

**The Driving Forces for Unwanted Reforms: Lessons from the Ukrainian Transition**

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This work explores the political-economic mechanisms that lead to economic reforms even if the state is "captured" with the rent-seeking interests, as was the case in Ukraine in 1990<sup>th</sup>. We argue that unless the social capital is strong enough to solve the coordination problems, the rent seeking can be sustainable for a long time only if the players are coordinated forcedly by an authoritarian arbiter. Such arrangement is mutually associated with peoples' passivity, and inability of comprehending the virtues of market coordination based on the private property rights.

Until this public consciousness change, so already emerged market institutions start crowding out the rent-seeking ones, deterioration of authoritarian control and coordination due to the technical and societal progress remains the main long-term factors of reforms. Although such deterioration does not cease the rent seeking, and can even release it, lack of control makes it unsustainable, so ultimately requires replacing a forced coordination with the market one based on universal protection of the property rights. On the other hand, the longer this stage lasts, the stronger get intermediate (and often informal or illegal) rent-seeking social structures and practices fed with the rent from uncontrolled resources, which obstruct establishing the market order.

In Ukraine deterioration of totalitarian control started at least since Stalin's death brought about the proliferation of interpersonal networks of mutual exchange based on blat. Price liberalization of 1992 was a "passive" systemic reform that the government had to accept because of the far-went deterioration of centralized control and coordination. Then the gap of control was mostly closed in two main waves of reforms, each of them coming as a reaction to crisis: monetary stabilization plus privatization (1995-96), and fiscal stabilization plus contracting of state paternalism towards the enterprises (1999-2001). However, the market adjustment after initial shock appeared to be delayed for almost eight years due to the persistence of deep-rooted rent-seeking interpersonal networks, and thus incurred very high social cost.

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## CONTENT

Introduction.....	3
1. The Model .....	6
1.1. Problem of coordination in rent seeking society of Ukraine .....	6
1.2. Rent-seeking society as a system .....	7
1.3. Reforms under rent seeking .....	8
1.4. Hypotheses.....	10
2. Dissolution of USSR and first wave of reforms in Ukraine.....	12
2.1. Soviet variant of arbiter-clients system.....	12
2.2. Dissolution of the USSR, and price liberalization.....	14
3. Second wave of reforms: disinflation and privatization.....	16
3.1. Crisis of overappropriation: why the gap of control was not closed?.....	16
3.2. Inflation .....	18
3.3. Economic decline .....	19
3.4. Disinflation: initial attempts.....	20
3.5. Emergence of an arbiter.....	21
3.6. Privatization .....	23
4. The third wave: reforms without interests.....	26
4.1. “Virtual” stabilization and the role of IMF .....	26
4.2. Curbing the paternalism, and fiscal stabilization.....	28
5. Consequences of reforms.....	30
Conclusions.....	34
References.....	36
Appendix. The main interest groups of the late Soviet society, their role before and after the crash of Communism. ....	41

## Introduction

During the 1990s and early 2000s Ukraine underwent a period of reforms, well in accordance with the “Washington consensus triad” of liberalization, stabilization and privatization. Initially Ukraine lagged behind Russia in its market reforms but it managed to catch up as a result of comprehensive reforms, undertaken after the 1998 crisis, that have mostly accomplished the country’s transition to a market economy. By 2004 Ukraine became one of the world’s leaders in growth of per capita GDP.

While the actual occurrence of effective reforms seems to be out of question, the particular motivation for and the mechanism of political decisions to implement the reforms raises controversies. The question “Why to reform?” is a key to understand the Ukrainian transition, as well as, perhaps, similar historical processes in other post-Soviet countries and possibly some other rent-seeking societies (Krueger, 1974) too. Providing right answer to this question turns out to be non-trivial and mostly overlooked in the literature.

For the needs of this study we define the rent-seeking society as a two-sector economy, where the rent-seeking sector initially prevails over the value-adding one. By the rent we understand any kind of income originated from:

- Involuntary re-distribution of the value being created by others:
  - o explicit redistribution, e.g., subsidies, or
  - o implicit redistribution, e.g., protectionism or granting monopoly powers<sup>1</sup>
- Appropriation of already existing wealth

Three kinds of institutions are needed to eliminate the rent seeking:

- Property rights, hereinafter understood as residual rights of control over any kinds of property, including public funds
- Market competition, and/or
- Effective state governance able to prevent:
  - o private appropriation of natural resource rents
  - o socially inefficient allocation of budget spending, and/or
  - o ill regulation of natural monopolies

These institutions are interrelated to each other.

A protected monopoly actually violates the control rights of consumers by limiting their choice, as well as the rights of the would-be competitors by hindering their access to protected markets. But even more importantly, weak property rights are inconsistent with competition.

By Demsetz (1967), the private property rights can be regarded as a special sort of constraints protecting the potential sources of rents from overappropriation (known as “the tragedy of the commons”, e.g., overfishing) by granting the rents only to the owners of property. When the property rights are weak, some other institutions are needed to prevent overappropriation by imposing some controls over the rent seeking. Unlike the private property rights, any kinds of alternative institutions tend to restrict the market competition.

Contraction of the rent seeking is a necessary condition for establishment of the property rights, as well as for emergence of a truly reformist government. Sonin (2002), Polishchuk and Savvateev (2000); and Hoff and Stiglitz (2004) show that the wealthiest “oligarchs” are not interested in the establishment of property rights and good governance as long as lucrative rent seeking

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<sup>1</sup> In the case of natural monopolies, when a “market” value cannot be defined by competition, the definition of a monopoly rent is vague.

opportunities associated with weak rule of law persist. If also the voters who resist rent seeking are politically underrepresented, the state may become “captured” by the oligarchs, thus unwilling to undertake the reforms potentially subversive to rent seeking (Hellman, 1998; Hellman, Jones, and Kaufmann, 2000). In such a way there emerges a vicious circle: weak property rights facilitate rent seeking while the latter further weakens the former. However historically similar kinds of ‘bad’ long-run equilibriums (Sonin, 2002) can be found in different countries, including those which nonetheless have managed to become mature market democracies.

So, there must be some way out of the above-described vicious circle. A rent-seeking society should be able to undergo essential changes occurring even if no major political force be interested in them. We argue that this is exactly what happened in Ukraine in the second half of 20<sup>th</sup> century. Here all major changes took place not as deliberately sequenced market reforms conducted by a benevolent government, as often assumed in the normative literature focused on prescriptions rather than explanation and analysis. Instead they were either imposed on the authorities as a sort of self-produced *fait accompli* in the transition process, or were undertaken as unavoidable emergency measures necessary to prevent or overcome a crisis.

Some theoretical models provide for such opportunity. McGuire and Olson (1996) suggest that a rational power-encompassing ruler, while being a rent seeker himself, should still provide some amount of public goods to ensure economic efficiency, thus restrain the rent-seeking, in order of maximizing his<sup>2</sup> own rent. Dixit, Grossman and Helpman (1997) show how he can accomplish this by playing a divide-and-rule game, even while being “captured” by diverse rent-seeking interests. But these models seem to be inconsistent with observed persistence of the rent seeking. Mere combination of them with the ones of the ‘bad’ equilibrium, even if possible, is still insufficient for understanding of evolution of a rent-seeking society because they fail to answer a critically important question, namely:

*When and Why does a rent-seeking society remain relatively stable for some periods of time? What has to change in order to make it reforming? Which forces may eventually drive a rent-seeking society out of the “bad long-run equilibrium”? How does it happen?*

While these driving forces may vary from case to case, they should be exogenous to the political-economic factors responsible for ‘bad’ equilibriums. In application to Ukraine, Paskhaver (2003) classifies the reforms of the 1990<sup>s</sup> as a sort of revolution that he defines as radical changes driven by some exogenous forces remaining out of government’s control, caused by an exogenous challenge of modernization that Ukraine had faced.

However, the mechanisms that transmit such long-term modernization trends and external shocks into eventually successful economic and political reforms still remain unclear. Our study attempts to fill this gap in the case of Ukraine of the 1990s. Based on our analysis, we suggest some policies for a rent-seeking society to undertake and implement market reforms.

We describe political economy of a rent-seeking society by means of a hierarchical “arbiter-clients” model (Section 1). We argue that at a certain stage of its evolution, a rent-seeking society may need an authoritarian ruler (“arbiter”), as a second best arrangement, who is able to reduce the overappropriation or the cost of infighting between rent-seekers. Such arbiter, in turn, suppresses or crowds out social capital<sup>3</sup> (Putnam et al., 1993), democratic institutions, and other alternative societal and political mechanisms that could replace him in this role. Under such a polity, the rest of major rent seeking players (usually referred to as “the oligarchs” or “clans”) become clients of the arbiter.

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<sup>2</sup> Such rulers are almost exclusively male, since their rule is essentially based on patrimonial institutions. Of course, this can hardly be regarded as a compliment to the men.

<sup>3</sup> According to [Robert Putnam](#), social capital “refers to the collective value of all ‘social networks’ and the inclinations that arise from these networks to do things for each other.”. According to Putnam and his followers, social capital is a key component to building and maintaining [democracy](#).

At the societal level, the people have no reason to overcome the rent seeking and develop the market institutions as long as they perceive the market transactions as a sort of zero-sum game<sup>4</sup>, and hence fail to realize the advantages of market reallocation over the coerced redistribution, practiced by the arbiter. Such perception reflects the fact that rents rather than efficiency gains stemming from market competition are a prevailing source of high incomes of wealthy individuals in a rent-seeking society. Besides, efficiency losses from constraints on competition are intuitively unobvious, while the ones caused by the overappropriation, resulting from unconstrained competition for rents, are more easily visible. These factors legitimize arbiter's coercive control and coordination.

In turn, the inability to distinguish between rents and efficiency gains makes any kind of business income and accumulated wealth equally illegitimate, regardless of its source. Thus, the society fails to selectively discourage the rent-seeking behavior. Moreover, the people endowed with such a perception do not restrain the arbiter from preserving of a monopoly rent in favor of its clients, as described in Section 1. Both effects result in proliferation of the rent seeking.

Combining these arguments with above-cited description of a 'bad' equilibrium we state that a rent-seeking society led by a sufficiently strong arbiter is a self-sustaining system.

However, unlike the above-cited studies, our model demonstrates how the increase in cost of centralized control and coordination of economic activities (in turn, caused by technological and societal evolutions) deteriorates the arbiter's ability to preserve the sources of rents. On the other hand, as long as he formally preserves his power, the other societal mechanisms and institutions that are able to prevent overappropriation, remain suppressed, as mentioned above. Therefore, some part of economy becomes left out of any form of control and coordination at all. Such a "gap of control" leads to overappropriation of rents, hence to a crisis. The latter sometimes can be resolved by temporary restoration of authoritarian or totalitarian control and coordination. But if the process of decay gets too far, a reform enabling emergence of competitive market in certain segments of the economy becomes a "second best" for the rent seekers in power as long as they fail to control these segments anyway.

The described mechanism determines both the particular way in which the reforms in transition went out ("How?"), and their outcomes ("How well?").

In Section 2 we analyze the main institutional and politico-economic patterns of the late soviet society. We argue that the economic and administrative soviet elites were predominantly rent-seekers, tightly controlled and coordinated by power-maximizing arbiters, mostly associated with the communist *nomenklatura*. This approach helps identify the roots and nature of *nachal'niks*, "red directors" and "business-administrative groups" ("oligarchs") that played key roles in transition. We can also trace the connection between societal evolution and the deterioration of control: disappointment in the communist ideology undermined the legitimacy of the communist party, which was the main arbiter in charge of control and coordination.

We argue that the erosion of totalitarian control in the USSR that led to reforms started at least with Stalin's death, almost forty years before the market reforms actually began. This long-term decay, not the first wave of reforms (1992) itself, created a gap of control, which resulted in a deep initial recession, which we describe in Section 3. This gap was mostly closed in the second and third waves of reforms, which occurred in the years 1994-96 (Section 3) and 1999-2001 (Section 4) respectively.

We argue that the drastic nature of price liberalization in Ukraine was an inevitable outcome of avalanche-like destruction of the soviet system, rather than an implementation of some radical reformers' ideas. The reformers were called up to power in Russia and Poland because they were better prepared for implementing drastic but unavoidable measures. The Ukrainian government had to lift the price controls simultaneously with the Russian one regardless of its initial intentions. But in Ukraine the reformers were even weaker politically than in Russia, so the institutional and structural reforms were delayed. As a result, in the early 1990s in Ukraine a sort of "market

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<sup>4</sup> A sort of game in which the total pool is just divided between players, so the total sum of gains and loses is always equal to zero

socialism” emerged. Its main actors were state-owned enterprises poorly controlled by the authorities. While operating under free pricing, they still were subsidized by soft credits, open subsidies, and cheap energy imports. A five-digit hyperinflation and severe economic recession were outcomes of this arrangement. We attribute these events to an overwhelming political domination of “Red Directors” lacking the arbiters able to prevent overappropriation.

We show how overappropriation of the major initial sources of rent, primarily increase in relative prices of energy and exhausting of revenues generated from an “inflation tax”, brought about an authoritarian arbiter (President Kuchma) who managed to partly restore the control and coordination. But a full restoration (i.e., the return to the totalitarian regime) was impossible; and the Ukrainian *red directors* in mass appeared to be hardly manageable clients for their arbiter. So, Kuchma had to undertake the reforms, including monetary stabilization and mass privatization, even contrary to his initial intentions and electoral pledges.

We demonstrate how these reforms partly closed the gap of control by strengthening the property rights. Just like Yeltsyn, Kuchma became an arbiter of business-administrative groups, which had benefited from reforms *ex post*, though were too weak to undertake them beforehand. However, while succeeded in preventing a collapse, these measures appeared insufficient for jump-starting the economy. Instead they resulted in a sort of “virtual economy” (Ickes and Gaddy, 1998), an obscure arrangement pervaded with false accounting, non-payments, barter, budget arrears, and diverse other non-transparent procedures of payments needed to cover up rent seeking. It was supported by rents stemmed from irresponsible external borrowing, facilitated by paternalistic treatment of Ukraine by international donors.

But these external sources were soon exhausted (“overappropriated”) too, which caused the crisis of 1998-99, which brought about a third wave of reforms: fiscal stabilization and reduction of state paternalism towards the enterprises. These reforms resulted in economic growth and improvements in well-being of population. One can also argue that these events made the way to the Orange Revolution of 2004; however now it is still too early to make any confident statements.

We show that as a result of reforms the gap of control was mostly closed and the country has returned to the path of growth. However, the depth of this gap, and procrastination with necessary reforms at the late soviet times resulted in proliferation of temporary arrangements that largely contributed to creation of the Polterovich (2001) *institutional traps* preventing establishment of property rights and market coordination, thus further magnifying the social cost of the whole process of this dramatic change.

A main lesson from this exercise is that reforms can occur even if there is no major political force interested in them. They may appear chaotic, procrastinated, and incomplete, and thus failing to prevent the high social cost caused by the persistence of the gap of control. Yet, this may be the only way in which modernization of a rent-seeking society can proceed.

## 1. The Model

### 1.1. Problem of coordination in rent seeking society of Ukraine

Uncoordinated rent seeking leads to the overappropriation of sources of rent (“overfishing”), or waisting of rent for nonproductive fighting (as described by Tullock, 1980). Poorly controlled production assets (e.g., state-owned assets under a weak or docile government) become swarmed with parasite firms competing for stripping these assets. The state budget becomes overappropriated by interest groups. As a result, either inflation or overtaking is used to finance a budget deficit. This in turn deteriorates the tax base, as described by Tornell and Velasco (1992). So do the “mirrored” to those above described phenomena of tax evasion and lobbying for tax privileges studied by Kaufmann, et al. (1999). The uncoordinated monopolies, competing for their

shares in the total monopoly rent, set their prices higher, and the output lower, than a single monopoly does; so the deadweight loss from monopolization increases (Cournot, 1838)<sup>5</sup>

The well-established and allocated property rights could either solve these problems, or open the way toward an efficient allocation of ownership. But if these rights are weak or fuzzy, a socio-economic system, to be sustainable at least in a short run, needs some other source of coordination. For example, strong patriotic feelings, beliefs or other culture-related factors can restrain competition and set up some effective limits for the rent appropriation.

Ukraine has inherited another kind of coordination arrangement that we call the “arbiter-client hierarchy” that is described below in greater details. Here the coordination is secured by a third party player akin to Mancur Olson’s *stationary bandit*<sup>6</sup>, unable to extract the rent directly by himself, but instead endowed with a monopoly on coercive force. We call him an **arbiter** because he is empowered to (a) divide the “quotas” on rent *arbitrarily* at his discretion, and (b) enforce his decisions. Under these conditions, he is able to extort the rent collected by the other players (for example, through auctioning of quotas<sup>7</sup>), or trade some of it for their political loyalty. In such a way he becomes a paternalistic principal (patron) using the rent seekers as his agents (**clients**) “working” for him<sup>1</sup>. An arbiter acts like a landlord who owns<sup>8</sup> the rent sources but allows his clients to take away some rent as a reward for providing some gains for him.

In a rent-seeking society such arbiter-clients structures form a hierarchy, where every senior arbiter coordinates the rent seeking at his level, so the lower-level arbiters are among his clients, along with the rent-seeking firms of the respective level. This allows, at least potentially, for arranging of the control and coordination at all levels basing on similar principles embodied in the (patrimonial) societal norms.

## 1.2. Rent-seeking society as a system

Once empowered to control the sources of rent, an arbiter gets an interest and means to expand his power and to enhance his rent by suppressing competition (e.g., by enforcing the cartels) in other sectors. Noteworthy, in such a way he creates the Cournot’s complementary monopolies, and thus has to become engaged in the coordination of them. Proliferation of the rent seeking increases income inequality in the society as well as it undermines the property rights, so the competitive firms should oppose to it. In this struggle they might be supported by the impoverished population at large. However, as long as an arbiter coordinates the rent seekers, the need for an alternative coordination is weak. This can provide a partial explanation why the civil society remains weak under authoritarian and totalitarian regimes (as observed by Putnam et al., 1993)<sup>9</sup>. Also, as mentioned above, people tend to view economic activities as a sort of zero-sum game; the perception known in anthropology as a “limited good” case (Foster, 1965). This is a quite pervasive view which fails to distinguish between economic profits and rents. The former are stemming from competitive reallocation and efficiency gains, which increase incomes and the overall well-being. The latter are stemming from a forced redistribution of incomes and deepen income inequality.

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<sup>5</sup> Cournot considers two firms, one of which is a monopolist supplier of certain intermediate commodity, while the other one is a monopsonic consumer of this commodity, and at the same time a monopolist in production of certain final good (as rocket fuel and rockets). Equivalently, this model is applicable to several monopolies producing the complementary goods that have certain consumer value only in a particular combination (as rocket missiles and launchers). Both cases take place in highly specialized industries, for example the machine building and military production. He calls such firms “complementary monopolies” and shows that their merging (“vertical integration”) results in lower final prices and higher output, thus increases the social wealth.

<sup>6</sup> Olson (2000) argues that unlike a predatory “roving bandit” that undertakes plunder forays on his neighbors, a “stationary” one has an incentive to abstain from predation and even provide certain amount of public good to its homagers

<sup>7</sup> for example, allocating of the quotas to those players who offer him a higher share of rent, or higher fixed flow of rent

<sup>8</sup> In terms of residual rights of control and the cash flow rights – which not necessarily imply any title ownership.

<sup>9</sup> Of course, a weak civil society in its turn allows for proliferation of rent seeking, which is yet another feedback supporting a vicious circle of a rent-seeking equilibrium. The main question is, however, why the people do not get together in fighting the rent seeking.

As long as people view any above-average wealth as a result of a “theft” (except if it is legitimized by a reward granted by the authorities), they tend to tolerate the rent seeking. They see no virtues in market coordination in contrast to a coordination conducted by an arbiter. In absence of the latter they believe the market would simply reallocate the wealth toward a small group of business owners and speculators extracting the wealth from the rest of people in an uncontrolled way. They demand and expect a part of rent to be redistributed in their favor as a reward for their loyalty to the ruler. In such a way an arbiter gets legitimization, while the people become the rent seekers themselves. Moreover, the people do not oppose to suppressing of competition in the value adding sector as described above.

In their turn, firms are not interested in abstaining from the rent seeking, since their property is equally illegitimate regardless of its origin. Thus, even a “honest” firm cannot expect for any protection by the public against the abuses by an arbiter or even by another firm. The overwhelming majority of businesses seek rent as long as it brings positive returns (which it does in most cases), so the “perception of the limited good” becomes self-fulfilling.

These feedbacks make such political-economic system self-sustainable during a certain period of time despite its numerous deficiencies (in particular, described by Shleifer et al., 1993; Murphy et al., 1991). Moreover, this kind of system can reincarnate even after some of its components were removed. For example, if an arbiter disappears for some reason, but the rent seekers remain, nothing prevents from the uncoordinated rent seeking that soon leads to the exhaustion through overappropriation. If the public consciousness remains unchanged, another arbiter is welcome to “restore order”.

### 1.3. Reforms under rent seeking

By applying the Coase’s theory of a firm to a rent seeking society one can hypothesize that a rent-maximizing authoritarian ruler would impose his controls only as far as the gain (marginal rent) from an additional “unit” of control would exceed the cost of control. A power-maximizing totalitarian arbiter is budget-constrained: he can expand his control and coordination only while it covers the total cost. This optimizing principle and budget constrain would always leave some room for property rights and economic freedoms. Both existed to some extent even under the deliberately and ideologically totalitarian soviet regime.

But the extent of arbiter’s control tends to diminish with time. The long-term tendencies in public consciousness (like erosion in the patrimonial norms of obedience to the authoritarian rule and tradition) undermine arbiter’s control. Technical progress augments diversity of technologies and goods, increasing the cost of coordination and constraining its scope. The same tendencies aggravate arbiter-client difficulties, boosting clients’ bargaining powers in their negotiations with the arbiter. This, in turn, further diminishes his controlling powers and his capacities to prevent the overappropriation. As a “second best” strategy, the arbiter decides to abandon some of his controls. We classify such a move as the destructive phase of reforms. Notably, the reforms of this kind occur as an at least partly “passive” acceptance of realities (ineffectiveness of control and coordination), rather than a deliberate move towards a market economy.

An authoritarian arbiter is also interested in maximization of efficiency of the sector remaining outside of his direct controls, the residual value adding sector since this sector can indirectly contribute to his rent (see McGuire and Olson, 1996). Thus, a rent-maximizing arbiter would also deliberately promote partial market reform and emergence of some democratic institutions. This becomes the constructive phase of reforms. These two reform phases eventually downsize the rent-seeking sector.

We call such reforms *systemic* because while reaching certain critical mass they eventually change the fundamental balance between the rent-seeking and value-adding sectors, thus may undermine the system of rent-seeking society described above.

Sequencing of the above described phases is critical for success of reforms, and especially for social cost associated with escaping of a rent-seeking equilibrium. Many prominent scholars argue that the reforms to be successful should be designed in such a way that (in our words) constructive phase always precede the destructive one – which is, in turn, can be possible only if the reforms



are gradual (Dewatripont and Roland, 1992, Polterovich, 2001, Stiglitz, 1999, Roland, 2002, and many others). In addition to the obvious argument that the opposite sequence (i.e. destruction preceding construction) incurs inevitable social cost, they point out that special interests (Hellman's (1998) "intermediate winners") whose emergence these authors associate with destructive phase, impede further construction. Consequently, abrupt liberalization – hence, in terms of our model, removal of coercive control and coordination – can result in an "institutional trap" (Polterovich, 2001) that explains the phenomenon of partial reforms in transition. For this reason Stiglitz (1999) argues that reversing the sequence of the above-described phases of reforms, hence creating of the market institutions before lifting of administrative control and coordination, could prevent partial reforming.

Such an advice certainly implies a benevolent reformist government in power, which is hardly feasible in a rent-seeking society. However, even in this case there are numerous problems with implementation of such a "gradualist" strategy.

- The government may be not strong enough to overcome the resistance of those who are afraid to lose from such reforms, thus oppose to new institutions. Destructive phase may be necessary to weaken these interest groups.
- What the government can create are just formal market and democratic institutions that can be effective only when they are backed with the informal ones (North, 1990). The latter, in turn, emerge in response to the societal demand for them. This process takes time, and usually starts when the arbiter's control and coordination are formally removed (Paskhaver, 2003).
- Public consciousness formed under the rent-seeking society should undergo a time-consuming evolution in order to make the market and democratic institutions effective
- The government or a ruler may be self-constrained with certain ideological or cultural traditions (e.g. religion, communist ideology, paternalism, etc.) which, on the one hand, legitimize its power, but on the other hand may be inconsistent with market and democratic institutions. If it fails to find an ideological justification for reforms, such a government or ruler risks to undermine its own power by creating of institutions that could potentially crowd it out. For these reasons many attempts of authoritarian modernization failed despite the benevolence of their initiators

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But, the most important impediment is that a rational rent-seeking arbiter has no incentive to undertake the reforms proactively, hence before he sees his control and coordination abilities eroded. Still, a rational arbiter would undertake the necessary reforms instantly with the process of such erosion. However, in reality he tends to procrastinate them. First of all, reforms always involve a risk of failure, which may be significant. Even if an arbiter has no risk aversion, perceived losses associated with such a failure can outweigh expected gains, unless the crisis become inevitable.

Secondly, an arbiter operates with imperfect information, and not always can assess his real capacities properly.

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As a result, the reforms become delayed and partial. Consequently, certain sectors remain out of any kind of effective control and coordination for a while, so become subject to overappropriation. Such *gap of control* emerges **before** a systemic reform starts. Once emerged, it begets the informal rent-seeking practices (like corruption, smuggling or black market activities) and respective structures (like mafia).

These practices and structures typically reduce the discrepancy between the formal and actual institutional arrangements. For example, before the systemic reform occurs, they may partly compensate for the allocation failures with arbitraging. Interest groups associated with some segments of the rent-seeking sector may support the destructive phase of reforms, because they

expect to win from deepening of the gap of control caused by lifting of the remnants of arbiter's control and coordination. Yet such *intermediate winners*<sup>10</sup> (Hellman, 1998) indeed have vested interests in suspending of reforms after this phase, thus keeping them *partial*, just as the gradualists argue. But as our model suggests, gradualism does not prevent their emergence. The opposite, the longer the initial delay is, the deeper and longer lasting the gap of control becomes. In such situations the intermediate winners become stronger and solidify existing arrangements

However, their role is not just negative, because they possess a vested interest in reforms, at least in their destructive phase. Although this phase may further deepen the gap of control, it opens the way for development of the competitive market's players and institutions. Thus, initially the intermediate winners play a positive role by providing demand for launching of the reforms, but then make them stalemated in the 'bad' equilibrium. We further argue that equilibriums that have emerged in such a way **are unsustainable in a long run**. Unlike an arbiter, the intermediate winners are not encompassing,<sup>11</sup> therefore behave predatorily. They lack the internal mechanisms of coordination and their rent seeking activities are in effect constrained by the arbiter. If the alternative sources of coordination, such as civil society, are weak (as they are under the arbiter's rule), nothing prevents intermediate winners from overappropriation of rent. The resulting crisis weakens the intermediate winners; while making an arbiter interested in implementation of the constructive phase of reforms. Thus, in-line with Drazen and Easterly's (2001) findings, crisis does facilitate completion of reforms.

Still, an arbiter is interested in suspending of the further reforms as soon as the particular crisis of overappropriation is overcome. For this reason, each crisis results in a new temporary rent-seeking equilibrium (such as the ones described by Sonin (2002), Polishchuk and Savvateev (2000), Hoff and Stiglitz (2004), or Polterovich (2001)). But any incomplete set of market institutions is unsustainable, so a new crisis comes soon. Subsequent crises and respective systemic reforms come one by one as a chain reaction. This process goes on until the rent-seeking sector contracts far enough that the market control and coordination become dominating; so the competitive market sector can become a basis for the pro-market and pro-democratic political forces.

The constructive phase of reforms produces immediate welfare gains, and therefore can become popular. In this way the systemic reforms can get an *a posteriori* public support resulting from a sort of learning-by-doing process. Eventually an active civil movement emerges which supports the property rights, market competition, and democratic controls over the state. Starting from this point, the public's vote can become an engine for further reforms. The reform supporting forces become proactive, so the new institutions, which already emerged in the market sector, can start further crowding out the arbiter's control and coordination with no gaps of control.

#### 1.4. Hypotheses

1. Economic reforms can occur without a public mandate. They can be driven by the interplay of rent-seeking interests.
2. In a rent-seeking society, diminishing of rent (manifesting itself in economic crises) eventually promotes expansion of the competitive market sector, strengthening of the property rights and the rule of law, and indirectly facilitates democratization.
3. Social costs of changes are determined mostly by the depth and longitude of deterioration in the direct control and coordination, which precede the reforms. The longer the procrastination of reforms is, the higher costs of reform become. The faster the market

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<sup>10</sup> We will use this term to denote the set of players involved in the above-described informal rent-seeking arrangements and practices, thus interested in deepening and prolongation of the gap of control. However, unlike Hellman (1998), Polterovich (2001), and other scholars of post-Soviet transition representing the same line of thought, we emphasize that the true source of rents begetting the intermediate winners is not the destructive phase of reforms itself, but the gap of control created by procrastination in these reforms.

<sup>11</sup> Olson (1980) argues that the larger is a rent-seeking player or a group, the greater share of social losses from the rent seeking it encounters. For this reason, an encompassing player has an incentive for self-restraining, because it becomes concerned with preserving of its sources of rents. On the contrary, each of the smaller players or groups normally can appropriate as much rent as it is able to extract, without suffering from the externalities it creates. Therefore, as itself it can afford ignoring the damage it incurs, and has no reason for self-restraining.

institutions of control and coordination emerge, the lower the social costs are. Thus, (1) delayed, slow and inconsistent reforms are more costly; (2) the availability of rent (as the “curse” of natural resources) can increase the social cost of reforms unless this rent goes directly to the broad population.

4. External factors (like foreign aid) facilitate the reforms when and where they help strengthen the property rights and competition, and restrain the rent seeking. But they can also do harm when providing the authorities with sources of rents that can be used as a substitute to reforms.
5. Reforms can lead to the immediate gains (and thus can become popular) to the extent to which they establish universal protection of the property rights, promote the market reallocation, competition, etc., and improve the public (democratic) control over the natural rents<sup>12</sup>.
6. Evolution of public consciousness largely determines the course of reforms. Particularly, deterioration in the patrimonial norms supports reforms while a “zero-sum” view of the economic activities hampers reforms. Together these factors indirectly determine the social cost of changes.

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<sup>12</sup> Gylfasson (2000) argues that public control, usually exercised through a democratic government, is the best way of dealing with rents stemming from natural resources. In terms of our model, such kind of control replaces an arbiter in his crucially important social role of preventing of the overappropriation, and therefore effectively prevents from the very emergence (or re-emergence) of such an arbiter. However, in distinct to the arbiter, ideally the public control confiscates the most of rent to the benefit of society as a whole.

## 2. Dissolution of USSR and first wave of reforms in Ukraine

### 2.1. Soviet variant of arbiter-clients system

The soviet state was a specific kind of arbiter-clients system. Its main informal institutional features persisted over time and largely shaped the institutions of post-soviet period.

Soviet legislation was based on the “zero-sum” views on society, polity, and economy. Market transactions, partly except retail, were prohibited and replaced with administrative distribution; the connection between officially regulated wages and contribution to creation of value added was weak.

Thus, in our definition the USSR was a follow-out rent-seeking society. Yet, the rents were rarely monetized, and inequality usually associated with rent seeking was quite low due to the totalitarian (hence, power-maximizing, in our terms) nature of the system. The most of rent was traded for loyalty of the critically important social groups<sup>13</sup>, dissipated for coordination and control; and used for maintaining and increasing of the military power.

But the control and coordination of such all-embracing rent-seeking sector appeared infeasible from the very beginning. The communist regime could not coexist with any substantial market sector, because the latter have been “permanently begetting the capitalism” (Lenin) by questioning the necessity of central planning. In accordance with Russia’s deep-rooted tradition of “soft” rule of law (Dubrovskiy, 2006), soviet legislation was often impracticable (excessively severe, obscure, and internally inconsistent), or ambiguous. As long as everyone has to break the law, everybody should be penalized – which was of course unfeasible. Therefore, the law can be enforced and implemented only at the discretion of state executives (*nachalniks*), who, in distinct to Weberian bureaucrats, have discretionary power (*vlast*) making them **arbiters**, while those subject to this power became **clients**.

“Soft budget constrains” (hereinafter – SBC) (Kornai, 1986) were the most important economic manifestations of the “soft” rule of law. The state endowed the enterprises with investment funds and other kinds of resources on the basis of plan tasks they were required to fulfill, regardless of their capacity. Such paternalism towards the enterprises contributed to vague and asymmetric property rights: while the people formally held the “title” to all of the property, and bore the losses, the residual rights of control were seized by *nachal’niks* and directors of enterprises (Boycko, Shleifer, and Vishny, 1995). Because such an arrangement was essentially informal, the actual allocation of control rights was obscure, thus subject to permanent “hierarchical bargaining” (Gaidar, 1999).

In turn, the soft rule of law is unsustainable without an effective arbiter-client hierarchy, because vague and asymmetric property rights typically result in overappropriation. Furthermore, by Klitgaard (1988): “monopoly + discretion – accountability = corruption”. The latter undermines control and coordination. As the monopoly and discretion were essential parts of the system, accountability was crucial for its survival. In the absence of democratic oversight and “checks and balances”, which were inconsistent with the ideology, the accountability was secured by the Communist party.

Its leaders of respective levels were put in the positions of arbiters in hierarchical bargaining and scrutinized the consistency of discretionary decisions with the communist ideology. At the same time, they were personally responsible for the fulfillment of plan tasks at their territories (nonetheless they did not have any production facilities in their direct disposal!), and accountable to the higher-level Party leaders. In such a way, digressions from Marxism-based regulations that were vital for the survival of soviet system (Smith and Swain, 1998) were kept under informal control. From another perspective, this made the pseudo democratic lawful state just a cover-up for

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<sup>13</sup> as the workers in defense industry that earned twice as much as an engineer; or the coal miners that earned four times as much

actual arbiter-clients hierarchy. Communist ideology provided a universal normative basis for all levels of this hierarchy and ensured total domination of the same ideological values within the society, hence secured the legitimacy of power.

Control over the appointments was the main instrument for above-described ideological control. The Communist party officials were the main kind of arbiters at each stage of hierarchy, because they had the veto right on the promotions and demotions of all other *nachal'niks* of the same level of *nomenklatura*. While the formal criteria for promotion were opaque, controllability based on *compromat* – the files of violations, and other facts that can be used for blackmailing – was one of the main factors. Such files were kept on all *nomenklatura* members, and used as a stick for making them obedient.

Flagrant violators, as well as fully law-obeying individuals, or the ones just insufficiently loyal to the boss, were rarely promoted. Some lawbreakers were waived and promoted if they were able to convince the Party leaders that their violations were aimed at “common good”, while they personally got no benefits. Meanwhile, limited abuses of power were tolerated in order to make the power-maximizing (precisely speaking, *vlast'*-maximizing) strategy rational for *nomenklatura* members, even despite relatively modest formal material rents it brought. So, *nomenklatura* was largely composed of risk-taking individuals, although used to deal with the administrative instead of business risks. While some degree of risk-taking was absolutely necessary for economic development, it has further reduced the controllability based on fear. Thus, the gap of control has emerged from the very beginning.

It was filled in with all-pervading informal interpersonal *blat* (Ledeneva, 1998) networks of reciprocal exchange with “favors” of access to the goods and services in short supply; career opportunities; and even the resources and facilities needed for exercising of the official roles (e.g., material supplies needed for the plan fulfillment) (Smith and Swain, 1998). Since such transactions, as the favors themselves, were often illegal, *blat* networks were needed to substitute the rule of law in reducing of the transaction costs.

The main interest groups of the late Soviet society - *nachal'niks*, *khosyaistvenniks* (particularly, *directors*), underground, etc., as well as their roles before and after the crash of Communism are described in details in the Appendix. Their coexistence was secured by a specific sort of “tacit social pact” on the mutual tolerance to rent seeking between *nomenklatura* and the rest of society: “we do not impede *them*, *they* do not impede *us*”. For example, the workers of a plant or *kolkhoz* as a rule did not complain to police for the asset shading and other misuse of state property by the directors, while the latter used to tolerate petty theft by the workers, provided that it remained within certain vaguely defined limits. Just as many other kinds of informal arrangement, such a social pact has survived the crash of Communist ideology and can be observed in the modern Ukraine, although to much lower and steadily diminishing extent. Due to a number of reasons that we are going to address in the forthcoming work, the communist ideology steadily eroded, and control capacities of soviet system started perishing soon after Stalin's death. At the same time, technical progress aggravated both the principal-agent problem (due to increase in the information asymmetry that was especially severe in the absence of market pricing), and the problem of centralized coordination. With erosion of centralized control, the directors have been gradually seizing the residual rights of control over their enterprises, and uniting against the arbiters, mostly the Party leaders.

## 2.2. Dissolution of the USSR, and price liberalization

As a result of deteriorating control and coordination, the economic difficulties in USSR tended to aggravate. The crisis was postponed for a decade or two by the large state revenue from exports of oil and gas. But sharp decrease in rent brought about by the decrease in oil prices, Afghan war, arm race, and other factors in the 1980<sup>th</sup>, along with the notorious inefficiency have ultimately made the totalitarian control and coordination unaffordable. Meanwhile, rents provided by the widening gap of control became lucrative alternatives to the ones officially granted by authorities, which gradually altered the incentives. In the early 1980<sup>th</sup> the societal values based on communist ideology further eroded, so the ideological reasons were unable to constrain the rent seeking and paternalism. In 1981, only about 5% of the Ukrainian population admitted the political and ideological values as important ones, while the material wealth, interesting job, and family values became prioritized (Golovakha, 1988). Given the role of the communist party and its ideology, such a shift in public consciousness made the collapse of the USSR just a question of time<sup>14</sup>.

According to an opinion poll, in 1990 the population at large supported the market reforms and institutions, including the private property, competition, etc. (Golovakha and Pakhomov, 1993). In January 1991, 48% believed that they would be better off if they would live in a Western country than they are now, while only 4% were afraid that they would be worse off. Noteworthy, the price liberalization did not enjoy much support.

The weakening Soviet state became unable to secure the supply of goods and services under the administratively set prices. Trying to fill the gap between demand and supply, Gorbachov has finally started downsizing the rent-seeking sector by allowing small private firms ('cooperatives') in 1987. But along with increase in supply of consumer goods and services, some of the new entrepreneurs (mostly those well-connected to *nomenklatura* through *blat* networks) started to gain from arbitrage that further aggravated the distortions. At the end of 1980 the forced savings reached 170-190 billion rubles, close to 20 percent of GDP and around one third of the existing financial assets (Cottarelli and Blejer, 1991). Through all of the USSR the distribution of goods increasingly concentrated at the black market.

When the *nomenklatura* members in mass realized the inevitable decay of totalitarian regime, most of them<sup>15</sup> started a sort of yardstick competition for the access to rents and sources of real power that left out of the decaying arbiter's control. While the top-level *nachal'niks* lacked resources to preserve the totalitarian power, their clients fought for emancipation. Finally, the lost of confidence in the future of Soviet system as such, and respective shortening of the time horizon for *nomenklatura* officials resulted in abrupt breakdown of hierarchies akin to a "bank run" (Solnick 1999). All these processes led to the avalanche-like destruction of the whole system of centralized control and coordination. The main collective totalitarian arbiter – the Communist party – was dissolved and banned after the defeat of GKChP coup d'état attempt in August, 1991.

Abandoning of the communist ideology opened a way for the official lifting of the remnants of ineffective arbiter's controls and coordination, primarily the price control and central planning. But no pro-reform coalition was in place in Ukraine by the end of 1991. Among all, the policymakers feared that reforms will hurt the integrity and independence of Ukraine that was not a mature political nation at this time. The directors that have just got rid of communist control behaved rather cautiously. Escaping from the Russian radical reformers (and, plausibly, the Russian "Kremlin capitalists" that were much stronger than their Ukrainian competitors those times) was the main genuine reason for Ukrainian *nomenklatura* to join the nationalists in their aspiration of independence<sup>16</sup>.

<sup>14</sup> All three Soviet leaders of the after-Brezhnev epoch tried to reverse this trend, but failed.

<sup>15</sup> Except those who stick with the failed ideology, and desperately called for harsher control that was already unenforceable those times

<sup>16</sup> Ironically, as an independent state lacking the easy-to-extract natural rents, Ukraine has much better long-term perspectives of establishing the competitive market and democracy than Russia does.

The newly elected president Leonid Kravchuk, the former First Secretary for the Communist party of Ukraine, was an outspoken opponent of Yegor Gaidar's "shock therapy" in Russia. However, his power was not nearly as strong as it used to be. At the maximum, he could become an authoritarian arbiter, because no source of legitimization of totalitarian power was in place. But even in this role he was weak: Institutionally, he could fire a prime-minister or appoint key enforcement and economy ministers only with the consent of the parliament. Nevertheless, by the end of 1991 deterioration of control and coordination went so far, that he had to undertake the first wave of reforms (which, in our case, coincided with the destructive phase described above) regardless to his own views and intentions.

Most consumer goods were rationed since October, 1990 with the means of special coupons that one had to add to cash payment in order to make it valid. Furthermore, when similar factors caused a real threat of famine in Russia, its authorities had no choice but allowing for the lifting the state control over prices on majority of goods and services altogether. In Ukraine the situation was not that much severe due to relatively better-performing individual agriculture production. But when the prices in Russia were freed, the Ukrainian government had no choice than following up with the kind of "passive" destructive-phase reform. On December 27, 1991, the Government Decree "On the System of Prices in National Economy and Consumers' Market of Ukraine"<sup>17</sup> was adopted. There was no other way to prevent the outflow of goods: the country had no economic borders, no own currency, and the production was dependent on components from throughout the USSR.

Similarly, Ukraine has to follow the trade liberalization that was introduced in Russia in order to alleviate shortages and price increase caused by monopolization of the economy. In Ukraine both reforms were not that radical, and thus granted more rent-seeking opportunities to the members of *blat* networks connected to *nomenklatura*. The Cabinet of Vitold Fokin tried to keep control over the prices on "critical" goods and services (foodstuffs, utilities), and "strategic" commodities, as fuel (Dabrowski, 1994). Such mixed policies continued until December, 1994. However, these attempts did not have any observable effect on actual prices, because the control was already ineffective.

Directors appeared the main winners of this wave of reforms. Liberalization just reflected *nachal'niks'* (as arbiters') failure in exercising control and coordination over the enterprises. There was no even a whole-national register for business entities, so a number of enterprises that were previously subordinated directly to the central ministries remained "undiscovered" for a year or more. Since the population was also not ready for collective actions (unlike, for example, Poland where Solidarnosc took control over the enterprises), *khosyaistvenniks* (primarily, the *directors*) have emancipated from any kind of control. They have finally seized vaguely limited residual rights of control, and even, to some extent, the disposal rights. Meanwhile, title property rights, and respectively the formal cash flow rights, still belonged to the people. Moreover, being state-owned, the enterprises remained subject to vast state paternalism.

Such asymmetry in the property rights meant that directors were in position of gaining the rents while being virtually irresponsible for the externalities they created. Furthermore, their position in charge of real assets made them the most powerful players of those times having overwhelming economic and political power. Their influence on the employees, was augmented with vast representation in the Parliament<sup>18</sup> and informal influence on decision-making. But nonetheless they comprised an allegedly "encompassing" (Olson, 1982) group, *khosyaistvenniks* behaved predatory, because they were not organized enough to prevent overappropriation. Also, no new arbiter was able to coordinate them at that moment.

Consequently, they engaged in the unconstrained competition for rents stemming from three main sources: cheap Russian energy (oil and especially gas); paternalistic treatment of the state (docile to the demands of directors, and partly controlled by them directly); and monopoly power.

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<sup>17</sup> It worth noting that the same legislative documents have frozen the households' deposits in order to alleviate the "money overhang".

<sup>18</sup> According to Haran' and Mayboroda (2000), directors along with the heads (actually also directors) of kolkhozes, and the workers, comprised the largest component (39.1% of sits) of the communist majority in the Ukrainian Parliament before 1994. They also could influence a second largest group of "*nachal'niks*" (former CPSU's and executive leaders) that occupied almost 35% of sits. Thus, even while formally being in minority they were able to pursue their interests through a sort of "leverage" mechanism of control akin to the one that is used in large business holdings.

### 3. Second wave of reforms: disinflation and privatization

#### 3.1. Crisis of overappropriation: why the gap of control was not closed?

The crash of communism along with consequent price liberalization opened the way of immediate closing the gap of control with market institutions. Weakness of the official elites along with the bankruptcy of its ideology, and avalanche-like decay of centralized control in 1990-91 seemingly gave a chance to the market-oriented and democratic counter-elites. Why both market institutions and new elites remained weak despite seemingly high demand for them?

The people were not ready to use the democratic institutions that were formally established. They lacked the social capital, and considered the state as a patron, rather than a mediator of the common interests. Respectively, they expected its protection and help, while being reluctant to provide anything in turn, and even considering it as an enemy subject to fraud – because it does not provide as much support as it allegedly should.

Although the people at most denied the communist ideology, they were not yet ready for the consecutive and comprehensive market reforms able to substitute the centralized control and coordination with private property and market competition (Ryvina, 1998). No direct measurements were done, but the indirect empirical data suggest that “zero-sum” perception was strongly dominating. In 1991 84% respondents in Kyiv (a 3 millions capital city!) considered necessary to strengthen the “fighting the non-labor incomes” (*netrudoviye dokhodi*). Among the categories of the latter, bribing was named as the most harmful by only 15%, drug dealing – by 17%, while “speculation” (arbitrage trading with goods) took 25% - perhaps, due to the fact that under the regulated prices such a business was essentially rent seeking. 17% of respondents blamed the “cooperators” (private entrepreneurs allowed by Gorbachov in 1987) for “braking the perestroika” (Golovakha and Pakhomov, 1993). In 1993<sup>19</sup>, 63% respondents supported the idea that the salaries should not be restrained with any upper limit, while only 19% agreed to allow the unlimited entrepreneurial incomes. Golovakha and Pakhomov (1993) interpret this fact as follows: the salaries were considered as set “fairly” by the State, while the entrepreneurial incomes were perceived as stemmed from redistribution.

Therefore, the broad population was not ready to mandate the second phase of reforms. But neither were the rest of major interest groups (see Appendix). Moreover, among these groups only directors appeared organized enough to assert their common interests, yet short-sighted and mercenary according to their subculture. But they were exactly those intermediate winners that benefited from the gap of control, thus interested in procrastination of the further reforms.

In particular, directors, as well as BAGs (see Box 1), took advantage from asymmetry in the initial trade liberalization: negligible prices on energy were maintained, while exporting of the output at World market prices was allowed. The respective rents roughly proportional to the share of energy in total costs of inputs have created the typical Polterovich’s “institutional trap” as described in Babanin, Dubrovskiy, and Ivaschenko (2002). As a result, the energy-intensive industries became subject to paternalistic treatment to such extent that allowed them for increasing their share in total output despite the negative price shock (ibid).

#### **Box 1. The business-administrative groups (BAGs)**

Instead of breaking up the arbiter-clients hierarchy, the incumbents have re-arranged, incorporated some selected new members, and during the first post-Soviet years re-structured into the business-administrative groups (BAGs) (Turchinov, 1997) at all levels of this hierarchy.

A BAG is a product of evolution of a *blat* network constituted of *nachal'niks* and rent seeking businesses closely interrelated with each other. They have much in common with clans, mafia, oligarchs, and other forms of patronage. However, unlike clans, they are organized rather on the ground of reputation, cronyism, and cover-up, than the family links (although the latter also matter). Nonetheless many people identify them with mafia the BAGs rarely conduct explicitly criminal activities, though sometimes include or employ the criminals. Respectively, there is no formal

<sup>19</sup> Unfortunately, we failed to find any earlier data that are most probably non-existent. In 1993 the responds could be already influences by the experience of the first years of transition.



inception (*omerta*), the rules and norms are vaguer than the “code” of the criminals is, and they significantly vary from one group to another.

The BAGs are often referred as oligarchs, or the financial-industrial groups. But the essence of their competitive advantages is not in just large capital, or uniting of the financial capital with industrial assets, but rather in uniting of the *vlast'* of *nachal'niks* with the opportunities of converting it into the material rents. The BAGs not just collude with some government executives from time to time on ad hoc basis, but incorporate them as their senior partners, or even have them as bosses<sup>20</sup>.

BAGs provide alternative sources of rent for the *nachal'niks*, criminals, and other categories of post-soviet elites lacking direct access to the property. At the same time, they provide control and coordination (including vertical integration) for the enterprises they unite. At the regional and local levels they can be encompassing. But an arbiter of such a group meets the same problem of coordination and control, thus the larger the scale, the more internal instability and the higher cost of coordination. As a result, the BAGs tend to split up when they overgrow certain size.

Notably, all major BAGs but one emerged at the Eastern Ukraine where accessible sources of rent are combined with discipline of proletarians and the Russia-like “mobilization culture”. Being more flexible and suited for the market competition than the directors were, the BAGs by the end of 1990<sup>th</sup> have mostly (but not completely) crowded out or subordinated the directors, and became the main political-economic players. However, competition between BAGs rarely takes place at the open market: just as directors, they use to compete for rent using administrative levers.

The most powerful nationwide BAGs appeared in the energy-intensive industries<sup>21</sup>.

The domination of BAGs made the Ukrainian economy “insider-oriented” (World Bank, 2004). Such closeness obstructed the competitive selection and FDI. Meanwhile, it prevented the massive expansion of the Russian oligarchs. Also, the BAGs has consolidated the industries, restored the vertical integration, and arranged the enterprise restructuring. Still, they limit the internal competition, and have bounded capacity in improvement of management.

No party or movement supporting the **liberal democracy** and market economy as such, without the nationalistic ideas (often opposing to these values) has ever got significant political influence<sup>22</sup>. In 1991, Wyacheslav Chernovil, the Presidential candidate of Rukh (the national-democratic movement somewhat akin to the ones in the Baltic countries, but with vague economic program) has yielded only 13% of votes. **Directors** used to “settle the problems” at the level of executive, so they have established their own party only at the end of 1990<sup>th</sup>, when they have already mostly lost their influence. However, some of the most entrepreneurial and wise representatives of this group used their informal political influence and parliamentary votes for supporting the price liberalization and initial privatization.

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<sup>20</sup> Since the BAGs are closed formations with unclear and non-transparent structures, we know little about their internal mechanisms, and the information revealed on public may be misleading. For example, some observers believe that the true leaders of the main BAGs are criminal authorities that keep behind the scene. Unlike the Russian FIGs, only one or two of the first-rank Ukrainian BAGs are organized around a big bank. Instead, they always had their representatives as ministers, governors, and key persons in the law enforcement agencies, not to mention the Parliament deputies. For example, in the Ukrainian government of 2004, the Prime-Minister Yanukovich represented the “Donetsk” BAG, the head of Presidential Administration Medvedchuk represented so called “Kyiv 7”, or SDPU(o) BAG; and the head of Interpipe BAG Pinchuk was a son-in-law of the President Kuchma.

<sup>21</sup> Detailed analysis of the major BAGs is provided by Verkhovodova (2004)

<sup>22</sup> the so called “Liberal party” in fact has nothing to do with the genuine liberal values and serves mostly as a political wing for one of the middle-sized BAGs. The Reforms and Order Party founded in 1996 is usually considered the most pro-reformist one, although by no means liberal, because it does not support business deregulation and tax cuts, nonetheless it includes some of the prominent politicians with the reputation of reformers (V.Pynzenik; S.Teryokhin; V.Fylenko, T.Stets'kyv and others). But this party has never got a rating beyond few percent points.

**The lefts** opposed to reforms under the slogan of “fighting oligarchy”. Ironically, since totalitarian control was already lost forever, this resistance de-facto helped the intermediate winners in preserving the reforms partial<sup>23</sup>.

The rest of major political parties were the political wings of certain BAGs, or “parties of power” composed of *nachal'niks* and their clients not necessarily sharing same ideology or political platform. They had neither clear ideological position, nor permanent electoral basis. Nevertheless, such parties had a majority or near majority in the Parliament since 1994.

Therefore, the beginning of second phase of reforms was procrastinated for three years, which led to further overappropriation of rents resulting in economic decline and hyperinflation in the first half of 1990<sup>th</sup>.

### 3.2. Inflation

At least initially, inflation was driven by the producers' aspirations and markup pricing, which were later supported by the government with the monetary emission.

Although by the end of 1991 the monetary overhang amounted for about two thirds of private consumption (Dabrowski and Antczak, 1995), just for the first month of free prices and without any substantial monetary emission the CPI hit 286,2%, hence almost twice as much of this overhang. Such initial “jump” was evidently too high to be explained by the excessive demand only, giving that the deposits were frozen. We attribute it to massive breaking-up of coordination of the complementary monopolies<sup>24</sup>.

In full accordance to the theory (Cournot, 1838), it led to sharp increases in prices, accompanied with the fall in output further aggravated by “disorganization” (Blanchard and Kremer, 1997, see next subsection for discussion). This was a painful shock, but not a hyperinflation yet. However, when increases in stocks compelled *directors* to cease the production, they blamed “scarce demand”, and appealed to the government for the monetary expansion under pseudo-Keynesian arguments. Of course, despite some superficial similarities, the situation had nothing to do with true “demand restrains” or downfall phase of a business cycle.

According to Vladimir Lanovoy, the market-oriented Minister of Economy in those times<sup>25</sup>, during a few months of 1992 the Ukrainian government resisted the pressure of directors, but soon had to start the emission according to the law adopted by the Parliament, where the directors in fact dominated. Unsurprisingly, paternalism has just stimulated large-scale rent seeking and further advanced price increase, because the complementary monopolies become engaged in devastating competition for shares in the total monopoly rents at the markets of final goods.

Initially, the markup pricing supported by monetary emission was beneficial for enterprises (and hence, directors). However, very soon many of them realized that their enterprises are so inefficient that under the market pricing could not cover even their material input costs<sup>26</sup>. Besides, they have seen their liquid assets devalued due to inflation tax, and started pressing for credit emission. According to research of Babanin (1994) and Kravchuk (1998), cheap and “soft” credits to enterprises that along with off-budget subsidies amounted to around 16% of GDP (Kravchuk, 1998: 14) were the primary source of the 1992 to mid-1993 price surge. At the same time, Kravchuk (2003) still attributes the inflation to the necessity of financing of the budget deficit<sup>ii</sup>.

However, in 1992 the budget deficit (including the Pension Fund) was 6.3 millions UAH, but National Bank's credit to the government increased by 17 millions UAH. The money base meanwhile remained at the level of just 6 million despite the negative interest rate. In 1993 the

<sup>23</sup> For instance, “strong role of state in the economy” provided *nachal'niks* with bribe extortion possibilities. Suspension of a moderate Land Code allowed former kolkhoz heads in most cases to control situation in the agriculture. “Support for the national producers” was a ready justification for cheap credits that were not to be returned, tax exemptions, protectionism, etc.

<sup>24</sup> Enterprises chose to maintain excess demand for their goods and see prices for their products rising – just as the monopolies do (Sundakov et al., 1994).

<sup>25</sup> the personal interview.

<sup>26</sup> Some estimations are provided by Aslund (2002).

deficit was 85.1 millions, the credit to the government increased by 96 million, the money base went up for 263 million. This means that the emission was mainly used not to finance the budget deficit, but for different needs, mainly the provision of soft credits.

Wages were strictly regulated, and their indexation was limited by the law to 80% of the growth of CPI. In 1992 the increase of producer prices (42.2 times) was twice as large as the increase of consumer prices (21.0 times)<sup>27</sup>, thus inflation was not demand-driven. Unsurprisingly, wage restrictions did not prevent the acceleration of inflation, while contributing to massive impoverishment. Although this effect was somewhat alleviated by the “soft” rule of law, in 1990-93 real wages dropped by 44%. In the meantime, despite obvious inefficiency, the high costs of the so called “breaking the business ties” with the rest of the former USSR, and high inflation, the share of profitable enterprises was above 90% in 1992-93, while during the whole forthcoming decade it was about 50%. Under the severe depression, priority was given to upholding of the investments rather than consumption: despite more than twofold decline of the official GDP from 1992 to 1994, the share of investments in GDP remained nearly stable and very high, about 35%. Therefore, paternalism toward enterprises, not a broad population, was the main inflationary factor driven by the directors and acted through the monetary emission in support of markup pricing.

The five-digit inflation of 1992-94 was probably the most notorious episode of the history of economic reforms in Ukraine. The prices have increased more than a hundred times for a single year of 1993, which was a world's record for this year among the countries not engaged in a war. The household deposits frozen at the State Savings Bank have almost<sup>28</sup> vanished<sup>29</sup>. Meanwhile, Leonid Kuchma, who was Prime Minister in 1992-93 gained political support among the directors.

### 3.3. Economic decline

Just as inflation, the official GDP decline (almost 60% cumulatively) in Ukraine was the highest among the post-soviet countries not engaged in wars. Its overwhelming part occurred in 1992-95. In 1993 the retail trade of consumer goods diminished by almost 52% compared to 1990. While in 1990 retail trade was dominated by non-food products (about 56%)<sup>30</sup>, in 1993 these products constituted only 39%<sup>31</sup>. These changes were to a large extent an effect of declines in households' incomes.

These declines began in 1991 or earlier, hence preceded the reforms. Its long-term cause, the **gap of control**, emerged and was widening for several decades. Two important factors stems from our model.

**Breaking-up of the complementary monopolies that constituted the most of industrial sector.** In-line with the Cournot's model of complementary monopolies (see Section 1.1., footnote #7), it led not only to one-shot price increase mentioned above, but also to respective reduction in output. The monetary expansion further aggravated this fall. Blanchard and Kremer (1997) associated this component of decline with “disorganization” caused by increased transaction costs, information asymmetry, and the like problems. Although such factors were in place too, they were alleviated by the *blat* networks that allowed not only for quick recovering of many production links, but also for a successful organization of complex multilateral non-monetary transactions. Restoring of production links in 1992-95 did not lead to recovery of output, what could be expected based on the Blanchard-Kremer (1997) hypothesis.

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<sup>27</sup> the average monthly change in CPI constituted 28.9% (here and after in this part – according to UEPLAC), while for the PPI the same indicator was 36.6%. The described discrepancy might result from adjustment of the relative prices. However, at this time the energy prices remained negligible. Moreover, the magnitude of total initial distortion is estimated by Aslund (2002) as 40% for 1990. At the meantime, just during 1991 the consumer prices increased by 23%, while the producers' ones – by 55%, so this distortion should be mostly eliminated by the end of 1991.

<sup>28</sup> decreased in value from USD163 in 1990 to USD2.40 in 1993 (the World Bank Poverty in Ukraine, June 27 1996. World Bank, page 8.).

<sup>29</sup> Here it is necessary to mention, that the reduction of deposits value might be less drastic as indicated by the above figures, because their real value was already close to zero in 1990 due to the fact that these bank deposits were not properly backed by the supply of goods and services.

<sup>30</sup> This high figure should be at least partly attributed to the treasuring of devaluing rubles in the durable consumer goods

<sup>31</sup> These figures should be taken cautiously due to the high and hardly estimated share of the unofficial sector.

**Massive embezzlement and “tunneling” of assets of state-owned enterprises enabled by vague property rights.** Enterprises lacking owners’ control became a source of rents for the rent seekers. From the anecdotal evidence we know that the SOEs were swarmed with intermediaries (mostly established by the *directors*, but also sometimes imposed by the *nachal’niks* or criminals) that served for assets’ shedding. Perhaps, the most flagrant affair was the one of the Black Sea Shipping Company (BLASCO) that has leased the most of the Ukrainian ships for low rates and eventually lost almost all of them in favor of some suspicious firms.

In addition,

**The most of directors appointed during the Soviet epoch were gravely inefficient managers** (see Appendix) under the market conditions. But no effective and capable owner was in place to replace them with more appropriate persons. Being used to operate under the SBCs, they also rationally allocated more efforts for lobbying than for production.

Privatization was necessary (though not always sufficient) condition for solving these problems. But the *directors* benefited from the asymmetry in property rights that allowed them converting public losses to private benefits. They were also afraid of losing their control over the enterprises, and thus their formal and informal powers, which protected them from criminal prosecution. The harshest foes of privatization were *nachal’niks* not incorporated into any BAG (particularly those representing the government bodies in charge of state-owned enterprises). Although already weakened by liberalization, they remained quite influential<sup>32</sup> and successfully opposed, together with leftist bloc, any legislative initiatives aimed at privatization.

The most entrepreneurial *directors* supported the insider-oriented privatization of some enterprises through a leasing-buy-out scheme and used it for taking over their enterprises officially. But the mass privatization was postponed for more than three years.

### 3.4. Disinflation: initial attempts

Ukrainian government did not try to combat inflation<sup>33</sup> until the inevitable overappropriation of inflationary rents put the disinflation on the agenda in the late 1993 (Kravchuk, 2003). At the final stage inflation devalued the enterprises’ liquid assets, so the directors eventually became interested in disinflation. But unlike the problem of lobbying for the monetary and credit emission, now all of them were receiving individual benefits from “soft” crediting; so the problem of collective action became much severer. Meanwhile, President Kravchuk as an arbiter was too weak. It looks like he tried to lean on the other groups, interested in disinflation, but mostly failed.

Those times the BAGs became interested in expanding their control over the enterprises, hence, in the general weakening of directors. Unlike directors, the BAGs were flexible enough to shift to other sources of rents and to locate their capitals in tax heavens, which made them less vulnerable to disinflation. Therefore, in spirit of the Tornell’s (1998) model of “reform from within”, they would support reform. Moreover, using their links to authorities and criminals they took over the informal control over supply of gas and oil, thus became creditors interested in curbing the inflation.

In July, 1993 President Kravchuk appointed the Acting prime-minister Yuhym Zvyagilsky representing the Donetsk BAG tied to coal mining, a recipient of large subsidies, which real value was being reduced by inflation. On December 29, 1993, President Kravchuk created the commission on financial stabilization in Ukraine. Three of its six members (Surkis, Medvedchuk, and Gubsky) belonged to the “Kyiv-seven” BAG. By February 20, 1994 this commission created the plan of financial stabilization through tightening of monetary policy, though with little attention to the institutional and structural reforms necessary for alleviation of the causes described above. This plan was never implemented in full.

<sup>32</sup> Although the respective ministries in charge of particular industries (e.g. the one of the food industry) were dissolved soon after the peak of the mass privatization, their remnants survived until now united under the umbrella of the Ministry of Industry (later – the Ministry on Industrial Policy) that remains the house of state paternalism for the enterprises.

<sup>33</sup> The first legislative act aimed to reducing inflation (the President’s Decree “On measures for stabilization of prices and containment of inflation”) was adopted on January 31, 1992 – probably to calm down the population. After this, for 20 months the authorities (including the Prime-Minister Leonid Kuchma endowed with power of issuing the decrees on economic issues) were doing little about the problem.

Some reduction of the inflation rate began in January 1994<sup>34</sup>. The 1994 was the first year without any hyperinflationary episodes. The state-owned enterprises responded to the lack of liquidity by ceasing payments for the already supplied commodities and utilities. In particular, they did not pay for the energy resources (mostly imported), and this debt, according to a bilateral Russian-Ukrainian agreement, was taken over by the state. As a result, in the first quarter of 1994 the national income dropped by 36% year-to-year, and the industrial output declined for 38,4%. The pressure for “supporting the domestic producers” with new credits arose.

The BAGs as an interest group was not coordinated enough, and remained weaker than directors. Thus, despite some political will supported by the coalition-building, inflation was only slightly reduced. Accomplishment of disinflation required a strong arbiter able to withstand the pressure of directors. For this reason President Kravchuk agreed to the presidential elections in package with the parliamentary elections. He felt strong enough, saw no potential rival, and hoped to be reelected with enhanced legitimacy.

### 3.5. Emergence of an arbiter

Kravchuk miscalculated the support that directors provided to Leonid Kuchma. In June 1994 the latter outstripped Kravchuk by 2% mostly due to the support of communists in the run-off. A main slogan of Kuchma's campaign was: “Under Kuchma's rule the factories will keep working”. He criticized the disinflation “at the expense of production” and favored the continuation of monetary emission partly restricted at that time. But following the logic of authoritarian (rent-maximizing) arbiter, he soon became an arbiter of the BAGs, and undertook the wide-scale reforms that allowed him to consolidate the rent-seeking sector: restore controllability of the most lucrative sources of rents at the expense of releasing of the rest of the economy by exposing it to market forces.

Kuchma was personally more capable as an arbiter. He made a number of steps in order to strengthen his *vlast'*:

- Brought under the law enforcement agencies
- Conducted a campaign of fighting the organized crime, primarily racketeering, which served as informal arbiters for the business firms; instead, the *nachal'niks* of respective levels (often the police servants) took their place
- Established strong and powerful Presidential Administration
- Restored the so called “vertical of *vlast'*” – an arbiter-client hierarchy of regional and local state administrations reporting to him
- Threatening the parliament with referendum, he abolished the outdated Constitution of 1977, replacing it by the “Constitutional Accord”, which placed him in unilateral control over the government (1995)
- Established the State Tax Administration (STA) as effective instrument of *vlast'* essentially based on the soft rule of law

The STA became a separate government body subordinated directly to him, and further augmented with tax police. Supplementary to the vast budget funding, the STA accumulated 30% of exhorated fines and penalties in off-budget fund assigned for bonuses to employees – which provided them with specific kinds of incentives. At the meantime, in-line with tradition of the soft rule of law, the tax rates were high for such a poor country<sup>35</sup>, and the legislation was punitive, contradictory, and often ambiguous. Furthermore, the STA was put in charge of development of tax

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<sup>34</sup> According to V.Pynzenyk, the reason for such a drop (from 90,8% in December, 1993 to 19,2% in January, 1994) was of the monetary character. The growth of monetary base was only 4% in January, 1994, the lowest for the years of 1993-1994. In 1994 the M2 raised by 6,67 times (in 1993 by 19,28 times). The M0 in 1994 raised by 6,2 times (in 1993 by 25,6 times). Besides, M2 rose faster than M0 did – the share of banking sector gradually spread.

<sup>35</sup> 52% of the payroll tax, 28% of the VAT, 30% of the corporate profit tax, and up to 90% of the progressive individual income tax

legislation and endowed with a right to interpret the laws in the form of elucidative letters, often restricted for internal use only.

Another important move was to allow Pavlo Lazarenko, Kuchma's compatriot and ally of those times, to monopolize the gas and energy sector with his crony firm UESU<sup>36</sup>.

In these ways Kuchma managed to become a strong authoritarian arbiter. Although being elected under the anti-reform and populist slogans, he realized that undertaking of market reforms, which could at least partly close the gap of control, is the only way for him to survive as leader of an independent country. This was also in his own political and mercenary interests, as long as he was able to control the major sources of rents (the energy supply and natural monopolies).

At that time the main sources of rent for the country ended: Russia has increased the prices for energy resources and threaten to cease the "soft" supply of these resources. Babanin, Dubrovskiy, and Ivashchenko (2002) argue that irresponsible borrowing, as a sort of "virtual" rent, became an at least temporary substitute for the diminishing rent. Some experts suggested that Russia colluded with IMF in forcing the indebted post-Soviet countries to borrow from IMF and pay full price for the energy on-time. But to make the massive borrowing possible, Ukraine had to demonstrate its commitment to market reforms.

The *directors*, as intermediate winners, were inappropriate allies for this task. Soon after they got rid of Communist party and a centralized control and coordination, the *directors* as a whole became disappointed with liberalization and turned into a major anti-reform force. Also, they were inconvenient as arbiters' clients: their multiplicity and diversity led to a high cost of coordination. Thus, Kuchma opted to rely on the BAGs. Initially, the Dnipropetrovs'k BAG and some particular oligarchs (like A.Volkov) hoped for his help in competition with other oligarchs in exchange for the support they provided Kuchma during his election campaign. Their main rivals have even escaped from the country for a while after Kuchma's victory. But according to the logic of an arbiter (Section 1), a rational ruler is better off by playing the "divide-and-rule" game rather than being closely tied to a single player. Although Kuchma still favored some old cronies for a while, he soon started rotating his favorites.

His reformist policies failed to satisfy his voters' will. In October 1994, Kuchma made a speech before the parliament on the strategy of Ukraine's economic reforms which included financial stabilization, mass privatization (declared but not implemented by his predecessor), and structural reforms aimed at creating a "socially oriented market economy". Moreover, he involved the IMF and the WB<sup>37</sup> into active operations in support of reforms.

The IMF approved the program and provided the Ukrainian government with the STF (Systemic Transformation Facility) – an arrangement designed for countries in transition that lacked funds to finance the critical imports. The loan was conditioned by a set of requirements that remained confidential. But most probably they included currency convertibility and reduction of budget deficit. Also, the ban for financing deficit by means of direct monetary emission was a standard condition of IMF.

In the October 1994 the decree on "setting prices under conditions of market reforms" removed some remaining limits on the mark-ups on prices of consumer goods. Some observers characterized this move as a "shock therapy", although it was still far from the famous Polish example, and even from Gaidar's reforms in Russia. According to V. Lisitsky the crust of disinflation measures was designed in the National Bank under V. Yushchenko.

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<sup>36</sup> The United Energy Systems of Ukraine. The firm was run by Yuliya Timoshenko. Officially, Lazarenko was the vice-Prime-Minister, and became the Prime Minister in the Fall 1996. Although at this time the Dnipropetrovs'k BAG he allegedly led has already split up, Lazarenko took too much power and threatened to the rest of the players, including Kuchma. He was in one step of establishing a kleptocratic dictatorship in Ukraine, but Leonid Kuchma was not interested in such developments (see Section 1), and so were the rest of the BAGs. Lazarenko was dismissed in Summer 1997, and become Kuchma's political enemy. Later on he was arrested in Switzerland with the passport of Panama and convicted in the USA for the money laundry.

<sup>37</sup> Ukraine has formally joined the IMF and the WB already in September of 1992, but did not cooperated with them until 1994

In 1994-95 Ukraine received \$763 million under the STF program, which helped to calm down inflationary expectations and to finance the current account deficit. As a result, the inflation was brought down to below 20%.

### 3.6. Privatization

Kuchma as an authoritarian arbiter was interested in personal control over only a handful of the most lucrative enterprises, mainly the monopolies, while enhancing productivity of the rest of the economy, in order to increase the common pool of rents for his main clients, the BAGs. To the extent he was accountable to the broad population he also got interested in preventing further economic decline that jeopardized his power. But among the sources of decline only inflation was curbed, but this success remained endangered by the paternalism towards enterprises. Privatization was necessary (although still not sufficient) for restraining of paternalism, and closing the gap of control at the micro level. This gap kept causing economic decline, of about 10% in 1995, despite a relatively modest inflation. According to this logic, the assets that an arbiter failed to control effectively should be privatized as soon as possible, and preferably to the benefit of the BAGs.

But most directors were not interested in mass privatization (Paskhaver). In addition to the general reasons described above, the most entrepreneurial and capable of them managed already to privatize their enterprises using the leasing-buy-out scheme. The remaining were rightly afraid of any sort of market competition, and being disappointed in reforms even aspired returning to the central planning.

Respectively, contrary to Stiglitz (1999) the process could not just move ahead on a “natural” decentralized basis. There was no alternative to the intervention of a strong arbiter, able to divide one-shot rent from privatization between the real players. Just as in the case of disinflation, President Kravchuk was not strong enough to accomplish this task; but the President Kuchma was. He needed to stop overappropriation of rent stemming from state property, and increase the BAGs’ common pool of rent.

The BAGs, in their turn, were interested in property titles. They got access to the rents from assets’ stripping through control over the monopolized supply, primarily of energy and gas; and imposition (often in collusion with *directors*) of transfer pricing for outputs. But this so called “privatization of cash flows” was vulnerable to political risks, while after disinflation some investment opportunities became lucrative comparing to alternatives abroad. Some *nachal’niks* and their crony firms also gained a one-shot rent from buying assets at below market prices. Thus, unlike most other reforms, privatization was supported by the rent-seeking interests.

There were a few more factors that together made privatization a true “locomotive of reforms” (Paskhaver, 1999).

1. Contagion effect of Russia, where the mass privatization was already completed at this time
2. Support for privatization by the Russian government that was interested in making Ukraine more solvent as a debtor, and also hoped for the investment opportunities that privatization in Ukraine could provide for Russian companies
3. Support for privatization by the IFOs, primarily the World Bank; in particular, they deserve large credit for explaining to the Ukrainian government the straight causality between paternalism towards the enterprises and macroeconomic instability.

Notably, the population of Ukraine has never mandated the large-scale privatization. While the privatization of small-scale entities was always supported by a majority, the balance between positive and negative attitudes towards large-scale privatization was always negative. It was quickly worsening during the years of mass privatization, and since 1998 (hence, when it has actually happened) the majority of respondents has become treating it constantly negative (Panina, 2005, 20-21)

According to the concept adopted in 1992, the mass privatization should immediately follow the price liberalization. But it was postponed mostly because *directors* were not interested in it. Only the voluntary and privileged insider-oriented schemes (buy-out and leasing-buy-out) were successfully implemented. However,

“ ... unlike other countries, trade, consumer services and public catering sectors in Ukraine have not become the priority of [initial] privatization. Instead there has been a trend to privatize industrial giants, monopoly enterprises within the sectors that were planned to be “de-statized” at subsequent stages of privatization when necessary market environment and infrastructure were formed ... more than 77% of the overall number of entities was privatized [during the years of 1992-94] through buy-out by the partnership of buyers established by the workmen collective or through the lease with buy-out” (Voronkova, 2000).

Noteworthy, such course of events could be justified neither by any theoretical reasons, nor by the public's attitudes (Panina, 2005, 20-21). These schemes were restricted to small enterprises in 1994. However, even later on some firms -- agricultural processing factories and individual enterprises, such as Illich steel mill -- were privatized to insiders by special laws.

The rest of initial privatization occurred through auctioning of very small entities in trade and catering.

Privatization certificates were issued in the electronic form already in 1992, but could be used mostly by insiders. Effective certificate privatization started only in 1995, when cash certificates were issued with help and under the pressure of the WB. The Ukrainian certificate privatization was even more insider-oriented than the Russian one, due to the numerous privileges granted to insiders, first of all *directors*, and the option of making large enterprises closed joint-stock ventures. Later on, it was accompanied with selling shares in large-scale enterprises to strategic investors under investment commitments. Both schemes were used until 2000 when cash privatization started. But special conditions stipulated for the formally open tenders often restricting them to one-buyer deals, as it happened in the notorious (but certainly not the worst) case of KrivorizhStal' steel mill in 2004. The privatization was a few times interrupted with moratoria. A number of enterprises were kept state-owned by the law. Nevertheless, most entities went to the private sector by the end of 1997<sup>iii</sup>. Not surprising, they mostly appeared under control of *directors*, and to lesser extent – of the BAGs. The secondary market remained slack (unlike Russia), and the benefits of outside minority shareholders were insignificant.

Box 2. Methods of privatization varied by the types of assets.

	Buy-out by insiders	Leasing-buy- out	Cash sales (tender or auction)	Privatization certificates	Free transfer (distribution) to insiders
House and apartment	+				+
Small enterprise	+	+	+		
Medium and large enterprise		+	+	+	
Of them “strategic” (very large, monopolies, ecologically dangerous, etc.)			+		
Land					+
Land plots	+				+

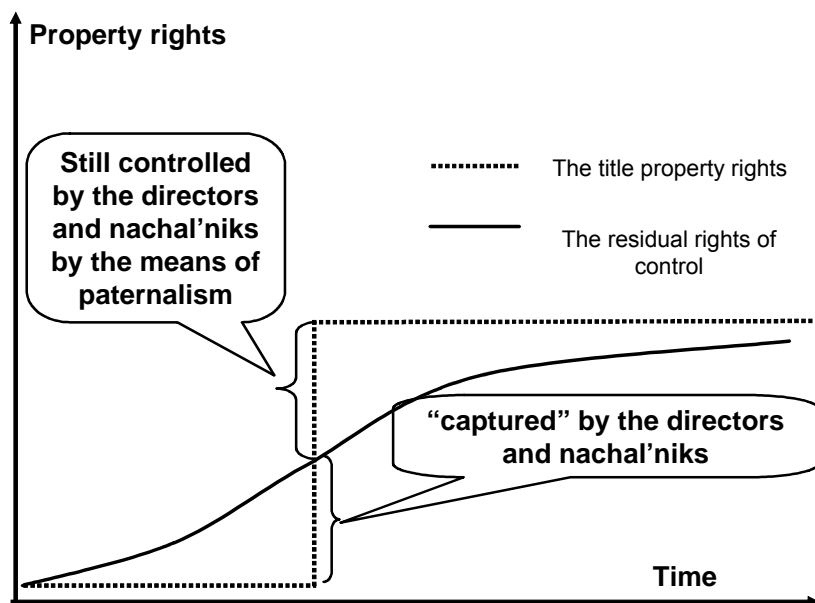


From the institutional viewpoint, privatization was a shift in the formal institutions, while the informal ones could not change so quickly. This means that its outcomes should roughly reflect the distribution of informal residual property rights existed at that moment; and only marginal shifts could be achieved.

In particular, according to the intentions of authors of this reform (primarily, V. Lanovoy and A. Paskhaver) supported by the WB, a large portion of assets in the form of privatization certificates was disseminated among the population in exchange for its support. It also reflected the formal allocation of the title property rights, since the broad population, as title owner, controlled state-owned assets via state apparatus that served as its agent.

But since in reality this control did not work, the peoples' real rights of control were negligible. In fact, *nomenklatura* seized these rights from the very beginning of soviet times (Ryvkina, 1998). For decades the people never intervened when *nachal'niks* and *khosyaistvenniks*, as arbiters and clients, competed for their shares in the property rights which officially belonged to the people. So, when the title rights were adjusted to the actual ones they appeared distributed mainly between directors and BAGs in rough proportion to their influence, and in exchange to their support to the arbiter, while the people have got something roughly corresponding to their true political influence, and hence true residual property rights. Not surprisingly, the broad population came out disappointed ). Besides, privatization of the large enterprises that were the main victims of petty theft has partly broken a "tacit social pact" described above: while the rents for people became restricted, the ones for elites remained. *Nachalniks*, although not officially endowed with any formal property rights, still had vast stakes in "state property", which was reflected in the resulting allocation of residual property rights. To a large extent *nachal'niks* preserved their control over the enterprises through state paternalism, mostly in the form of SBCs.

**Picture 1.** Formal and actual institutional changes in the process of mass privatization in Ukraine



Thus the allocation of privatized property revealed the pre-existed institutional patterns. From the perspective of social welfare and efficiency, it was a "second best" solution that, despite all its shortcomings, still partly closed the gap of control. Since the privatized enterprises were not common resources any more, they become to lesser extent subject to asset tunneling and petty theft. Also, privatization restricted the paternalism toward the enterprises, and opened a way to its further curbing, though did not cease it completely. Equally important, it was a precondition for enterprise restructuring and, first of all, for changing its management. Before 1997 the average

tenure of a director was more than 9 years. Hence, the majority were appointed already under the Soviet regime (Pryor and Blackman, 1998). Other data testify that after privatization 38% of directors were changed by 2002, 70% of which after 1997 (Akimova, 2004). Privatization also opened a way for the consolidation of industries and vertical integration.

These reforms have strengthened the BAGs and ultimately established Kuchma as their arbiter. In this status, he could afford policies not necessarily immediately supported by the BAGs – yet not contradicting to their interests completely. In turn, as a former soviet *khosyaistvennik* he used to be subordinated to some paternalistic *nachal'niks*. Kuchma acted as an agent (Dixit, Grossman and Helpman, 1997) in respect to his international senior partners, like leaders of Russia, USA, EU, and the IFOs, whom he treated as a sort of “*nachal'niks*”. As long as they behaved paternalistically, supporting Ukraine with a sort of SBCs, Kuchma traded their support for part of sovereignty, and wherever possible manipulated them in favor of the rent pool he controlled (not necessarily his own rent) – just as a smart *khosyaistvennik* would. Until 2000 this favorable position gave him plentiful political choice, and helped in maintaining the rent pool despite a disastrous economic decline.

The year 1996 appeared the turn point for many social and economic parameters, like innovation rate (Dubrovskiy and Shygayeva, 2004)). But just as soon as the immediate threat of large-scale crisis was postponed, further systemic reforms, mainly reducing the paternalism towards the enterprises, were procrastinated again. While partly bridging the gap of control, Kuchma at the same time started using his power of an arbiter for suppressing market competition through protectionism and monopolization (cartelization) of the markets – like establishing of privileged traders, state concerns, and so on. These activities are well documented in the media, and constantly associated with the large-scale rents.

On the other hand, later on (in 1997-98) he agreed on essential deregulation of small and micro businesses, and later (in 1999) even released it from the discretionary power of the STA by introducing of a simplified taxation. This was done under the pressure of the SME lobby (a part of emerging civil society) supported by the World Bank and other international organizations. Such reforms were in-line with the logic of an authoritarian arbiter, similar to the one revealed in privatization: the cost of control over this sector did not justify the potential rents it could bring to the arbiter; while its efficient functioning has generated the value that can indirectly increase this rent. He was also interested in political support of the entrepreneurs. This was probably the only case when market reforms in Ukraine were driven by political-economic mechanism of the kind studied in mainstream literature. It has promoted SME development (Dubrovskiy, 2002).

## 4. The third wave: reforms without interests

### 4.1. “Virtual” stabilization and the role of IMF

By the end of 1996 most enterprises were privatized and inflation decreased to 14%, so the main causes of the first crisis of overappropriation were eliminated. Still, the gap in control was deep, since paternalism towards the enterprises persisted. It led to pervasive rent seeking that reduced the productivity. As public funds were the main source for this rent, they were constantly overappropriated. So, an arbiter required a permanent inflow of rent to fill in the rent pool. This rent originated from the abuse of trust of the creditors, augmented with paternalistic treatment of Ukraine (in the spirit of SBCs) by the IMF and some bilateral creditors.

Enterprises, especially the SOEs, still enjoyed “soft” taxation: the notorious *kartoteka-2* (see Dubrovskiy, 1999 for details) inherited from soviet times widely allowed them bargaining for their tax liabilities, delays in tax payments, and favorable terms for paying back their tax arrears in-kind. In the similar way the enterprises effectively reduced their energy and utility bills, so the budget had to cover the difference (see Dubrovskiy, 2003, for details). While the official credit emission was restricted under the IMF’s scrutiny, enterprises widely leaned to “soft” forced crediting (Kornai, 1996), because *kartoteka-2* allowed them getting automatic “softly” limited tax credits. This made each enterprise a sort of independent, irresponsible and uncontrollable emission unit (Dubrovskiy, 1999). Under these conditions, the macroeconomic stabilization was just an illusion (Szyrmer, 2001).

The official fiscal deficit constituted 6.7% in 1997, but the one calculated on the commitment basis reached nearly 11% of Ukrainian GDP, which was higher than in 1994 (Kovalev, 1999) and caused primarily by the paternalism towards the enterprises. While the emission financing of deficit and crediting of the government were restricted by IMF, wage and pension arrears along with irresponsible borrowing, were used as an alternative. T-bills floated at the rates well above 15% (in hard currency), which were characteristic to the Ponzi scheme (Ivaschenko, 1999), became a sort of “virtual” source of rent for the government partly substituting the diminished rents from cheap energy (Babanin, Dubrovskiy, and Ivaschenko, 2002). The respective inflows offset highly negative current account balance and helped supporting the fixed<sup>38</sup> exchange rate regime, which created an illusion of stability. Although cheap IMF loans constituted a minor part of total crediting, they served as signals to the rest of creditors implying that the situation is under the IMF’s scrutiny. Thus, the position of IMF effectively facilitated procrastination of reforms (Banaian, 2003; Babanin, Dubrovskiy and Ivaschenko, 2002).

While some of the IMF’s conditions were well-targeted and played positive role<sup>39</sup>, the standard macroeconomic benchmarks set by the IMF failed to restrain the rent seeking<sup>iv</sup>.

First, the IMF underestimated the political realities. In fact, it negotiated not with a politically responsible government, as it implied, but with an arbiter, former *khosyaistvennik*, that colluded with his clients in expanding the pool of rent by cheating the IMF’s – just as they used to do with any kind of *nachal’nik* before. For example, direct subsidies were merely substituted by indirect ones that constituted about a quarter of GDP (Lunina and Vincetz, 1999).

Second, the IMF, by virtue of its very name, used to deal with the monetary transactions. However, in Ukraine the *blat* networks were already well-established and widely used for barter transactions. Under the pressure of monetary constraints the enterprises shifted to non-monetary transactions that constituted more than half of all official payments in the Ukrainian economy in 1998, and concentrated in the rent-seeking sector. Thus, monetary restrictions, although necessary from the macroeconomic perspective, further stimulated the proliferation of barter<sup>40</sup>.

Meanwhile, barter transactions were gravely inefficient, primarily due to their non-transparency and inherited closeness of exchange. In combination with state paternalism they allowed for survival of the loss-making enterprises, and made the transactions essentially interpersonal, thus the persons in charge were made unchangeable. In this way this arrangement known as “virtual economy” (Ickes and Gaddy, 1998) inhibited enterprise restructuring and first of all it’s most important change – improvement of management. Agriculture suffered especially hard from vague and asymmetric property rights on arable land. The government subsidies and credits were officially provided in-kind, with tremendous abuses.

The residual rights of control remained vague and asymmetric. As long as rent-seeking opportunities were in place, the new owners, primarily BAGs, were interested neither in the universal protection of property rights (Sonin, 2002), nor in strengthening of the rule of law (Hoff and Stiglitz, 2004). For these reasons, and contrary to initial expectations, the property rights did not automatically emerge with privatization (Sonin, 2002; Polishchuk and Savvateev, 2000). Moreover, the owners were still interested in trading of their property rights for the rents from paternalistic treatment. However, according to our model, unlike the situation of 1994, the arbiter was also reluctant to restrict the rent seeking, while he had his own stake in this rent and was able to maintain the pool of rent by other means. Substantial part of rent went to the directors in exchange for their political support, while the rest was appropriated by the BAGs, with some part allegedly going directly or indirectly to Kuchma.

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<sup>38</sup> Within the narrow currency corridor declared by the central bank and the cabinet, and agreed with the IMF.

<sup>39</sup> In 1996 the government ceased the direct guaranteeing of gas import. In 1997 the important steps on deregulation were undertaken under the pressure of IMF and the WB. Many important reforms aimed for decreasing in paternalism were stipulated in the conditions for the World Bank’s PAL (Program Adjustment Loan) credit.

<sup>40</sup> There were a number of other plausible reasons for proliferation of barter schemes. The most important of them are discussed in the works of Gaddy and Ickes (1998), Guriev and Ickes (1999), Shyrmer and Besedina (2001). We have to skip these issues because of space constraints.

Therefore, none of major political players were interested in further reforms. Those suffered from the rent seeking – the households and independent entrepreneurs – were not adequately organized, unable to arrange a collective action, and largely supporting the paternalism. Not surprisingly, early attempt of curbing the paternalism, undertaken already in the late 1996 by the vice-premier V.Pynzenyk, failed. In cooperation with international experts he prepared a legislative package (so-called "Package for Economic Growth") aimed at making the tax system more structured and coherent. In particular, these laws eliminated many loopholes and tax exemptions, and abolished the *kartoteka*. However, none of the bills aimed at strengthening the financial discipline was adopted. The new laws on VAT and corporate profit tax were finally adopted with hundreds of amendments maintaining and even enhancing the privileges. As a result, Ukraine obtained overly complicated, often ambiguous, and highly unstable tax legislation that was of little help in curbing the paternalism, providing instead the tax authorities with high discretionary power.

According to the "predictions" of our model, a crisis was needed to make any real changes. And it came soon.

#### 4.2. Curbing the paternalism, and fiscal stabilization

By the end of 1990<sup>th</sup> Ukraine faced a triple crisis of overappropriation.

Creditors' trust and Ponzi-like game with T-bills were exhaustible sources of rent subject to overappropriation. So was the IMF's patience. Russia has defaulted on its T-bills, and giving to the low prices on energy could not afford the paternalistic treatment of Ukraine for a while. So, the new crisis of overappropriation occurred in September, 1998 ended the period of fragile stability. It took the form of currency crisis, which, however, revealed mostly the fiscal problems, in turn caused by paternalism towards the enterprises<sup>41</sup>.

As a result of this crisis the players started feeling limits of the pool of rents available for them. We argue that such clear and credible signal was the major change in the situation comparing to the previous period when this pool was perceived "soft". Although Ukraine was lucky to avoid full-fledge default, the threat of the one was just postponed. In the eve of presidential elections of 1999 the debt was restructured, but in 2000 Ukraine had to repay about 3 out of 13 billion dollars<sup>42</sup>. Meanwhile the reserves were depleted, and no further roll-over was possible.

At the same time, adverse developments caused by paternalism in agriculture and energy sector resulted in the crises of overappropriation in these vital sectors that could not be any more compensated with external supply.

As a result of the described above "institutional trap", the energy sector became a common pool for energy-intensive industries. Partial privatization of the power-distributing companies only has created a literal common pool of payment for electricity. For a few years the most of Ukrainian population suffered from the ordered cut-offs unrelated to their payment discipline but needed to avoid the crash of energy system. But the BAGs in charge with energy supply that benefited from this system were among the main supporters of Kuchma.

After the currency crisis the situation aggravated, because tariff rates, as well as the prices for main agricultural outputs, were frozen in Hryvnya while the costs of inputs increased with the depreciation of exchange rate. Along with the previously accumulated problems, it resulted in large arrears, comparable to total assets of the banking system, in the energy sector; and the worst harvest after the Second World War (see Babanin, Dubrovskiy, and Ivaschenko, 2002 for details).

In 1999 President Kuchma, despite his very low ratings, has won the re-election in a well-staged scenario "reformist President vs. orthodox Communist" (similar to what Yeltsin did in Russia in 1996). His main possible right-wing rival, Vyacheslav Chornovil, has died a year before in the very

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<sup>41</sup> The immediate causes of this crisis, and course of events are described in greater details in the work of Babanin, Dubrovskiy, and Ivaschenko (2002)

<sup>42</sup> \$890 million had to be repaid to IMF, \$177 million – to the World Bank, \$140 million – to Russia, over \$160 – to Turkmenistan, and over \$1 billion – to private investors on the Eurobonds, that were issued in 1997 with abnormally high 14.75% interest.

suspicious car accident. During the elections Kuchma's rhetoric was anti-reformist; he called for a major revision of reforms and increase in state intervention in the economy (Kravchuk, 2003). He was successful in mobilizing the resources of all BAGs and neutralizing all non-left rivals.

However, unlike the reforms of 1994-96, now the arbiter had to downsize the whole rent-seeking sector, including the part under his control, according to the diminishing amount of rent. Such reforms were expected to be highly "unpopular", since all of the major political players should lose at least in a short run.

Kuchma appointed his potential right-wing rival Victor Yushchenko as Prime-Minister, and distanced himself from the reforms subversive to the BAGs. For the first time of the presidency, Kuchma provided a Prime-Minister with certain freedom of decision-making and recruiting his team, even including the Kuchma's enemy Yulia Tymoshenko. According to V. Lysytsky, Yushchenko's team "did not [have to] ask for any permission to implement the reforms". Yushchenko had an image of pro-Western politician, and the necessary experience of communications with international institutions and foreign investors, which helped in solving the debt problem<sup>43</sup>. Kuchma has successfully pressed on the Parliament through his clients (remember that political parties, especially the newly appeared ones, were mostly the wings of BAGs) to make it more compliant for the necessary reforms. In the late-1999 and 2000 Yushchenko's Cabinet successfully conducted a series of reforms addressing all of the problems described above<sup>44</sup>.

To restrain the paternalism towards the enterprises, Yushchenko committed that his government would not tolerate the mutual settlements and in-kind payments to the budget any more. Although he failed to sustain this commitment in full and had to adopt some settlements on previously accumulated arrears, this policy stopped the further accumulation of arrears (Dubrovskiy and Shygayeva, 2004). His Cabinet immediately abolished 800 of previous Cabinet's resolutions granting the privileges to specific enterprises, and has withdrawn over 400 bills sent to parliament by his predecessors, including the 2000 year budget. The new zero-deficit budget suspended the validity of several privileges. As a result, tax exemptions decreased for the first time (ibid). These changes were supported with reforms in the Cabinet procedures that largely complicated lobbyism and bargaining.

Payment discipline in the energy sector was tightened by implementation of simple and strict rules of revenue sharing between the power-distributing companies and the common pool of generation; banning of non-monetary payments and eliminating of "soft" supply. Already in 2000, share of payments in cash (as opposite to in-kind, discounted, or delayed payments) rose to more than 90% (Dubrovskiy, 2003).

The arable land was finally privatized, although with restrictions, and ban on purchase and sale. Barter schemes of subsidizing and crediting of the agricultural enterprises were replaced with more transparent ones. The "collective agrarian enterprises" were abolished. In 2000 the prices for agricultural products were liberalized, so the price of wheat increased by three times, of livestock – by 2-3 times, which increased total peasants' income by about UAH 3 bln. Yet, the tremendous subsidies and vast tax exemptions for agriculture remained.

These reforms have mostly closed the gap of control, so the year of 2000 became a turning point in many microeconomic trends (see Section 5).

The most distorting forms of state paternalism, such as SBCs and non-monetary transactions were drastically reduced and concentrated in the relatively narrow sectors (Dubrovskiy and Shygayeva, 2004). The new owners (most probably, the BAGs), took over many enterprises, changed their

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<sup>43</sup> In 6 weeks since February, 2000 Yushchenko's government managed to restructure the \$2.6 billion debt on Eurobonds. In cooperation with ING Barings, Commerzbank, CSFB и Salomon Smith Barney the government staged road-shows in Western Europe and the USA, convincing 95% of bond holders (about 5000) that outright pressure for debt will not work, and it is better for the creditors to wait for 7 years. At the same time, Tymoshenko has recognized the \$2.233 billion debt of state company "Naftogaz Ukrainy" before Russian "Gazprom" (although the leadership of the company claimed the debt to be only about \$780 million), and then in principle agreed to restructure this.

<sup>44</sup> Authors have already analyzed these reforms and their consequences in greater details in the works of Babanin, Dubrovskiy, and Ivaschenko (2002), Dubrovskiy (2002), Dubrovskiy and Shygayeva (2004). See also the CEM study of the World Bank (2004)

management or at least improved their structure of incentives (Akimova, 2004), and restored the vertical integration, which resulted in the output growth (as in oil-refining, metallurgy and ore, coal mining, and some other industries). Leap in the labor turnover rate (Dubrovskiy and Shygayeva, 2004) is evidence for massive enterprise restructuring.

The share of respondents reporting that they are employed at the private companies doubled in two years (Panina, 2005), despite actual sharp decrease in the pace of privatization and very modest growth of employment at the newly established entities, which indirectly confirms strengthening of the property rights<sup>45</sup>.

Competition increased from 13% of enterprises reported to feel competitive pressure in 1999, to 39% in 2002 (Akimova and Kuzyakiv, 2003). Even more important, the tendencies in competitive selection altered: instead of paternalism, investments became driven mostly by the market forces (Dubrovskiy, 2003, Dubrovskiy and Shygayeva, 2004).

Respectively, the macroeconomic situation has dramatically improved. As a result, for the first time since 1990 the economy started to grow, with the annual rates of 6-9%.

Despite such bright results, and the outright signals from the Western countries, Kuchma allowed the communists and politicians affiliated with major BAGs to remove the reformers as soon as the threat of crisis was overcome. For the first time in the Ukraine's history the Cabinet was ousted in the no-confidence vote. Interestingly, in-line with tradition of "soft" rule of law, the formal reason for this was the non-obeying of populist legislation (adopted already in 1991-92) that was never obeyed in any budget for the whole history of Ukraine. But even when Yushchenko's Cabinet was ousted, the reforms were not reversed.

Furthermore, increase in tax revenues, including those from the energy sector, allowed paying back the wage and pension arrears, and in this way making the reforms popular. Contrary to expectations based on the J-curve theory and other concepts developed in application to the welfare states, and despite such indeed unpopular measures as increase in the tariffs on communal utilities, food prices, and elimination of some privileges for the broad groups, the liberal reformer Yushchenko immediately became the most popular politician in the Ukrainian history with personal rating of around 30% that he maintained for the coming four years until he became a President in 2004<sup>46</sup>.

## 5. Consequences of reforms

Most of social indicators started improving after the second wave of reforms. The ratio of the highest income quintile to the lowest income quintile increased from 3.6 in 1993<sup>47</sup> to 4.8 in 1996 and then declined to 2.8 in 2000<sup>48</sup>. Infant mortality was 20 cases per 1000 live births in 1995, comparing to 18 in 1990, and 17 in 2000. Tertiary enrollment and many other indicators reached their bottom values in 1995-96 and started improving thereafter (Dubrovskiy and Shygayeva, 2004).

Still, some important indicators remained stagnant, or even continued deteriorating, although at a slower pace, between the second (1996) and the third (1999) waves of reforms. Per capita GDP almost halved from 1992 to 1996 and stagnated thereafter. In 1999, at its highest point poverty

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<sup>45</sup> a quotation from the real conversation with a taxi driver (April, 2005).

D: I do not care much about my car, because it is state-owned

I: Is it really owned by the state? May be, just by the firm?

D: It is ATP-2034 [generic Soviet name for the transport companies]

I: Perhaps, it is privatized?

D: Yes, they call it now ZAO [a closed joint-stock corporation]. **But all of the faces [persons] are the same.**

<sup>46</sup> Then, while being elected largely due to the hopes of continuation of his successful reforms, he had disappointed the adheres of market reforms. Maybe partly because those times the crisis was not at the gate, as in 1999.

<sup>47</sup> the data for this year are unreliable due to the hyperinflation

<sup>48</sup> here and after, if not admitted separately – by the World Bank (through [www.gdnet.org](http://www.gdnet.org))

reached its peak of alleged 45.7% of population having the daily incomes lower than \$2 PPP<sup>49</sup>, which was higher than in Egypt (43.9% in 2000) and twice as high as in Russia (23.8 in 2000) or Romania (20.5% in 2000), although still lower than in China (50.1% in 2000). Most of this fall occurred in the beginning of the 1990<sup>th</sup>. In 1990 the average person consumed 3597 Kkal per day. In 1999 this became 2505 Kkal<sup>50</sup>, a level close to the physical minimum. In 1998-1999 the self-assessment of social satisfaction reached its bottom value (Panina, 2005).

Why was the decline so deep in Ukraine? We put forward the following hypotheses:

1. Two important factors – a relatively high level of complexity of production and erosion in public consciousness -- were strong in Ukraine, unlike, for example, in the Central Asian countries.
2. Elites were weaker, and the general quality of governance worse, than in Russia and Belarus. Centralized decision making left the regional elites with limited competences, mostly boiled down to implementation of decisions adopted in Moscow<sup>51</sup>. In Ukraine this problem was further aggravated by a sort of career “pipeline” to the most prestigious central Soviet government bodies that systematically deprived Ukraine from the most capable cadres, promoted within the blat networks attached to the USSR leaders originated from Ukraine, in particular, Khrushchev and Brezhnev (Babanin, Dubrovskiy, and Ivaschenko, 2002). Finally, Ukraine’s population is five times larger than Belarus’ population, and far more diverse; both factors being often associated with the lower quality of governance.
3. Ukraine was the most industrialized republic of the USSR, so inherited the strongest intermediate winners of the destructive phase of reforms (directors) that procrastinated their constructive phase.
4. At least during the first years of reforms the easy accessible sources of rent in Ukraine were as much distorting, as they were in Russia<sup>52</sup>. Just as in Russia they were related to export of cheap energy, directly or embedded in energy-intensive commodities, like metals and chemicals. But unlike in Russia, the primary sources of these rents were located outside of Ukraine. The rent was soon ceased, so could not compensate for losses incurred by these distortions. Besides, the Ukrainian rent seekers have shorter time horizon, since their businesses in fact benefited from the Russian competitive advantages.

Plausibly, in some other transition countries (like Georgia, Albania, Moldova, etc.) the gap of control, and respectively the decline, appeared even deeper, and was among the main reasons of civil conflicts. Ukraine managed to avoid such misfortune even despite the huge gap of control it suffered from, and nonetheless sharp increase in inequality. We suggest that at least two kinds of immediate consequences of reforms were alleviating the social cost of crisis.

**Benefits from liberalization.** Adjustment of the rent-seeking sector was spontaneous, due to the lack of control capacities, rather than deliberate. But even such partial and inconsistent liberalization eliminated pervasive shortages of Soviet times, dramatically increased the consumer choice, and provided lucrative job opportunities. Even more importantly, the government lacked control to enforce tax collection and other regulations. So, it in a way offered a tacit “social contract”, or rather a sort of “non-aggression pact” that was just a slightly modified extension of the soviet-like one (see Section 2.1): “we” do not protest and allow “them” to gain their rents, while “they” do not intervene, and allow us to do the same. In Russia, Gaidar and Yeltsyn accomplished this by the famous Decree on the Freedom of Trade (which, however, was soon reversed). In Ukraine, the people, as clients, were granted with some petty rent unofficially (mostly illegally, but without punishment for a while) in exchange for social peace.

<sup>49</sup> [http://devdata.worldbank.org/wdi2005/Table2\\_5.htm#about](http://devdata.worldbank.org/wdi2005/Table2_5.htm#about)

<sup>50</sup> Statistical Yearbook of Ukraine for 2001, 2002. State Statistics Committee of Ukraine

<sup>51</sup> Some observers argue that weakening of the republican elites was intentional policy purposed to prevent nationalistic movements.

<sup>52</sup> Being the net importer of energy resources Ukraine has the energy consumption per GDP ration higher than Russia (Babanin, et. al., 2002).

**Strengthening of property rights in the areas that nachal'niks failed to control anyway.** The households benefited from privatization of housing and especially from allotment of land plots launched at the end of the 1980<sup>th</sup> and continued till the mid-1990<sup>th</sup><sup>53</sup>. In 1994, 43.2% of respondents reported that they possess either an orchard or a garden plot, and in 1994-1996 revenues raised from agricultural products' sales exceeded 30% of total households' incomes.

Note that only those methods of compensation not related to the state paternalism indeed worked – unlike the official compensations, such as wage indexation, social benefits, and privatization certificates. Because of inflation, and despite indexations, the real wages more than halved; all kinds of social benefits were devalued to a few dollars per month; and the black market value of privatization certificate amounted of less than ten dollars.

People learned this lesson very well. Since 1998 the share of self-reliant individuals started increasing along with satisfaction with the social status (Panina, 2005).

Inequality, although dramatically increased comparing to the low values in the Soviet times<sup>54</sup>, but still did not become too high. According to the estimations that can be made based on available official statistics, the ratio of maximum to minimum wages at the inter-industrial level increased from 1.92 in 1985 to 4.69 in 1996 and then to 5.48 in 2001<sup>55</sup>; which is higher than 4.6 in Canada, 2.7 in the United Kingdom, and 1.4 in Norway<sup>56</sup>; but still less than 6 in Germany, and 6.7 in Russia. In 1999 the Gini coefficient in Ukraine was 29, while in Morocco and Tunisia (2000) it was almost 40, in Egypt (2000) – 34.4, and in Bolivia 44.7.

Although the second wave of reforms brought just partial success, the third wave of 1999-2001 reversed most negative trends, at least for several years.

One can believe that, by 2004, as a result of reforms, the crisis caused by the decay of the Soviet system was mostly overcome. Although formally the GDP per capita remained lower than in 1990, in reality giving to enormous fictitious component of the Soviet output and pervasive shortages, we can assume that real incomes of the population are not lower than during the Soviet times and seem to be growing in a more or less sustainable pace.

Indirect measurements show that while some groups of goods decreased in their availability (primarily foodstuffs and books), others, primarily durables, increased (color TV sets, automobiles, audio and video equipment)<sup>57</sup>. The availability of housing clearly improved: from about 18 sq m of living space per person in 1990-1991 to 21 sq m in 2001<sup>58</sup>. Besides, consumers enjoy plentiful choice; citizens enjoy civic rights and freedoms – although, still limited, but greater than under Soviets; and despite persistent problems the human development is in progress.

Still, the living standards remain low, even comparing to Russia (which, however, enjoys vast natural rents). The property rights are still quite weak and vulnerable; capital markets are still feeble, which impedes efficient allocation of production assets. The people's control over the state assets is still insufficient<sup>59</sup>, which leads to massive embezzlement.

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<sup>53</sup> On November 10 1994 the President of Ukraine adopted Decree "On the Indispensable Measures to Accelerate Land Reform in the Agricultural Production Sphere", which has stipulated the private ownership on the land plots. At the beginning of 1994 96% of arable land in Ukraine belonged to the state. Within the next five years already 16.2% of total arable land of Ukraine (14.5 mln land plots that exceed in total 7.4 mln ha) was owned by the individuals;

<sup>54</sup> There were no Soviet data on inequality and poverty collected according to the methodology comparable to international standards, and even the available data on incomes and wages were highly unreliable. Under the pervasive shortages the differences in the actual availability of goods and services varied tremendously, and to large extent determined true purchasing power of incomes earned by different social groups and in different regions. Of course, these inequalities were not reflected in any official data.

<sup>55</sup> Since 1990 highest level of wages in Ukraine was registered in the financial and insurance sector.

<sup>56</sup> Author's calculations based on the data provided by LABORSTA, an International Labor Office database on labor statistics operated by the ILO Bureau of Statistics (<http://laborsta.ilo.org>).

<sup>57</sup> Panina and Golovakha (1999), page 36.

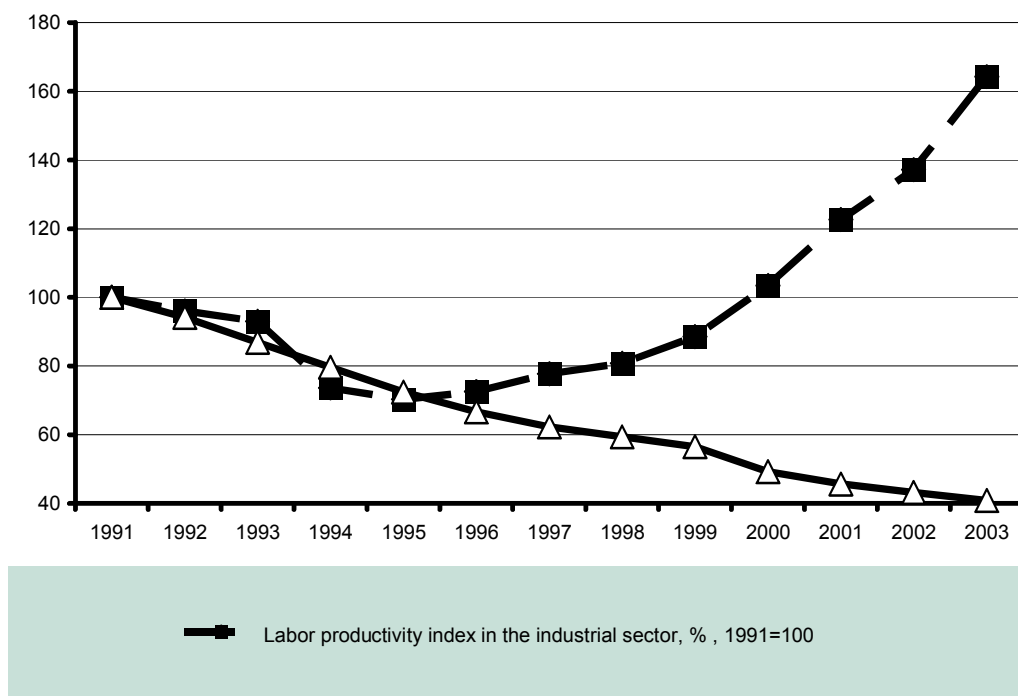
<sup>58</sup> State Statistics Committee of Ukraine.

<sup>59</sup> At least it was such until the Orange Revolution of 2004



Unemployment was one of the few indicators that started deteriorating during the second wave of reforms. However, this was attributed mostly to a shift from hidden unemployment to the open one; and also introducing of some unemployment benefits that were not in place at all before 1994. It has been increasing until 1999, with no visible impact of privatization at least in the industrial sector (Figure 2\)). Notably, before privatization employment have been declining hand-in-hand with labor productivity. The mass privatization had immediately reversed the labor productivity trend, so it has got restored by the year of 2000. The further restraining of paternalism towards the enterprises has made it growing by more than 60% in 3 subsequent years. However, at least for a while, the employment continued to decline. But, quite surprisingly, the paternalistic attitudes did not resulted in the marches of unemployed. Instead, people try to implement a number of innovative strategies.

Figure 2. Labor productivity and employment in the industrial sector of Ukraine for 1991-2003 (before and after mass privatization)



Source: DerzhComStat

While in 1994 8.2% and 1.9% of respondents reported having changed their place of employment once and more than once, respectively, in 1998 these shares grew to 11.3% and 4.3%<sup>60</sup>. After the initial impulse given at the beginning of 1990<sup>th</sup> labor market mobility decreased slightly from almost 25%<sup>61</sup> till 18.8% in 1997 and then, following 1998 crisis, increased again to 28.8% in 2001<sup>62</sup>. Industrial sector exhibited even higher mobility rates (23% in 1997-1998 and 34.6% in 2001) (Dubrovskiy and Shygayeva, 2004). The private service sector absorbed most of excessive labor, so unemployment has never reached very high levels. It began decreasing after the third wave of reforms, when economic growth started. Also, by some estimation, 10-20% of Ukrainian labor is working abroad on a temporary or permanent basis<sup>63</sup>. In 2003, 12.1% of respondents reported

<sup>60</sup> Panina and Golovakha (1999), page 42.

<sup>61</sup> In this paragraph we use quit rates (the ratio of the number of people fired during the year to the total number of employed people) as a measure of labor market mobility.

<sup>62</sup> Ukrainian Economic Trend, March 2002. Tacis UEPLAC, page 26.

<sup>63</sup> According to the claims of the State Board Guard of Ukraine, about 3 millions of Ukrainian voters were abroad before the Parliament elections of 2007.

having personal or their family members' experience of working abroad (Panina, 2005) (of course, those working permanently were not surveyed). Therefore, what clearly changed was the labor morale.

Therefore, the reforms seemed to be a right remedy for the economic crisis. Nevertheless, they remain mostly unpopular.

Initially the population provided support to reforms. However, at this time the *nomenklatura* was not ready for these reforms. When the reforms were finally undertaken, they have lost the public's support. Even in 1996 the respondents viewed the "strengthening of discipline"<sup>64</sup>, and "fair remuneration" (in the sense of "equal compensation for the same work") as major components of market reforms. Development of banking and market infrastructures, and bankruptcies of loss-making firms, were not appreciated. About 40% responded that they were not familiar with basic principles of a market economy. Noteworthy, some of these attitudes have further aggravated in 2000 (Golovakha, 2001).

The people perceived state officials and politicians as corrupted or seeking their own agenda (e.g., *vlast* maximizing); the business was perceived as a rent seeking activity. Such views were strengthened by a disappointment with reforms, which were believed to have made the things worse. Thus, people considered both the state and business unworthy of their support, and call the ruling elites "mafia" (Panina, 2005, p.27).

Those respondents who were familiar with the principles of market economy, as well as the younger, wealthier, and having the experience abroad, had more positive attitude to entrepreneurship than the average (Panina, 2005). This suggests that learning, especially the learning-by-doing, could eventually alter the anti-reformist inclinations.

Therefore, the social costs of crisis were large. But they should not be associated with the reforms, as it is usually done. Since the crash of the soviet system was inevitable, reforms were not a primary cause of these losses. The opposite seems to be the case. We did not find any evidence for social costs related to the third wave of reforms. The second wave also had clearly positive impact on most of social indicators. Only data on unemployment remain ambiguous. Yet, the passive "reforms" of the first wave were followed by immediate deterioration of social standards. But we emphasize that this deterioration, as well as the "destructive" reforms, were results of long-term process of decay.

Probably, if the inevitable crash of Communism and the destructive phase reforms were less procrastinated (say, started immediately after Stalin's death, in 1950<sup>th</sup>, or at last in the mid 1960<sup>th</sup> when the slowdown of growth become evident) and then the constructive phase of reforms more resolute, better planned, and generally more consistent and comprehensive, then their outcomes could have provided better results at lower costs. Unfortunately, this is mostly wishful thinking. As the first Ukrainian President, Leonid M. Kravchuk, used to say: "We have got just what we have got".

## Conclusions

The main lessons concerning reforms in a rent-seeking society that one can derive from the Ukrainian experience are as follows:

- A rent-seeking society can hardly be truly democratic, even after the formal institutes of democracy are established. The necessity of preventing the overappropriation may beget an authoritarian ruler.
- Despite the lack of democracy, economic reforms do occur without a clear public mandate or the interest group pressure. They are driven by the interplay of rent-seeking interests that occurs under the threat of a crisis, or when such crisis comes. As a result the authoritarian control weakens, rents diminish, competitive market sector expands, property rights and the rule of law are getting stronger, gradual effective democratization occurs.

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<sup>64</sup> certainly not a financial discipline or market discipline as a Western-educated economist could suggest, but rather the "socialist production discipline"

- We can agree with the “gradualists” that a deliberate abandoning of government’s control and coordination may be excessively costly if it occurs “too early”, when the people are not ready to replace it with the property rights and market coordination. Yet, the procrastination with adjustment of the scope of government’s intervention accordingly to actual capacities of it’s effective execution<sup>65</sup> may incur even higher social costs in the future. In any case, when the government’s control and coordination is already ineffective or abandoned, the faster the market institutions replace it, the lower social costs of change become.
- Formal democratization that is not backed by abandoning of the “zero-sum” perception and paternalistic consciousness does not immediately lead to democracy. However, weakening of the authoritarian control can start the chain reaction of reforms that lead to establishing a market democracy.
- External factors (like foreign aid) facilitate the reforms and alleviate the hardships of changes by helping in (a) resuming or preserving of control over the natural sources of rents, and the public funds – hence, the resources that should be under control anyway (ct. “discipline to the old sector” by World Bank, 2002); (b) facilitation of establishing of the property rights, along with fair market and political competition (primarily, through altering of the public’s perceptions); (c) encouraging of the sector based on the property rights and market coordination (ct. World Bank, 2002).
- At the same time, international donors can harm the reforms by providing the authorities with sources of rents that can be used as a substitute to reforms. In particular, the credits for “financing of the budget deficit” can help delaying the reforms, and in this way eventually increase their social cost, as it happened in Ukraine in the second half of 1990<sup>th</sup>.

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<sup>65</sup> ct. the World Bank’s (1997) main conclusion that the most efficient size of the government is the one that corresponds to its institutional strength.

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**Appendix. The main interest groups of the late Soviet society, their role before and after the crash of Communism.**

Group	composition	Subculture and role	aspirations and role in the reforms
<i>Nachal'niks</i>	<p>The CPSU and <i>komsomol</i> executives.</p> <p>State executives of the Soviet government of all levels lacking immediate access to the sources of rents</p> <p>High officers of the army, as well as police, secret service (KGB), and other law enforcement agencies.</p>	<p>Arbiters. Sometimes – sincere believers in the Communism; sometimes – cynical rent-seekers, <i>nachal'niks</i> followed all the fallacies of an uncontrolled bureaucracies (corruption, personnel and task expansion, etc).</p>	<p>As the Communist ideology was their source of legitimacy, and the ideologically-based legislation provided them with <i>vlast'</i>, the <i>nachal'niks</i> largely lost their influence and power with the crash of communism and dissolution of the USSR.</p> <p>The most far-sighted <i>nachal'niks</i> have managed to arrange some access to the sources of rents in advance through monopolized arbitrating, regulations, etc. The personal connections (<i>svyasy</i>), <i>vlast'</i>, and <i>compromat</i> were their main assets that can be converted into rent or its permanent sources. Having no direct access to the property, <i>nachal'niks</i> supported more outsider-oriented privatization.</p>
<i>khosyaistvenniks</i> as a whole	<p>nomenklatura members in charge with some valuable assets</p>	<p>The main category of clients, and the first-phase intermediate winners.</p> <p>Although relatively more pragmatic (including the issues like property rights), clever, and sometimes even entrepreneurial (10-15%) than <i>nachal'niks</i>, <i>khosyaistvenniks</i> were necessarily involved into the illegal exchange, and thus subject to criminal prosecution. Thus, the line between “normal” activity and corruption was very thin, and they crossed it much more often than <i>nachal'niks</i>, partly</p>	<p>Aspired emancipating of the <i>nachal'niks'</i> control and enhancing of rent incomes. Meanwhile, all but the most entrepreneurial <i>khosyaistvenniks</i> wished to maintain paternalism that was the main source of such incomes.</p>

		compensating themselves for lesser official privileges with the illegally gained rents.	
director corps – the main part of khosyaistvenniks	Directors of the large industrial enterprises (known as so called “ <i>red directors</i> ”), and to lesser extent the mid-range industrial, transport and construction enterprises.  Heads of the <i>kolkhoz</i> collective farms.	<p>Intermediate winners. Sincerely saw their mission (and the mission of their enterprises) as “producing the goods for the State”, with the latter ought to supply everything needed and facilitate the production.</p> <p>According to Viktor Lisitsky, V.Yushchenko's advisor in the National Bank and in the Council of Ministers, who during the Soviet times was responsible for the finance of an industrial enterprise</p> <p>“...the directors were organizers rather than managers; they knew production, but lacked the skills of company management, had no idea of marketing, finances, and other things needed in a competitive market economy”.<sup>66</sup></p> <p>Instead, they were used to hierarchical bargaining characteristic to the Soviet economy, thus good in negotiating the terms to “push things through” in many instances.</p>	<p><i>Directors</i> were the most powerful player at the early stages of post-Communism. In 1991, 46% of Ukrainian GDP was produced by heavy industries. The directors and heads of <i>kolkhozes</i> occupied 35% of parliament sits, just as much as <i>nachal'niki</i> did. But the latter largely felt lost and demoralized after the crash of Communism.</p> <p>Since the last years of the USSR <i>directors</i> widely used their power for rent seeking through lobbying, inspiration of strikes and political blackmailing. Instead of improving the competitiveness, <i>directors</i> engaged in bargaining with government for paternalistic “support of production” in exchange for control rights and political support.</p> <p>Later on their dependence on paternalism was actively used for subjecting them to the BAGs.</p> <p>The <i>directors’</i> professional association, the Union of Industrialists and Entrepreneurs (USPP), is quite influential: its heads (L.Kuchma, A.Kinakh) occupied the positions of Prime-ministers, it has its own party and a faction in parliament.</p>

<sup>66</sup> Authors' interview with V.Lisitski, 1 October 2003.

			Finally, the directors succeeded in soliciting the election of one of them as the president of the country – under whom, ironically, they will lose their influence.
other khosyaistvenniks	<p>Top executives of the non-industrial enterprises (trading and material supply, catering, customer services, banks, etc.)</p> <p>Heads of the special supply agencies servicing nomenklatura and the governmental offices with goods in short supply</p> <p>Heads of the public utility and other municipal services</p>	<p>Intermediate winners.</p> <p>Were closely tied to the rest of groups within <i>blat</i> networks, since they immediately ruled with the flows of goods that were the most valuable source of the favors of access. On the other hand, they had limited access to the property that could generate rents. Besides, their enterprises were subject to less paternalistic treatment, than the ones “producing” [the material goods].</p>	<p>Were best suited and equipped for the unconstrained rent-seeking, so had particular interest in getting rid of arbiters’ control; while much less paternalistic. However, they still were against the consecutive liberalization that could undermine the arbitrating as a permanent source of rent.</p>
former underground	<p>Shadow economy operators of the Soviet times (so called “speculators”, currency traders, smugglers, underground producers and distributors of scarce goods).</p> <p>Criminal structures, if they were used as a surrogate of contract and loyalty enforcement</p>	<p>Intermediate winners.</p> <p>The most frank in lawbreaking, but at the same time the most entrepreneurial.</p> <p>According to Paskhaver, extreme degree of risk-taking inherent to such kind of entrepreneurs largely shaped the corporate culture of the whole business elite. They had short time horizon; low trust; low social responsibility; etc.</p> <p>The criminal codes, enforced by violence, became substitute for contract enforcement and guarantees of loyalty under conditions where the formal laws</p>	<p>The “underground” sector of Soviet economy was not too powerful<sup>67</sup>, yet gave rise to a number of prominent figures in post-Communist business and politics.</p> <p>Active involvement of shadow market operators and criminal bosses in economic and political processes added to the atmosphere of lawlessness during the first years of transition. However, as the petty trade, known in the USSR as “speculation”, by 1994 became the occupation of up to a quarter of population, the former shadow economy operators being more experienced in</p>

<sup>67</sup> according to World Bank estimates, the shadow sector of Soviet economy approximated 12.3% of GDP

		<p>were slowly issued and poorly enforced.</p>	<p>this business obtained an advantage over the newcomers.</p> <p>Moreover, with the collapse of law enforcement agencies that were under-financed and largely demoralized by new conditions, the criminal structures with their rigid discipline, large financial assets and "physical contract enforcement" became a component of politics.</p> <p>The politicians and influential businessmen used them as a tool for enforcement and "force competition" – in exchange for the patronage<sup>68</sup>, immunity from legal persecution, and the like. Later on the outright racketeering was limited and crowded out by the law enforcement agencies.</p> <p>The involvement of such practices in decision-making adds to the public mistrust to the incumbents, to the atmosphere of lawlessness in the society.</p>
labor and other broad groups	employees, retirees, students, and other categories having neither <i>vlast'</i> , nor access to the major sources of rent	<p>The public consciousness was ambiguous (Golovakha and Panina, 1994).</p> <p>While being the lowest-level clients in the hierarchy, the people had highly paternalistic aspirations. At the same time, they became disappointed in the communist ideology, tired of permanent and increasing shortages, low quality of goods and services, and other shortcomings of Soviet system. They</p>	<p>The people's voice was not adequately represented in politics, since both political and civic institutions, necessary for this, were nearly absent.</p> <p>The people, in turn, mostly kept silence about violations of the democratic principles, and until the Orange Revolution of 2004 did not make any major public protest.</p> <p>However, the authorities always had in</p>

<sup>68</sup> *krysha*, literally-"roof", meaning supervision, patronage

		also desired more freedom and independence.	mind the possibility of unrest caused by economic severity. This made them implicitly constrained in their rent seeking, and thus indirectly bounded the pool of rent available for redistribution. Still, this bound remained opaque.
"independent" entrepreneurs	entrepreneurial people not belonging to any of above-described categories and not included into the most powerful <i>blat</i> networks.	The only relatively less paternalistic group. Aspiration of personal independence from <i>vlast'</i> is very important, if not the main motivation, for these people. However, the most of them lacked not only the ties, reputation, and specific skills necessary for entering the <i>blat</i> networks, but also the knowledge and skills needed for any kind of business. Also, some of them still behave paternalistically, thus seek a "good state" that would protect them.	along with the most entrepreneurial <i>khosyaistvenniks</i> , the independent entrepreneurs filled the rapidly emerging competitive market sector. However, their influence remained weak through all of the period. Some of them, although often unwillingly, adopted to the rules of the game and were co-opted by more powerful players that employed them as managers.  The rest, either remained at the level of small and micro business, or gave up – emigrated, became employees again, and so on.

## Endnotes

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<sup>i</sup> Our model resembles the one of Dixit, Grossman, and Helpman (1997), although with a few substantial amendments.

Firstly, we let the rent pool be variable. If its size depends on the government's efforts, the latter gets interested in maximization of the total rent. Under sufficiently weak democratic institutions, this interest can outweigh the one in well-being of the population, so the state ends up "captured": government persuades policies increasing the common pool of rents in exchange to the contributions made by rent-seeking businesses. In particular, it is interested in restraining the rent seeking for the sake of preventing the overappropriation – just as if it would be an owner of this pool. Along with sufficient political choice, this interest makes such government a potential reformer interested in the partial reforms that maximize the rent, but not in their completion that could maximize public well-being. Therefore, in such a model, under the weak democratic institutions reforms remain partial even if the government is "strong".

Secondly, we point out that the model of Dixit et al. treats government as an agent bringing the rent to principals. But actually it is endowed with discretionary power of distributing this rent among the lobbyists, which makes it their boss. If we go a little bit further, and remark that in reality not the government, but the rent seeking businesses are active extractors of rent, we end up with a multi-agent model that we consider closer to the Ukrainian realities.

Third, we do not stick with a fixed norm of sharing the rent between principal and agents. Then, the principal-agent relations become paternalistic, since the amount of rent left for an agent becomes subject to negotiations and can be traded for loyalty of the clients. The "soft budget constrain" (SBC), described by Kornai (1986) as the state paternalism towards enterprises under central planning, is an example particularly important for our case.

<sup>ii</sup> The social expenditures were not prioritized in the budget. Indeed, the social liabilities inherited from Soviet times were huge. They were further magnified by the series of populist laws adopted by the Parliament during the first years of independence. But here the "soft" rule of law revealed in full: in deed, none of the state budgets respected these laws.

In fact, the social assistance, although substantial, did not prevail over the direct subsidies to enterprises ("national economy support") with the exception of 1993 and 1995-97. But exactly those years the subsidies to enterprises were provided mostly in the indirect form. Also, the budget deficit 1993 was still 63% lower than the expenditures "for the national economy" in the same year. In 1992 the planned direct subsidies also exceeded the deficit, and in addition were overfilled by 213%. Besides, the actual execution of the social articles was often incomplete and there was a strong tendency to delay the respective payments, which meant their devaluation giving to very high inflation rate.

<sup>iii</sup> "... the privatization process was most intensive in trade and public catering with 29917 privatized entities (44.8% of the overall number of privatized entities in all branches), in consumer services — 11859 entities (17.8%), industry — 6974 entities (10.5%), construction — 3293 (4.9%) and housing and municipal facilities sector — 3072 assets (4.6%)." (ibid). The trade (including public catering) and services sectors were mostly composed of the small enterprises subject to direct buy-out ("Group A"). In these sectors 72.8% and 74.4% of the overall number of the privatized entities were privatized through the above mentioned methods. "The most common privatization method for large-size and medium-size enterprises in industry (60.8% of the overall number of the privatized enterprises) and transport (74.4% of privatized entities) has been the sale of shares in open joint stock companies (OJSC). The share of this method in privatization of construction projects and agricultural assets was high (44.6% and 43.1% respectively). Sale of shares in OJSCs was rarely used in the other branches of economy." (Voronkova, 2000)

<sup>iv</sup> To be sure, some of the IMF conditions were targeted at the micro level too. But they constituted just minor parts of huge memorandums contained up to 89 points. The government often ignored them, since they could undermine the sources of arbiters' power and/or rents. But the IMF always prioritized its standard macroeconomic benchmarks, so delaying in the institutional and structural reforms did not affect further

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financing. Besides, when the IFOs insisted on structural reforms, they were mostly the ones aimed at restraining the possible paternalism and privileges for the households. Although significant, these problems were still of secondary importance comparing to the paternalism towards enterprises. Lunina and Vincenc (1999) estimated the total subsidies that went to enterprises in 1997 as 20-25% of GDP. There were no “informal” or “implicit” subsidies to the ordinary people, except for a cheap energy. But unlike enterprises the households paid for energy exclusively in cash, and more than 60% was paid in time. This is of course very low from the point of view of a healthy market economy, but still better than just 32% of electricity paid in cash at the end of 1999 (Dubrovskiy, 2003). Also, these subsidies were much less distorting, because the labor incentives remained very strong.

Plausibly, the respective harsh discussions were used by the government to advert the IFO’s attention from real sources of rents used by the BAGs.