these taxes had been set too high and given little bureaucratic relief. In 1998, the original idea was revived. An individual entrepreneur's only interaction with the government was that he or she paid a low, fixed, lump-sum tax a few times a year. No bookkeeping was required, and these single entrepreneurs were completely excluded from the inspection fury (Thiessen, 2001). This was how small enterprise had flourished in Poland in communist times (Åslund, 1985). For slightly larger enterprises with up to 10 employees, a low turnover tax of 10 percent was introduced as the only tax. As a consequence, the number of single entrepreneurs swiftly skyrocketed to an estimated 2.7 million by 1999, and 250,000 enterprises with 1-10 employees (Thiessen, 2001).

All kinds of services suddenly flooded the market at low prices. People who had undertaken substantial private work in the underground could legalize and intensify their trades, allowing them to raise their output and productivity, while strengthening their standing in civil society. Medium-size enterprises had not really resisted the inspection fury, because it guaranteed them certain monopoly rents. When facing price competition from myriad small entrepreneurs, however, the established business community insisted on lower regulatory costs, presumably one reason behind the declining inspections registered in 2000. After three years of trial and error, deregulation attempts finally started to bite.

A seventh measure was an intensification of privatization of large enterprises. Two waves were apparent in 1998-2000. In 1998 and 1999 a number of large enterprises were privatized to largely two people, Grigory Surkis, who acquired seven regional electricity distributors, and Viktor Pinchuk, who became the steel king of Ukraine owning five major steelworks. These privatizations were inspired by the loans-for-shares deals in Russia in late 1995, and the intention was to convince the oligarchs to raise funds for President Leonid Kuchma's re-election in October 1999. Another wave of large-scale privatization occurred in 2000, when several large enterprises were sold in tenders primarily to big private Russian enterprises, which usually won in competition with Ukrainian oligarchs because they had more money. Four major oil refineries were sold to three Russian and one Kazakh oil companies. Instantly, these refineries that had produced little in the 1990s started working to capacity, and Ukraine became self-sufficient in petroleum products. Ukraine's production rose, while the country economized on its import bill.

Until then, slightly over half of Ukraine's GDP had originated in the private sector, but privatization has not had much of an effect as yet (Estrin and Rosevear, 1999). By 2000, the EBRD (2000) assessed that the private sector provided 60 percent of Ukraine's GDP, and a critical mass appears to have been accomplished. The many medium-size enterprises that had been

⁹ World Bank survey undertaken by the EERC Program at the Kiev-Mohyla Academy.



privatized to insiders in 1996 and 1997 had finally adjusted and started expanding.

These reforms were substantial, and they were largely concentrated in 2000, although most had been under way for years. Ukraine's problem was no longer intellectual comprehension and the year 2000 brought execution. With the right resolve a great deal could be accomplished in one single year. All these reforms were important, but the reduction of energy rents was the greatest achievement, followed by the cleaning up of the state budget and payments. Rather than explaining Ukraine's new growth with minor issues, such as devaluation or high metal prices, we should infer that such substantial reforms would have strong and positive economic effects. The new growth was facilitated by a prior shakeout of value-detracting industry, and it might be overestimated by entrepreneurs shifting from the underground to the official economy (Åslund, 2000).

The breadth of the reforms should not be exaggerated, as the reform capacity remained limited. No fundamental social reforms were undertaken, and a new tax code has not been promulgated. Judicial reform remains an urgent demand. Yet, the reforms undertaken in 2000 were probably the most needed, and they were so radical that few observers believed they were real, while it is now becoming obvious that they were.

4 How Did Reforms Become Politically Possible?

On the eve of Ukraine's renewed reforms in 2000, the country appeared a full-fledged rent-seeking society, construed to benefit a small elite, living off monopoly rents at great cost to society at large. It appeared a strong and stable system that was likely to last for long. For instance, the prominent Ukrainian scholar Aleksandr Paskhaver (1999) argued that the Ukrainian system of "bureaucratic capitalism" implied that only private capital that had merged with the state bureaucracy could exist in Ukraine. The country appeared to be in the grip of a rent-seeking iron triangle of government, oligarchs and Parliament. They all favored a maximum of regulation and state interference to maximize rent seeking and corruption, while the population was of little consequence and partly co-opted. This model of self-reinforcing rent seeking was close to equilibrium and thus stable. It was reminiscent of the distribution of power in a stagnant African country (Åslund, 2000). Civil society is so frail that Ukrainians rarely stand up to defend their own interests (O'Loughlin and Bell, 1999). Even so, this rent-seeking society was broken up by reforms, and the question is how that could happen.

An underlying explanation is that many understood Ukraine's predicament and what needed to be done to improve the economy. Hundreds of drafted reform laws were collective dust in the Ukrainian parliament, as no power pushed for their promulgation. Yet, the government cadres remained largely the same, as the very same people continued alternating posts as musical chairs. Neither outsiders nor young well-educated people were welcome into the ruling circles. No popular pressure was apparent, and the

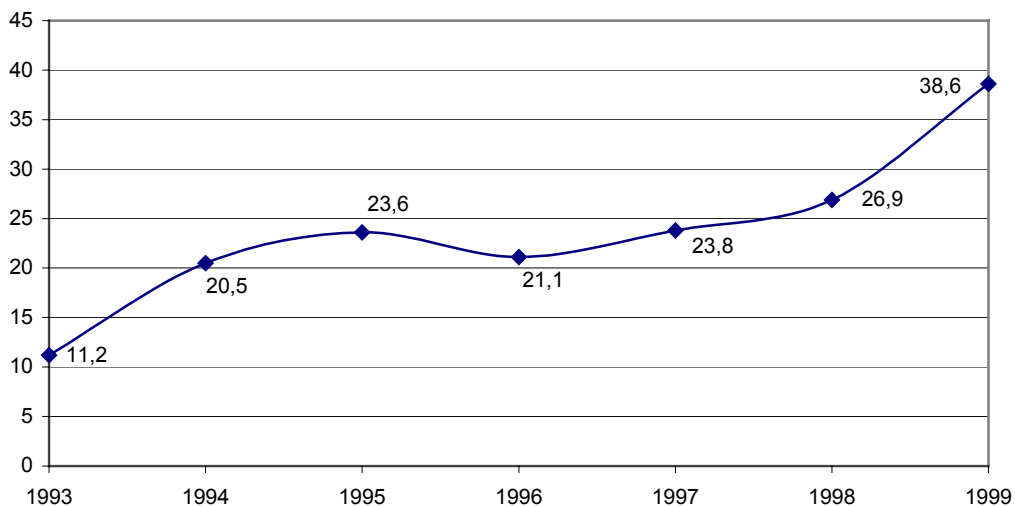


media had grown miserable because the oligarchs had bought up all significant newspapers in the prelude to the presidential election in 1999.

The most obvious cause of change was that Ukraine lingered on the verge of default for most of 1998 and 1999. Ukraine's foreign debt was rising as a share of GDP mainly because of devaluation (see Graph 3), although it was never large in comparison to its GDP, and it had peaked in 1997 in dollar terms (see Graph 4). Yet, it, and the international reserves were as low as m 600 USD in March 1999 (ten days of imports), but it avoided outright default. In 2000, Ukraine faced a seemingly impossible repayment schedule of its foreign debts, and no financing was at hand. Although Ukraine's payment crisis was protracted, it appears to have worked as an external shock. The Russian financial crash in August 1998 illustrated to the Ukrainian elites the danger to them to cross the brink. Even the oligarchs realized that they had to tighten their belts for their own survival, though that insight might have been fatal for their reign. This complies with Allen Drazen and Vittorio Grilli's (1993) argument that a crisis can facilitate reform by undermining the finances and power of opposing vested interests.

Graph 3

Ukraine's External Debt as Percentage of GDP, 1993-1999

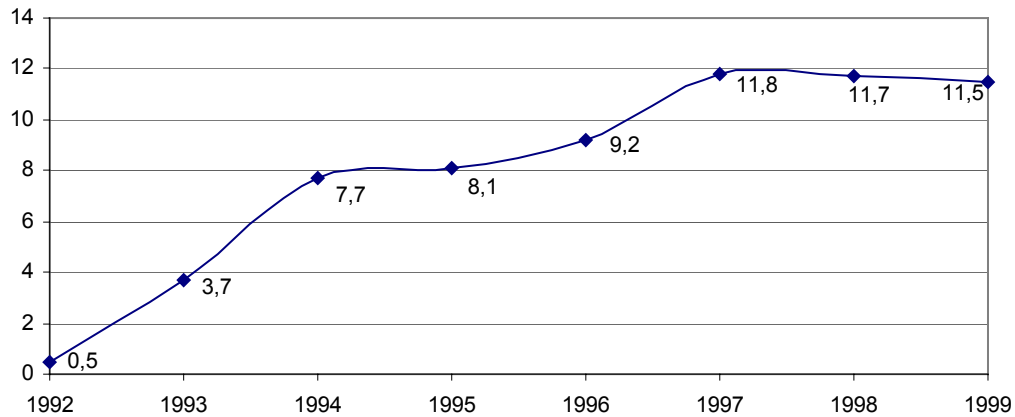


Sources: IMF (website); EBRD (2000); ICPS (2001)



Graph 4

Ukraine's External Debt (bn USD), 1992-1999



Sources: IMF (website); EBRD (2000); ICPS (2001)

Second, changes in the political decision making had made substantial decisions possible. For long, the President, the Prime Minister and Parliament were locked in a permanent battle, petrifying status quo. Through the new Constitution of June 1996, the President secured his supremacy over both Parliament and the Prime Minister (Wise and Pigenko 1999). Although the presidential elections in October/November 1999 were riddled with malpractices, President Kuchma's substantial majority in the second round clarified that he was really in charge and made him responsible.

The parliamentary elections in March 1998 were not pretty, but the new partially-proportional electoral system with a threshold for representation structured the new parliament in party factions. Although most deputies shifted party affiliation in the course of this parliament, the party factions provided it with sufficient structure to make bargaining possible. Three big centrist parties were formed around the major oligarchs (Surkis, Pinchuk, and Volkov-Bakai), while Timoshenko set up her own substantial party further to the right. The political representation of the oligarchs made their dealings more open and transparent. While not accountable, they became publicly responsible for their decisions. Facing the threat of default after the presidential elections in November 1999, the oligarchs joined the national and liberal right, proposing the highly-respected governor of the National Bank since 1992, Viktor Yushchenko, as prime minister. He was confirmed by Parliament in December 1999. Although Yushchenko was not close to the oligarchs, they saw him as the best man to avoid default, while they thought him too weak to threaten their power and wealth. This broad center-right coalition facilitated many decisions previously impossible, as one or two oligarchic parties usually joined the left to oppose market reforms. For instance, a land reform with the introduction of private ownership of land has been a persistent aim of the reformers, but the left in the parliament had previously effectively vetoed all land reform (Lerman, 1999).



The third political explanation of the new reforms was that Yushchenko successfully exposed the oligarchs to competition among themselves, taking his queue from Machiavelli rather than modern political economists, who emphasize the importance of consensus, trade offs, and compensation. Yushchenko's stroke of genius was to invite the forceful Yulia Timoshenko to diminish the oligarchs' energy rents. As she dared to challenge the major oligarchs, both Timoshenko and her husband have been arrested and are prosecuted for major crimes. Yet, her actions took two major oligarchs (Volkov and Bakai) out of business, while two others (Surkis and Pinchuk) are short of money, as evident from their repeated failures in open privatization tenders.

A fourth political factor concerns law enforcement. In the early postcommunist period, crime has skyrocketed, as is typical of the liberalization after a severe dictatorship. Soon, crime became organized, and by 1996 or so, the oligarchs took over, freeing themselves from the supremacy of organized crime. In the late 1990s, however, law enforcement recovered and seized control, but it had become a law to itself. In Ukraine, the main law enforcement agencies are the huge Ministry of Interior, the elitist Ministry of Security, the large new Tax Administration, and the Prosecutor General. Especially, the first three agencies with strong and the long-serving chiefs became centralized commercial organizations, while they were competing among themselves as oligarchic groups.

In late 2000, the power structure in law enforcement changed substantially and unexpectedly. In September 2000, a muck-raking internet journalist, Grigory Gongadze, was murdered. In late November, a former bodyguard of President Kuchma publicized a tape-recording from the President's office, in which he discussed illegal actions against Gongadze with the Minister of Interior and others. This scandal weakened not only the President, but all the law enforcement chiefs. Eventually, the strong Ministers of Interior and Security were sacked. In the aftermath of this scandal, the government offices were combed for illicit microphones, and a couple thousand were found, evidencing that numerous superiors listened to their subordinates, and vice versa. The central control of the law enforcement organs was weakened, and fractional and regional competition for power started. At least temporarily, the intrusion of law enforcement in enterprise life has diminished. Their sense of uncertainty has convinced the law enforcement officers to indulge less in extortion, while concentrating on watching each other, allowing entrepreneurs to develop in relative peace.

A fifth political reason for Ukraine's break from rent seeking was the effects of privatization and private enterprise development. Regardless of how Ukrainian oligarchs acquired property, their ownership of enterprises changed both their own behavior and their relation with one another. Traditionally, they had made their money through commodity deals secured in the corridors of power rather than out in enterprises. Ironically, the privileged privatizations before the presidential elections in 1999 separated the oligarchs' interests, by connecting them firmly with certain industries. Surkis and Pinchuk went into manufacturing on a large scale, while Volkov and Bakai lost out reluctant to evolve from elementary rent seeking in the commodity sector. The purchase by Russian oligarchs of major enterprises in Ukraine increased market competition. As privatization



proceeded, the popular respect for private ownership augmented, and private entrepreneurs gained courage. The emergence of millions of small legal entrepreneurs provided the market competition needed to clean out monopoly rents. The creation of a larger private sphere outside of state influence thus contributed to the development of civil society in multiple ways (Boycko et al., 1995).

The Ukrainian reforms of 2000 were enormously controversial. Yushchenko could get them done because he acted hard and fast. He concentrated on top priority measures and carried them out early on, while the elite still needed his international credibility to keep the country from default. From the spring of 2000, the centrist oligarchic parties felt the danger of default had passed, and they began complaining loudly about Yushchenko and Timoshenko's high-handed rule, calling for consensus and a coalition government. From the summer of 2000, President Kuchma and his administration increasingly intervened in economic policy, and the president even issued a decree on far-reaching regulation of agricultural trade, which fortunately appears to have been ignored. By November 2000, the Kiev rumor mill asserted that the President would sack Yushchenko within weeks, but the Gongadze scandal delayed this decision. Yet, in February 2001 Kuchma dismissed Timoshenko and in April 2001 the centrist oligarchic parties and communists voted Yushchenko out of power.

Yet, Ukraine's economic and political life appears profoundly transformed. The elite appears locked in an internecine war, with all top people fighting against everybody. The extreme competition at the summit appears to minimize rent seeking. The new Prime Minister, Anatoly Kinakh, appears a compromise figure representing the least common denominator of a broad center. Attempts to restore old schemes of rent seeking have been made, and even passed through Parliament, but so far the President has vetoed them. As all major powers are weakened, all rent seekers seem to be making less money. They can block one another but not conclude lucrative deals.

5 Conclusions: A Severe Break in the Ukrainian Rent-Seeking Society

For a decade, Ukraine seemed one of the sickest economies in the former Soviet Union, although it had not suffered from any warfare. By 1999, most observers had given up on Ukraine as a hopelessly corrupt and stagnant country. Therefore, it is all the more surprising that suddenly this country has soared with substantial growth, presenting an excellent test case for alternative ideas of reform.

Ukraine calls the bluff of claims of insufficient demand. Its economy started growing only when its budget was balanced, monetary policy rigorous, and financing absent. As all its reforms were highly gradual until the end of 1999, it evidences the inefficiency of gradual reforms. The country's sudden recovery, when finally turning to radical reform, suggests that radical reforms do not lose their effectiveness even after many years of



mismanagement, if the reforms are sufficiently radical. Clearly, disorganization is no relevant explanation in this story.

Ukraine's main economic problem was instead that it was the possibly most characteristic rent-seeking societies arising out of the former Soviet bloc. The surprise is that this seemingly stable oligarchic rule could be disrupted. The Yushchenko government concentrated on key economic measures, and its program amounted to straightforward radical market economic reform, though macroeconomic stabilization had already been accomplished, and half the privatization was done. Central state decision making had to be brought under control, and far-reaching liberalization was attempted, while misappropriation of budget funds was reduced. Privatization and private enterprise development were pursued however possible, with land reform and the legal security of small entrepreneurs being key. The greatest surprise was that the Yushchenko government succeeded in cutting the energy rents of the oligarchs just after they had financed President Kuchma's re-election. As value subtraction had already been minimized, the radical liberalization and hard budget constraints prompted an instant supply effect.

Yushchenko's reforms were amazingly politically astute. Although a broad political coalition including the oligarchs brought him to power, Yushchenko wisely dealt an early devastating blow to the oligarchs, before they could oust him. He provided a textbook case for how a rent-seeking society can be broken up through division and hard hits, focusing on the most important rents, while taking on one oligarch after the other. These reforms had not been possible, if consensus had been sought, while the breaking up the previously cohesive elite rendered them successful. Privatization had made the oligarchs more autonomous from the state and one another, which facilitated the intensification of the competition among them.

Ekelund and Tollison (1981) have argued that mercantilism in Britain broke down in the 18th and 19th centuries because of protracted rivalry between the royal court and Parliament over rents, leading to laissez-faire. Similarly, Andrei Shleifer and Robert Vishny (1993 and 1998) have advocated competition over bribes as the safest way to drive them down after communism. To date, this seems the best cure for Ukraine, but the legalization of the new state of affairs is not in sight as yet. Other means have been the clarification of responsibility, the drawing of clear lines, reduction of state authority, greater transparency. Yet, the clue to success has been the vicious internecine fight among oligarchs and law enforcement agencies. The role of the media has been surprisingly minor, while the underlying democratic verdict by voters has stayed important.



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