5

Viktor Yushchenko's Reforms, 2000

At the end of 1999, Ukraine looked miserable.[1] It was the only postcommunist country that had failed to achieve a single year of economic growth for a whole decade. With a registered cumulative decline of 61 percent of GDP from 1989 to 1999, it had suffered the greatest official slump of all postcommunist countries that had not been involved in war. Russia had suffered a comparatively moderate decline of 41 percent during the same period because of more far-reaching reforms. By contrast, Poland, the ambitious reformer, had recorded a growth of 22 percent (figure 5.1).

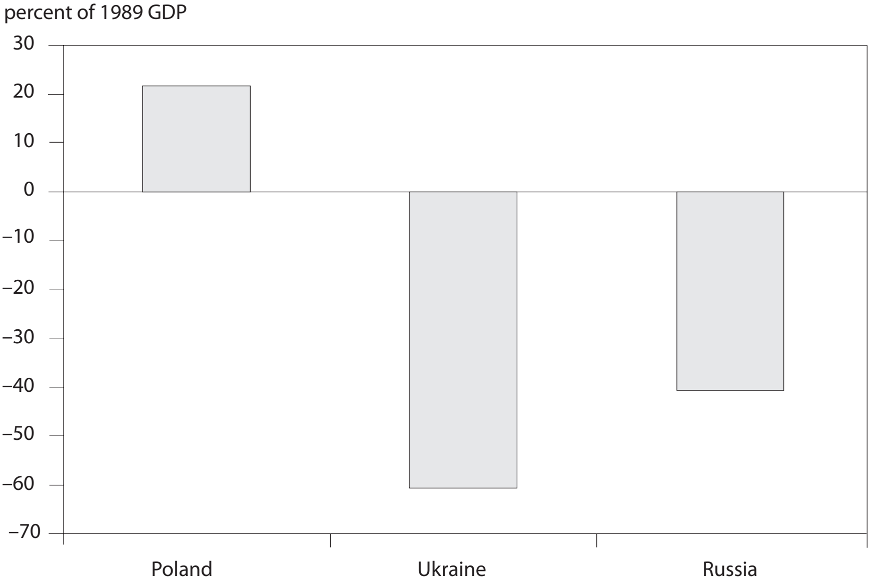
These large slumps should not be taken at face value. Considering the growth of the unregistered economy, the actual decline might have been only half of that recorded (Johnson, Kaufmann, and Shleifer 1997). The poor survived on moneyless subsistence agriculture on their small household plots, as neither pensions nor wages were paid on time or in full.

The titles of Oleh Havrylyshyn's analysis of the Ukrainian economy at the time are characteristic: "The Political Economy of Delayed Reform" (2000) and "What Makes Ukraine Not Grow?" (2003). Shockingly, by 2000 Ukraine's GDP per capita at current exchange rates was one-third of Russia's, although it had exceeded moderately reforming Russia's in 1990, and that was before the oil boom. Even worse, it was as little as one-seventh of radically reforming Poland's GDP per capita at current exchange rates, although the World Bank had ranked Ukraine as richer than Poland before the end of communism.[2] Naturally, this also reflects Ukraine's deflated

1. This chapter draws on Åslund (2001). An additional source is Deutsche (2001).

2. International Monetary Fund, *World Economic Outlook*, October 2008 (accessed on November 18, 2008).

Figure 5.1 Cumulative GDP change, 1989–99



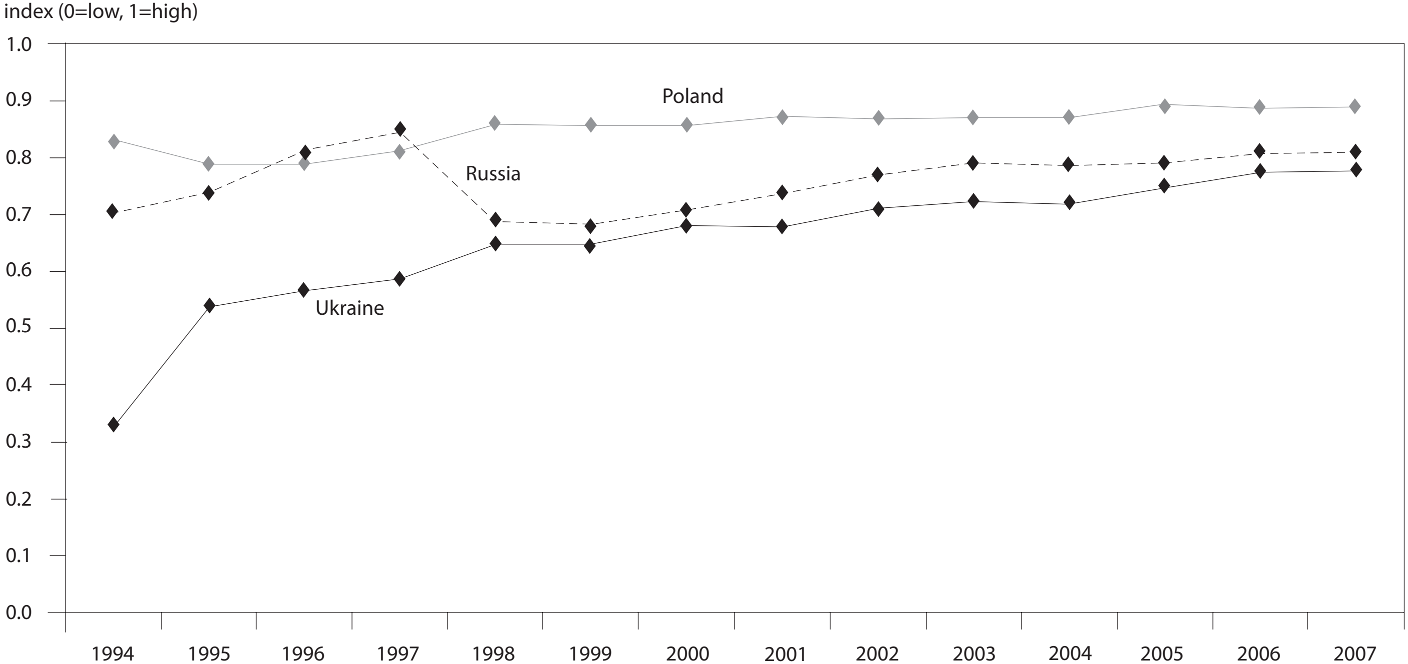
Source: UNECE (2004, 80).

exchange rate, and not only had the standard of living declined but also the social cost of delayed reforms had proven horrendous.

The decline and economic malaise could be seen in the streets. Until 2000 hardly any new construction took place in the cities. Soviet ruins and unfinished construction littered the city centers. On the outskirts, though, many new houses were being built by a budding bourgeoisie, and churches were being constructed all the time. Shops and restaurants were the first strong positive development, and the streets were filling up with imported cars, most of which were bought secondhand. Industry, however, was stagnant at best.

Market reforms had been tardy and half-baked, as the European Bank for Reconstruction and Development's composite transition index comparing Poland, Russia, and Ukraine shows (figure 5.2). Ukraine had not quite qualified as a full-fledged market economy, but the old socialist command economy was dead. Its cumbersome red tape bred ever more corruption. Inflation was high but under control, around 20 percent a year in 1998 and 1999 (figure 3.2). The budget deficit was small at 2.5 percent of GDP in 1998 and 1999, but larger than the financing and not planned (figure 3.1). Arrears were notorious, and barter rose until 1998. While the foreign debt was not large, much of it was nonpayments, mainly on natural gas imported from Russia and Turkmenistan.

Figure 5.2 EBRD transition index, 1994–2007



EBRD = European Bank for Reconstruction and Development

Note: The formula of this index is 0.3 times the EBRD index for price liberalization and competition policy, 0.3 times the EBRD index for trade and foreign exchange liberalization, and 0.4 times the EBRD index for large-scale privatization, small-scale privatization, and banking reform. Thus this index represents liberalization to 73 percent, while the rest is privatization.

Sources: De Melo, Denizer, and Gelb (1997); Havrylyshyn and Wolf (2001); author's calculations from the EBRD *Transition Report*, 1998, 1999, 2006, and 2007.

After the Russian financial crash of August 1998, investors and international financial institutions were suspicious of Ukraine, leaving the country on the verge of default. Its currency reserves covered less than one month of imports, and its export performance was poor. The International Monetary Fund (IMF) concluded repeated stabilization programs with Ukraine, but the government invariably violated them, prompting the IMF to stop disbursements from time to time. The social situation was dismal, with income disparity approaching Latin American levels (Milanovic 1998).

Ukraine had become an oligarchic economy, with a few tycoons dominating the economy and politics, as well-connected businessmen extracted tax rebates, subsidies, and regulatory privileges. A rent-seeking iron triangle of government, oligarchs, and parliament controlled the nation. They all favored extensive regulation and state interference to maximize rent seeking, while the population was of little consequence. This model of self-reinforcing rent seeking was close to equilibrium and thus stable.[3] Civil society was so frail that Ukrainians rarely stood up to defend their own interests (O'Loughlin and Bell 1999).

An archetypal rent-seeking society, Ukraine appeared stuck in a severe underreform trap. The prominent Ukrainian scholar Oleksandr Paskhaver (1999) argued that the Ukrainian system of "bureaucratic capitalism" implied that only private capital that had merged with the state bureaucracy could exist. President Leonid Kuchma had just been reelected because the situation was so bad that the threat of a communist *revanche* seemed credible. Democratic standards had slipped, and the country was semidemocratic at best.

Ukraine needed a radical break. The danger of default convinced the oligarchs that they needed a reform government, and they formed a center-right parliamentary majority to make the leading reformist of the day, Viktor Yushchenko, prime minister. He took the challenge without illusions and started 100 days of intense reforms, including the government itself, state finances, energy trade, agricultural land privatization, large privatizations, and deregulation of small firms. Ukraine swung to a substantial growth of 6 percent in 2000, primarily driven by industry, agriculture, and exports, and this broad-based economic expansion continued until the financial crisis of 2008.

In October 2000, however, the murder of journalist Heorhiy Gongadze became an all-dominant political scandal, which severely weakened Kuchma. In April 2001 Yushchenko was ousted, but Ukraine had been reformed, and its rent-seeking society had been transformed into a productive market economy.

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3. Murphy, Shleifer, and Vishny (1993) have shown how such a model works.

On the Verge of Default

After the introduction of the hryvnia in September 1996, the Ukrainian economic drama calmed down.[4] Economic decline continued, but it moderated, and every year growth seemed to be around the corner.

The IMF cooperated closely with the Ukrainian authorities, and since Ukraine's international reserves stayed tiny, every IMF disbursement was vital for state finances. Ukraine also borrowed on the international market through eurobonds and domestic treasury bills, but because of its miserable payments standards, the latter had horrendous yields fluctuating around 70 percent a year, which was costly to the Ukrainian treasury (Pynzenyk 2000, 90).

In the fall of 1997 the Asian financial crisis shook the world through financial contagion, as foreign investors abhorred risk. By October its impact reached Ukraine. International portfolio investors refused to buy Ukrainian eurobonds or treasury bills, which drove up yields and thus the refinancing costs of Ukrainian debt. The National Bank of Ukraine (NBU) defended the hryvnia's exchange rate within the band of 1.8 to 2.25 hryvnia per US dollar, but Ukraine's international reserves plummeted from $2.3 billion in January 1998 to below $900 million, less than one month of imports, in September 1998 (figure 5.3).

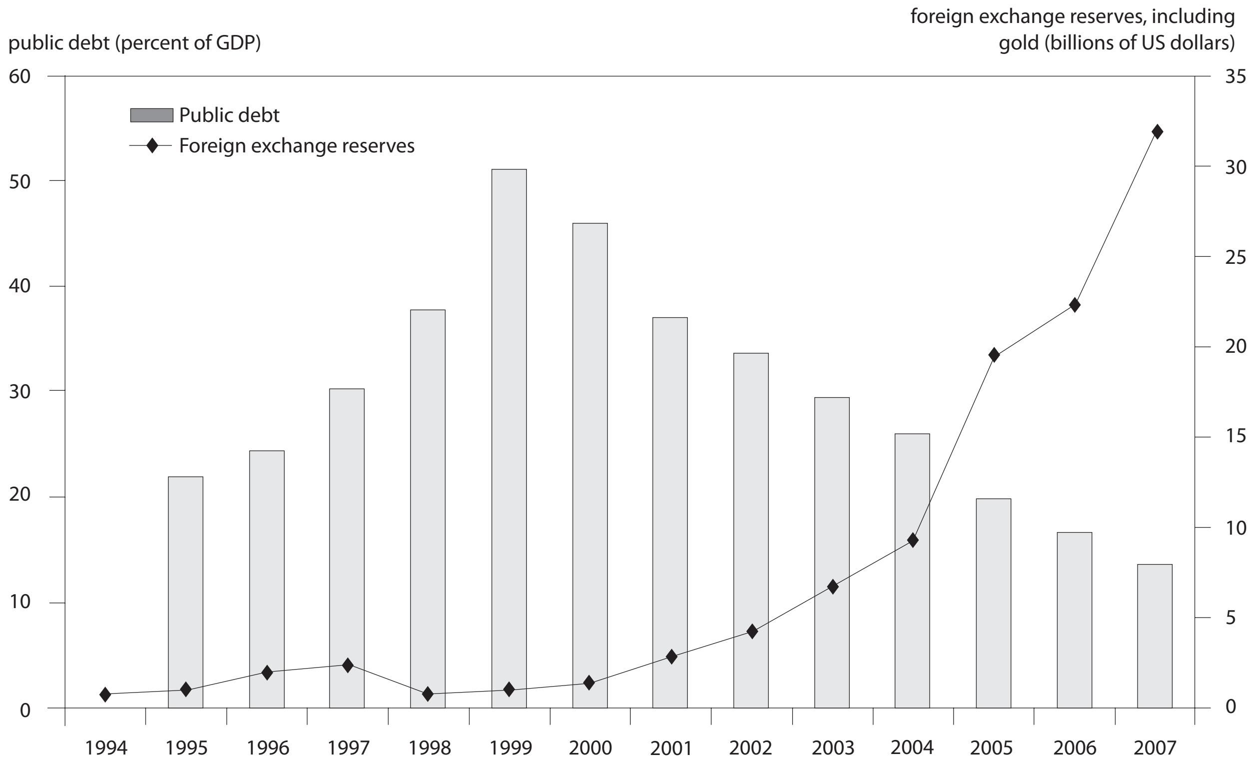
As was revealed in early 2000, Ukraine's reserve situation was even worse. From late 1996 until 1998, the NBU had engaged in impermissible transactions with its international reserves. It had deposited reserves with a foreign commercial bank that bought Ukrainian government bonds and treasury bills, although international reserves were supposed to comprise liquid foreign assets. As a consequence, the Ukrainian reserves were exaggerated, overstated by $400 million to $700 million in September–December 1997, which deceived the IMF into giving Ukraine three unjustified disbursements. Yet a serious investigation by the auditing company PricewaterhouseCoopers, instigated by the IMF, did not reveal any misappropriations, and, with the exception of one bad loan of $15 million, all the money was recovered (IMF 2000a, 2000b).

The stable exchange rate of the hryvnia had become a matter of national pride, and since most of Ukraine's state debt was denominated in hard currencies, its domestic cost would rise with devaluation. The left-wing parliament aggravated the situation by refusing to adopt legislation that the government had agreed with the IMF, prompting the IMF to withhold financing during the first half of 1998.

On August 17, 1998, the Russian financial crash exploded. Russia devalued sharply and defaulted on $70 billion of domestic treasury bills,

4. An overall source of this section is Kravchuk (2002, 73–83, 219–21).

Figure 5.3 Ukraine's public debt and foreign exchange reserves, 1994–2007



Sources: European Bank for Reconstruction and Development online database, www.ebrd.com (accessed on July 1, 2008); World Bank, *World Development Indicators* online database, www.worldbank.org (accessed on August 16, 2007).

while freezing the banking system for three months. International financial panic erupted, and the whole emerging financial world suffered. The NBU sensibly followed Russia's devaluation, depreciating the hryvnia by 60 percent on September 5. Further devaluations followed in fits and starts until the hryvnia stabilized at a historic low of 5.54 hryvnia per $1 in January 2000. The government enacted an anticrisis program on September 10, 1998. Its main measure was the forced conversion of 99 percent of the treasury bills held by nonresidents into eurobonds that were to mature in 2000. The purpose was to relieve the state budget from the enormous hryvnia bond yields.

For the moment, Ukraine had staved off external default, but the threat persisted, and financial worries gripped the population. From August until October 1998, 18 percent of all household deposits were withdrawn from the banks. Ukraine's foreign debt was rising as a share of GDP because of continuous depreciation of the hryvnia, although this share was never large. International reserves fell below $500 million (worth 14 days of imports) in February 1999.

Valeriy Pustovoitenko was so weak as prime minister that Kuchma had to do most of the heavy lifting himself, but his economic policy declarations became increasingly contradictory. In May 1998 he presented the Strategy for Economic Growth, 1999–2005, advocating a greater regulatory role of the state and more financial support for industry but also a smaller budget deficit. In early August Kuchma sensibly cut expenditures by decree. But in November 1998, in the midst of need for funding, he rejected the advice of the IMF, instead calling for stricter currency controls, monetary expansion, and the abolition of the NBU's limited independence. Not surprisingly, the IMF, the World Bank, and the European Union froze planned credits to Ukraine. Kuchma learned his lesson and stopped criticizing the IMF.

In the summer of 1999 Kuchma criticized the left-wing parliament for having failed to consider about 700 draft laws on economic and social issues that he had submitted to the Rada. In their place, Kuchma issued 39 decrees covering the most important economic issues, but the parliament vetoed nearly all of them. Legislation was deadlocked.

Kuchma seemed to have lost it, but he did not give up. According to the 1996 constitution, Prime Minister Pustovoitenko and his whole cabinet had to resign on the day of the presidential inauguration, November 30, 1999. Kuchma renominated Pustovoitenko, but the necessary parliamentary majority of 226 votes could not be mustered.

Ukraine's financial situation was untenable. In 2000 it faced a seemingly impossible repayment schedule of its foreign debts of some $3 billion, and no financing was on hand. External default was a distinct possibility. The Russian financial crash of August 1998 had sounded a stark warning to the Ukrainian oligarchs. They saw how their Russian brethren had suffered from financial chaos and realized that they had to tighten their belts for their own survival. Though protracted, Ukraine's payments crisis appears to have worked as an external shock. The top oligarchs came together and decided to act.

Oligarchs Opt for a Reform Government

Viktor Medvedchuk, who was first deputy speaker of the Rada and the foremost oligarch, took the lead. He formed an alliance of ten centrist and right-wing factions in the Rada for the financial salvation of Ukraine, which supported the candidacy of the liberal chairman of the NBU, Viktor Yushchenko, as prime minister. Kuchma accepted his candidacy, although he was not the first mover. At the request of the ten centrist and rightist party factions, he nominated Yushchenko on December 20, 1999.

Yushchenko, who knew Ukrainian politics far too well, demanded a free hand to appoint his own cabinet, guarantees from Kuchma for support from his presidential majority in parliament to legislate his reform program, and a mandate to carry out radical reform. Fearing financial disaster, the top oligarchs and Kuchma went along. The ten party factions voted overwhelmingly with 296 votes to confirm Yushchenko, and on December 24, 1999, they signed a government coalition agreement. This was quite a Christmas gift.

Yushchenko was an attractive political personality. He was young and handsome. His background offered an ideal political compromise. He came from the east, Sumy oblast, but he was a native Ukrainian speaker and an orthodox believer. He was a Ukrainian nationalist, though his father had fought in the Red Army during World War II. Yushchenko was a leading economic liberal, but he came from a village and owed his career to the agrarians, who had promoted him to chairman of the NBU. At a time of massive corruption and organized crime, Yushchenko had a clean reputation, although he had been in a high position of power for seven years. Yushchenko knew his political value, and he had chosen his moment.

After his confirmation, Yushchenko wasted no time. He appointed a strong and attractive government of reformist professionals. Yuriy Yekhanurov became first deputy prime minister with responsibility for administrative reform, privatization, and economic deregulation. Most surprising, Yushehenko named the former oligarch and now staunch oppositionist Yuliya Tymoshenko deputy prime minister for energy. The main reform endeavors rested on the shoulders of these three people. For the rest, Yushchenko appointed the best professionals at hand. Serhiy Tyhypko, who was Victor Pinchuk's top politician and had been deputy prime minister for the economy since 1997, became minister of economy. Ihor Mitiukov, Ukraine's most competent minister of finance since 1997, stayed on, though Yushchenko complained privately that he had wanted to appoint Viktor Pynzenyk, but Kuchma refused.[5] Yushchenko gathered Ukraine's best and brightest reformers as Kuchma had in 1994. They were more experienced and knowledgeable than in 1994 and ready to play hardball.

Yushchenko already had a reform program called 1,000 Days of Reform in Ukraine. It had been prepared in cooperation with the German Advisory Group on Economic Reforms with the Ukrainian Government (1999). This program summed up a consensus achieved in the market economic reform debate in Ukraine, calling for a retreat of the state from economic intervention through subsidies and tax privileges as well as administrative reforms and anticorruption measures. Yushchenko wisely realized that 1,000 days was more than he would get, so he opted for a shorter First 100 Days program, which became the real government program. Yushchenko boldly promised results on the 101st day.

Soon, Kuchma wanted to get back into the act. On February 28, 2000, he made a national address to parliament with a new long-term economic and social strategy for 2000–2004, which he labeled Ukraine Toward the XXIst Century. His policy prescriptions coincided with the Yushchenko program. He focused on regulatory reform for entrepreneurship, advocating that intrusive regulations be replaced with general laws and that administrative barriers to business development be eliminated. In mid-March, Kuchma followed up by presenting about 80 draft laws to parliament that were urgently needed to accelerate reforms. These drafts included many key laws that Ukraine was still missing, notably a tax code, a land code, a housing code, and a new criminal code.

The first four months of 2000 saw the greatest reform drive that Ukraine had seen since the fall of 1994. It was broader and more comprehensive, and it would put the market economy right. The main measures can be summarized as central government reform, fiscal reform, energy reform, land reform, large privatizations, and anticorruption measures. Yushchenko and his allies knew that the oligarchs would not tolerate them for long, so they struck while the iron was hot.

Government Reform

The first reform might sound surprising, but elementary order in government decision making was badly needed and was shepherded by Yekhanurov. Ukraine had been notorious for having no standardized

5. Personal communication with Yushchenko in 2002.

decision-making procedures. The state administration was too centralized and hierarchical, but responsibility was diluted as one decision often required a score of signatures. Top officials could sign hundreds of decisions in a day. No clear division of responsibility existed among the president's administration, the large cabinet of ministers apparatus, and the ministries. One could always blame someone else.

Extreme bureaucracy and anarchy characterized the Ukrainian administration. When I wanted to meet Yushchenko when he was chairman of the NBU, I would go to the NBU usually between 8 and 9 a.m. to make an appointment, because then Yushchenko's agenda was set for the day. I tended to opt for a meeting at 5 or 6 p.m. because I knew that he was often called to unexpected meetings between 10 a.m. and 5 p.m. One day, when I came for my 5 p.m. appointment, Yushchenko arrived at 6 p.m. He explained that in the morning my meeting had been the only one on his calendar that day, but some foreign prime minister was visiting Kyiv, and his schedule completely changed. In accordance with strict protocol, the president, the prime minister, and the speaker of the parliament called him to three two-hour meetings with this foreign prime minister. He thus lost almost his whole working day, which was a standard occurrence.

Senior officials did not respect their subordinates' time but demanded their presence at will. Consequently, nobody but the president could plan their day. As any conference organizer in Kyiv knows, ministers were reluctant to commit themselves to events, and, if they did, they often cancelled. Everywhere else in the world, cabinet meetings are held at a specific time every week. In Ukraine they were fixed ad hoc by phone the evening before the next morning meeting, obviously in the hope that key ministers would be absent. This system was typically Ukrainian. It was untenable, but it lasted until 2000.

The extreme voluntarism and collectivism meant that few had time to inform themselves about what they approved. Nobody was responsible, and no gatekeeper barred dubious decisions. The oligarchs, who were usually members of parliament, walked the corridors of the presidential administration and the parliament to extract formal decisions that granted them subsidies and regulatory privileges. The foremost master of this art was Oleksandr Volkov.

Government reform was simple and started from the top. At long last, Ukraine introduced regular weekly cabinet meetings. Four government commissions were set up within the cabinet, each headed by one of the four deputy prime ministers. Any government decision had to be prepared by one of these commissions, and the respective deputy prime minister was held personally responsible. In this way, the cabinet would only discuss well-prepared proposed decisions and be offered an orderly argument. An effort was also made to reduce the number of signatures needed on each decision and the number of documents senior officials had to sign. The number of state agencies was sharply reduced. Accountability was raised, and the president accepted that his administration lost operative power.[6]

Financial Cleansing and the Defeat of Barter

The second task was to clean up the fiscal system. Yushchenko had the draft state budget for 2000 revised. For the first time, the budget had to be balanced because of the complete absence of financing other than tax revenues. In addition, Ukraine had to service all its international financial commitments. Yushchenko emphasized cutting expenditures rather than raising revenues.

At the time, most payments in the Ukrainian economy were made through barter and offsets rather than with money. Russia suffered from the same problems. Many thought there was too little money in the economy. Yushchenko, however, understood that the problem was flawed incentives. Enterprises that did not pay their taxes extracted state orders at favorable prices by paying with services such as road construction. As a rule, the real monetary value of a service provided in barter was only half of the nominal price. Thus enterprises received both a tax rebate and state contracts by not paying their taxes. Barter benefited large corporations with extensive business and government contacts over small and medium-sized enterprises.

As a central banker, Yushchenko realized the importance of the remonetization of the economy, and the means of accomplishing that was not monetary emission but a change of incentives. Consequently, he requested that businesses pay all their taxes in real money and not through barter, offsets, or other monetary surrogates. A related reform was to put state payments in order. The key legislation was the budget code, which was adopted on June 21, 2001. Another important measure was the introduction of effective treasury control. A new Law on Procurement was enacted on February 22, 2000 to ensure competitive purchases and stop corrupt practices.

The combined effect of these measures was much greater than nominal budget statistics show, as they counted barter at face value, twice their real market value. Barter, which had risen for years until 1998, fell sharply, while monetization proceeded, rising steadily to 55.6 percent of GDP in 2007.[7] At the same time, the playing field was leveled and rents were eliminated, stimulating competition and thus economic growth. The

6. Interviews with First Deputy Prime Minister Yuriy Yekhanurov and Cabinet Secretary Viktor Lysytskiy in November 2000.

7. Statistics Committee of Ukraine, www.ukrstat.gov.ua (accessed on July 31, 2008); National Bank of Ukraine, www.bank.gov.ua (accessed on July 31, 2008); ICPS (1999a).

prevailing conventional wisdom was that barter could not be defeated, but Yushchenko did so in no time (Dalia and Schnitzer 2002).[8] Unjustified subsidies were eliminated, while the government budgeted so that it could honor all its commitments, notably pensions, and expenditures had to be adjusted to a lower level than revenue. One of Yushchenko's greatest claims to fame was that he eliminated Ukraine's persistent pension arrears from October 2000 and also paid public wages on time.

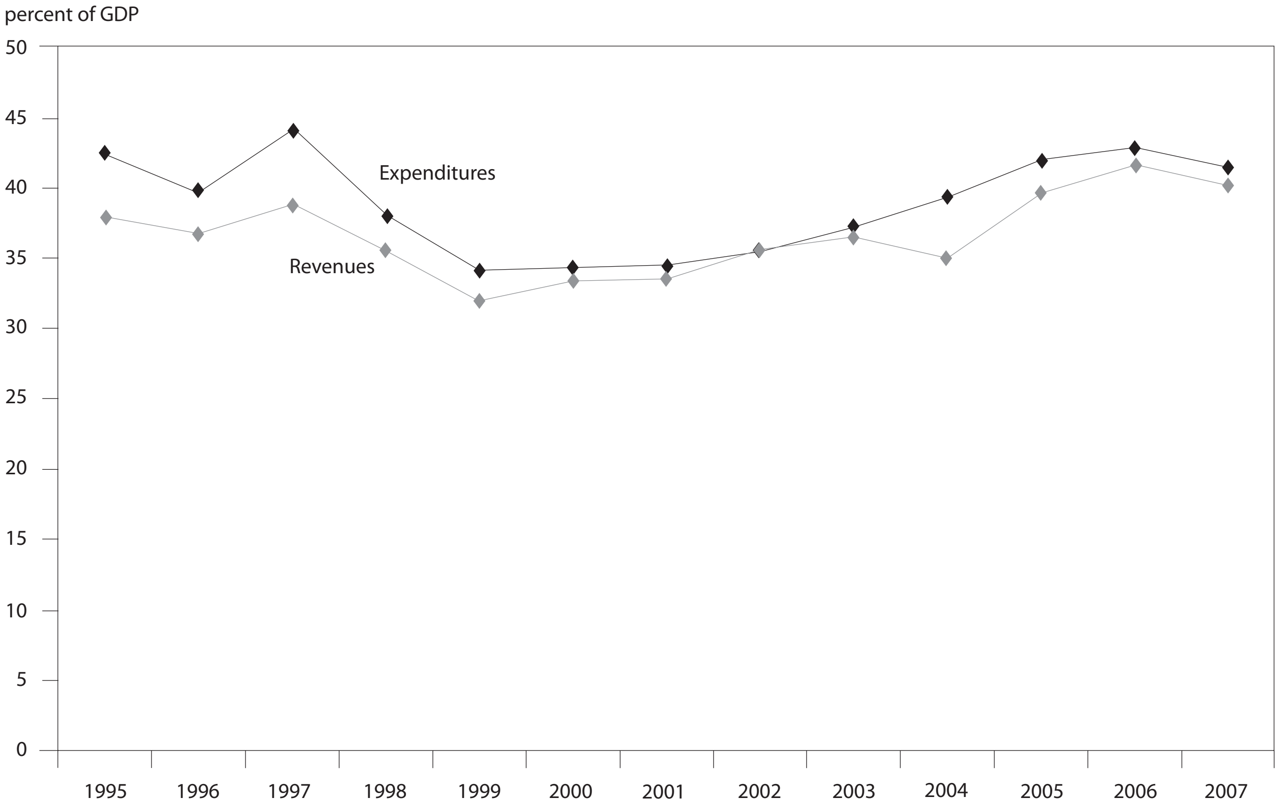
A large number of government and presidential decrees had awarded specific enterprises privileges in regulation or taxation, often tax exemptions and subsidies and sometimes monopoly rights. Yushchenko eliminated loopholes in taxation with great passion. He abolished numerous value-added tax (VAT) exemptions on imports and pharmaceuticals. The VAT would no longer be based on cash flow but on accounts, which eliminated the main tax advantage of barter. Overall, taxes were somewhat reduced. The main tax cut was that the 12 percent payroll tax for the Chornobyl Fund was abolished. Some of the least-justified expenditures came from the Chornobyl Fund, since the nuclear catastrophe in 1986 was used as a boondoggle by all kinds of privileged groups. Many enterprises and narrowly defined industries that had benefited from corporate profit tax exemptions saw their privileges eliminated. Similarly land tax exemptions and excise tax exemptions for goods manufactured in Ukraine were abolished. The oligarchs, who were the main culprits, were as stunned as they were furious.

On the expenditure side, the state had financed a large number of so-called categorical social benefits, which were primarily social transfers targeted at the Nomenklatura and paid out through the government budget. Yushchenko started his administration by instantly eliminating about 270 decrees awarding unjustified privileges for the well-connected. This action required little sophistication but a great deal of courage. Other important financial legislation comprised a law on banking and a law on promissory notes.

Although Ukraine has maintained relatively high public expenditures as a share of official GDP, this share declined by 10 percentage points from 44.2 percent in 1997 to a still high 34.5 percent in 2000, while the budget deficit shrank from 5.4 percent of GDP to 1.1 percent of GDP during the same period (figure 5.4). When the state possessed fewer resources, it caused less damage, and more people could break out of the stranglehold of the corrupt state. Yet this tax burden remained excessive (Tanzi and Tsibouris 2000).

8. For the corresponding situation in Russia, see Gaddy and Ickes (1998) and Pinto, Drebentsov, and Morozov (1999).

Figure 5.4 Ukraine's consolidated state revenues and expenditures, 1995–2007



Source: European Bank for Reconstruction and Development online database, www.ebrd.com (accessed on July 8, 2008).

Energy Trade Cleaned Up

The politically most sensitive measure undertaken by the Yushchenko government was energy reform. It was vital, but since all the leading Ukrainian businessmen were commodity traders, energy reform was considered politically impossible.

Few dared to fight these ruthless giants, and even fewer understood their intricate schemes of subsidization and arrears. Yushchenko invited the dissident oligarch Yuliya Tymoshenko to battle her previous competitors as deputy prime minister for energy.[9] By 1999 she had left active business. The question was whether she would clean up the natural gas business or reestablish herself as gas princess. She relished her assignment, and no credible claims of self-dealing emerged.

Tymoshenko knew all the tricks of the gas trade and did her utmost to clean it up. She tried to enhance transparency and eliminate barter as payments for imports with support from Russia. She insisted on tax payments in cash rather than through offsets and tried to stop theft of gas from pipelines. She ended up in a vicious conflict with Ihor Bakai, whom she sacked from his post as president of the Naftohaz Ukrainy, the state oil and gas company, in March 2000.

Electricity was another major source of rents. Here the rent-seeking scheme was much simpler, namely nonpayment. State-owned generators produced electricity, which was distributed by regional monopoly distributors, one-third of which were owned or controlled by Hryhoriy Surkis. While the distributors extracted payments from the final customers, they paid for only 6 to 7 percent of the electricity they "bought" and even less in taxes. Tymoshenko insisted on full payment of both electricity and taxes in real money, and she assessed that she forced the distributors to pay $1.8 billion more for electricity and in taxes in one year. This reform was promulgated as a law in parliament, which made it more difficult to reverse.

Oil was a minor source of energy rents. One oligarch, Oleksandr Volkov, had the exclusive right to import oil at one price, but he could sell it for double the price because of personal tax exemption. The government easily eliminated Volkov's privilege. The oil market was leveled, and Volkov went out of business.

The coal industry received direct government subsidies of hundreds of millions of dollars every year, but Tymoshenko was ousted before she could take on the powerful coal industry in Donetsk, which she blamed for her fall.

The total energy rents that were eliminated probably amounted to some $4 billion a year, or about 13 percent of official GDP, which had

9. This section is primarily based on an interview with Yuliya Tymoshenko in May 2001.

many positive economic effects.[10] Payment discipline and tax revenues improved. Ukraine's energy consumption and energy import costs fell sharply, as enterprises had to pay real money for the energy; and, as the playing field opened up, foreign companies entered Ukraine's oil and electricity sectors. Bakai, Surkis, and Volkov, however, suffered big losses, and they were furious.

Agricultural Land Privatization

Reformers persistently aimed at introducing private ownership of land, but the left in the parliament vetoed all land reform (Lerman 1999). The reform coalition finally made land reform possible.

As an original villager himself, Yushchenko's great passion was to decollectivize agriculture, and in early 2000 he carried out comprehensive land reform. State and collective farms were formally disbanded, and the land rights were distributed to the people on the farms. A shortcoming, however, was that agricultural land could not be privately sold during a transition period, and the left in the parliament stayed strong enough to maintain this land sales moratorium for years.

Initially, most land was leased back to the old managers of the state and collective farms for minimal payment, but much of the land went to private plots, private farms, and increasingly to large commercial holdings. Agricultural land ownership became varied, and the mixed ownership facilitated the deregulation of agricultural trade, which had eluded the country for so long. While little could happen during the redistribution of land, a major supply response occurred in 2001–02. Big new businessmen went into agriculture with a vengeance, and commercial banks were happy to provide loans to farms.[11]

Ukraine traditionally had relatively large private household plots in agriculture, which comprised 15 percent of agricultural land. During hard times, most poor Ukrainians survived through subsistence agriculture. According to official statistics, the share of agricultural production from the small household plots rose steadily until 2000, when they accounted for as much as 62 percent of all agricultural production (State Statistics Committee of Ukraine 2004, 157). However, the household plots did not evolve into real farms, although the small private land holdings expanded to about one-quarter of all land.

Instead, big businessmen, not only Ukrainians but also foreigners, acquired large chunks of land through long-term leases of up to 49 years.

10. Tymoshenko's approximate numbers: $2 billion of gas rents + $1.8 billion of electricity rents + $0.2 billion of oil rents = $4 billion.

11. Interview with Peter Sochan, an agricultural expert in Kyiv, in October 2000.

They usually took over one *kolkhoz*, about 5,000 hectares of land, at a time. By 2008 several agrofirms had accumulated a few hundred thousand hectares of land, and they occupied about half of the agricultural land. Ukraine had become a country of large estates.

The remaining quarter or so of agricultural land was still controlled by the old state and collective farm managers. The land often lay fallow, while new agrobusinessmen scrambled to seize it. Ultimately the parliament maintained the moratorium on private land sales because big businessmen wanted to acquire as much land as possible cheaply through leases before land trade started. In early 2008 the moratorium formally lapsed, but legal sales could not take place until a couple of laws regulating such trade had been adopted.

The vital land code was adopted after Yushchenko's fall on October 25, 2001. The ensuing year Ukraine had a bumper harvest of 39 million tons of grain, of which 10.7 million tons was exported, more than the Russian empire as a whole exported in its peak year, 1913.[12] In 2008 the grain harvest reached 49 million tons, with anticipated exports exceeding 22 million tons.[13]

Yushchenko's land reform of 2000 was sufficient to get Ukrainian agriculture going. The breadbasket had been restored, even though harvests have fluctuated greatly because of still-neglected agricultural infrastructure, especially caused by the late privatization of grain elevators.

Privatization of Large Enterprises

The privatization of large enterprises received new impetus. The transformation of the oligarchs from commodity traders to industrialists had started, and two waves of large-scale privatizations were apparent in 1998–2000.

In 1998 and 1999 numerous large enterprises were privatized to a few major oligarchs, notably Surkis, who acquired nine regional electricity distributors. Most of Ukraine's many large steelworks were quietly privatized at this time. These privatizations were inspired by the loans-for-shares deals in Russia in late 1995 (Åslund 2007b, 161–64). The beneficiaries were Ukrainian oligarchs. Usually, they had already secured control over the enterprises in question by buying the incumbent managers. Kuchma's staff desired that the oligarchs raise funds for his reelection in October 1999. Although these were privileged insider privatizations,

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12. "Eksport zerna iz Ukrainy sostavit 10,5-11,0 mln tonn" ["Ukraine's exports comprise 10.5-11.0 million tons"], www.gazeta.ru, March 3, 2005, (accessed on July 10, 2008).

13. Interfax—Food & Agriculture, Kyiv, Ukraine, September 10, 2008.

they improved the way these enterprises, big business, and the whole economy operated.

Another wave of large-scale privatization occurred in 2000, when several large enterprises were sold in tenders primarily to big private Russian enterprises, which could now win in competition with Ukrainian oligarchs because they had more money. Four major oil refineries were sold to four different Russian oil companies (TNK, Lukoil, Tatneft, and Alliance), a petrochemical factory to Lukoil, the big Mikolayiv alumina plant to RUSAL, and an aluminum factory to SUAL. Ukraine had huge but old refinery capacity. These refineries produced only a minimum in the 1990s, but privatization made them start working, boosting the country's GDP and allowing Ukraine to become self-sufficient in petroleum products, while it economized on its import bill.[14]

Later, other Russian companies expanded into Ukraine by buying private companies. The Moscow mobile telecommunications company MTS bought the leading Ukrainian mobile company UMC, while Alfa Group bought a large share of the competitor Kyivstar. Among the biggest "Russian" investors were Mikhail Fridman and Viktor Vekselberg, both from the Lviv region.

Yekhanurov also prepared the sale of six regional electricity distribution companies through open international tenders, which was carried out in 2001. This was the first truly open and fair international sale of big Ukrainian enterprises. Two of the companies were bought by American AES, while four were overtly purchased by the Slovak state utility company, which turned out to have acted as an intermediary for Aleksandr Babakov, a Russian businessman close to President Vladimir Putin's Kremlin and a business partner of Surkis and Medvedchuk.

By 2000 the EBRD (2000) assessed that the private sector generated 60 percent of Ukraine's GDP (figure 3.3). Until then, privatization had not had much impact (Estrin and Rosevear 1999). A critical mass had been formed, allowing the economy's mode of operation to change. Enterprises finally started adjusting and expanding.

Deregulation of Small Firms and Anticorruption Measures

The proliferation of low, simplified taxes for small entrepreneurs had started in the least reformist period. From 1986, Ukraine had fixed lump-sum taxes on the books for individual entrepreneurs, but these taxes had been set too high and given little bureaucratic relief (Åslund 2007b). This

14. Since 2005, however, these refineries have been working poorly again because Ukraine imposed close to confiscatory taxation on oil refining.

was how small enterprise was allowed to expand in Poland in communist times (Åslund 1985).

The idea was revived in 1998. The author was Yekhanurov, who was then chairman for the State Committee for Regulatory Policy and Entrepreneurship. A small fixed lump-sum tax was introduced for individual entrepreneurs to legalize them, minimizing their contacts with the authorities and prohibiting all inspections while making them official taxpayers. An individual entrepreneur had to interact with government officials only a few times a year when he or she paid this low fixed tax. No bookkeeping was required, and these entrepreneurs were completely excluded from the inspection rage.

For slightly larger enterprises with up to 10 employees, a low turnover tax of 10 percent was introduced as the single tax. It had similar advantages even if it did not altogether preclude inspections. As a consequence, the number of single entrepreneurs swiftly skyrocketed to an estimated 2.7 million by 1999, and 250,000 enterprises had 1 to 10 employees (Thiessen 2001).

Similarly, Ukrainian agriculture benefitted from a highly favorable fixed tax per hectare that corresponded to as little as 1.5 percent of the value of agricultural output, while being exempt from value-added tax and other taxes (Demyanenko and Zorya 2004). A consequence, however, was that many urban companies acquired huge tracts of land to be taxed as agricultural enterprises, ignoring the actual farming.

All kinds of services flooded the market at low prices. Businesspeople who had operated underground could legalize and intensify their trades, allowing them to raise their output and productivity. After three years of trial and error, deregulation started to bite.

The bureaucratic burden on medium-sized and large enterprises was also great. In a 1997 survey of new medium-sized entrepreneurs in Poland, Slovakia, Romania, Ukraine, and Russia, Simon Johnson, John McMillan, and Christopher Woodruff (2000) found that, in comparison with Central Europeans, Ukrainian entrepreneurs paid 50 percent more taxes as a share of their turnover and 75 percent more unofficial payments to officials. A World Bank survey established that inspections required more management time in Ukraine than anywhere else in the world (Hellman et al. 2000).

A large and intrusive state inspection apparatus of numerous competing agencies indulged in overgrazing of the same companies. The revenues went partly to underfunded public programs and partly to corrupt inspectors (Shleifer and Treisman 2000, Kravchuk 1999). The main scourges increasingly became law enforcement itself, the Ministry of Interior, the Ministry of Security, and the State Tax Administration, each of which was run by a loyal Kuchma strongman.

For long, medium-sized and large enterprises had not really opposed the inspection fury because it granted them monopoly rents. When it faced price competition from myriad small entrepreneurs, however, the established business community demanded lower regulatory costs as well, prompting a decline in inspections. In 2000 Yekhanurov instigated a series of laws to achieve a breakthrough in the conditions for small enterprises, state support for small enterprises, a program on the development of small enterprises, and a law on licensing.

Ukraine was the first postcommunist country where regulatory hazards were well analyzed,[15] and from 1997 onward a substantial reform agenda was gradually elaborated. The number of state agencies was cut, and the agencies were streamlined, while a special agency for the support of enterprises was instituted; licensing was reduced and simplified; inspections were registered and became subject to oversight; and underfunded public mandates were either eliminated or funded. Initially, little came out of changes such as the simplification of licensing and the control of inspections, as the fundamental problems of underfunded mandates and almighty corrupt inspectors persisted. As Iryna Akimova (2002, 168) summarized the situation: "the business environment in Ukraine . . . is characterized by a high level of corruption, insecurity about property rights, a weak legal system for contract enforcement, and extensive tax evasion." The tightening of public finance in 2000, however, brought about real success, as inspections fell off sharply (EBRD and World Bank 2002, 2005).

The Gongadze Murder and "Kuchmagate"

In the fall of 2000, one dramatic event brought about unexpected political change. Heorhiy Gongadze, an independent journalist, had launched an irreverent online newspaper called *Ukrainska Pravda* (*Ukrainian Truth*), which sharply criticized the authorities. On September 16, 2000, Gongadze disappeared in Kyiv. On November 2 his decapitated body was found in a shallow grave in a forest 120 km outside the city. From the outset, this looked like a political murder, but Ukraine had experienced a few other mysterious deaths of journalists, which had aroused no outcry.

Gongadze was a free spirit who had written many stories about corruption criticizing the authorities, but 11 days before his disappearance he had published a critical article called "Everything about Aleksandr Volkov," (Gongadze 2000) which was seen as a likely cause of his disappearance (Wilson 2005, 51–55).

On November 28, 2000, socialist leader Oleksandr Moroz made a sensational speech in parliament. He accused President Kuchma of being involved in Gongadze's murder, and he presented audiotapes as evidence.[16] One of Kuchma's bodyguards, Major Mykola Melnychenko, had

15. The pioneering work was Kaufmann (1995).

16. "Transcript: What Do Melnychenko's Tapes Say About Gongadze Case?" Radio Free Europe/Radio Liberty, March 3, 2005, www.rferl.org.

allegedly recorded hundreds of hours of Kuchma's private conversations in his office in the course of one year. As Adrian Karatnycky (2006, 33) writes: "In those conversations, Kuchma demanded Gongadze's abduction, discussed the criminal harassment of political opponents, engaged in high-level corruption, and revealed himself to be at the center of a criminal and corrupt system of rule."

Melnychenko released the recordings one after the other, discrediting Kuchma. When Moroz presented the tapes, Melnychenko was already in the Czech Republic under the protection of Ukrainian socialists. Later he received political asylum in the United States. However, his behavior aroused doubts about the veracity of the tapes and his intentions. He did not publish all the tapes but continued talking about his future extraordinary revelations, which never occurred, and he was trying to sell his tapes for millions of dollars. After receiving political asylum in the United States, he was sighted in Moscow. He alleged that he acted on his own, which was not altogether convincing. He and his intentions remain a mystery.

In March 2008 a Kyiv court convicted three former Ukrainian police officers from *Sokil* (Hawk), one of the many special units of the Ministry of Interior, for the Gongadze murder, but law enforcement officials were never able to identify who ordered the killing. The responsible lieutenant general of the Ministry of Interior was given the chance to flee abroad, while the key witness died in police custody. The chief suspect, Minister of Interior Yuriy Kravchenko, died in a suspicious suicide on March 4, 2005, just before he was supposed to testify in the Gongadze murder. The roles of Kuchma and his chief of staff Volodymyr Lytvyn in this drama remain unclear.

The Gongadze affair was nicknamed "Kuchmagate." Although the recordings were never fully verified, their impact was devastating for Kuchma. The picture of an administration regularly acting beyond the law was all too evident. The public blamed Kuchma, and their perception of him changed for good. His still respectable popularity rating fell to single digits, never to recover. For most purposes, this day made Kuchma a lame duck, but he had four years left in his presidency.

Kuchma appeared weaker than ever, and a protest movement against him, Ukraine without Kuchma, started. Thousands of people took to the streets in the middle of the winter, demanding his resignation and setting up a tent city in central Kyiv. Moroz and the Socialist Party initially led the movement, but it included protesters on the right as well. Anti-Kuchma protests continued for three months, but the demonstrations never exceeded 20,000 people. The organizers despaired because they had failed to reach a broader public. On March 9, 2001, violence broke out between protesters belonging to the hard nationalist right, UNA-UNSO (the Ukrainian National Assembly and the Ukrainian National Self-Defense Force), and the police. The protesters alleged that this was a provocation, but whatever the truth was, the incident led ordinary people to abandon the protests, which came to an abrupt halt.

Kuchma persisted, but he was forced to sacrifice his strong and long-serving head of the Security Services of Ukraine, Leonid Derkach, in February 2001 and his equally loyal minister of interior, Yuriy Kravchenko, in March 2001. Their departure seriously weakened the political strength of the law enforcement bodies and Kuchma's leverage against big businessmen. The presidential administration reinforced its control over the media (Prytula 2006; Wilson 2002, 32–36; Wilson 2005, 51–55).

A few other mysterious deaths of journalists followed. In July 2001, Donetsk regional television director Ihor Aleksandrov was beaten to death, and in December 2003 another journalist, Volodymyr Karachetsev, was murdered in a purported suicide (Pifer 2004).

The Melnychenko tapes also recorded that Kuchma had approved of the illegal sale of Ukraine's advanced Kolchuga radar to Saddam Hussein's Iraq, which was prohibited by a United Nations Security Council resolution. In September 2002 the United States claimed that it had authenticated this recording, but no Kolchuga radar was found in Iraq after the Western invasion there; it might not have been delivered (Pifer 2004).

These scandals curtailed Kuchma's hitherto extensive foreign travel. He was now considered persona non grata in the West, circumscribed to meetings with Russian President Putin and leaders of other countries in the Commonwealth of Independent States (CIS). The main exception was Poland's President Alexander Kwasniewski, who continued having frequent meetings with Kuchma. Kuchma loved travelling, and he intensified his exchanges with Russia and other CIS countries. Contrary to his desires, his multivector foreign policy had become a single-vector policy. Kuchma courted NATO by all means. In May 2002 he announced that Ukraine's ultimate goal was to join NATO (Pifer 2004). In November 2002 NATO held a summit in Prague, which Kuchma gate-crashed despite NATO having made clear that it did not invite him (Wilson 2005, 60).

Yushchenko's Ouster

Nobody had expected the Ukrainian reforms of 2000 to be so successful, but the elite considered them controversial. Yushchenko concentrated on priority measures and carried them out as planned during his first 100 days, while the elite still needed his economic reforms and international credibility to keep the country from defaulting.

In April 2000 the oligarchs perceived the danger of default had passed, and they began complaining about Yushchenko and Tymoshenko's high-handed rule, calling for consensus and a coalition government. In early April the Social Democratic Party (United), led by Medvedchuk and Surkis, and the faction led by Volkov and Bakai, now called Regional Revival, voiced concerns over the government's reform program. On

April 19, President Kuchma himself started criticizing the government quite sharply for being "insufficiently active." In particular, he disapproved of Tymoshenko's energy policy (Kravchuk 2002, 85).

During the early months of 2000, the *Financial Times'* stringer in Kyiv pursued a virtual campaign against Yushchenko for the incorrect reserve management at the NBU in 1996–98, with Medvedchuk as the apparent source. Because of these vocal complaints, the IMF could not give Ukraine any financial support during the first half of 2000. The consequence, however, was that the oligarchs became all the more dependent on Yushchenko for their own survival.

From the summer of 2000, the oligarchs stepped up their criticism of Yushchenko's economic policy and especially Tymoshenko's energy policies. The main critics were Yevhen Marchuk, Volkov, and Mykola Azarov, the head of the State Tax Administration, who also represented the Donetsk clan. Kuchma largely sided with the oligarchs, though wily as he was, not too obviously. His complaint now as always was that reforms were insufficient.

In September 2000 Foreign Minister Borys Tarasiuk was sacked for having offended Moscow and became the leader of Rukh instead. By November 2000 the Kyiv rumor mill asserted that the president would sack Yushchenko within weeks, but the Gongadze scandal delayed this decision.

On January 19, 2001, Kuchma dismissed Tymoshenko, and on February 13 she was arrested, accused of three crimes committed during her time as a gas trader in 1996–97. First, her company UESU had allegedly not paid VAT on gas sales amounting to $2.5 billion. Tymoshenko's response was that UESU was an offshore company that had been legally exempt from VAT. Second, she was accused of giving Lazarenko a bribe of $110 million when he was prime minister. Tymoshenko retorted that he was coowner of UESU so this was no bribe but dividends. The third accusation was that in a gas deal with the Russian Ministry of Defense she had not paid some $350 million in a barter deal. Tymoshenko stated that she would pay. On March 27 she was let out but not acquitted, as the legal case was only allowed to rest.[17]

In April 2001 four centrist oligarchic parties joined hands with the left and voted Yushchenko out of power. On April 19 they declared the work of the cabinet of ministers unsatisfactory with a large majority of 283 votes. On April 26 a majority of 263 deputies voted no confidence in Yushchenko and ousted him. The remaining center-right with about 170 seats continued to support Yushchenko. The old oligarchs were furious with Yushchenko and Tymoshenko for having deprived them of their old rents.

17. Interview with Tymoshenko in May 2001.

A Severe Break in the Rent-Seeking Society

For a decade, Ukraine had been one of the sickest economies in the former Soviet Union, seen as hopelessly corrupt and stagnant. The sudden substantial growth in 2000 was all the more surprising. Ukraine in 2000 offers a textbook example of how reforms can be successful even in adverse circumstances.

Yushchenko's reforms in 2000 were a stunning success in every relevant regard. The prime concern, external default, was soundly averted. Since 1999, Ukraine's public debt as a share of GDP has steadily fallen, and international reserves have risen (figure 5.3). Near fiscal balance was established and maintained for the next few years (figure 5.4). In 2000 Ukraine returned to economic growth after a decade of decline, and growth was substantial at 6 percent. It has proven sustainable and averaged at 7.5 percent a year in 2000–07 (figure 5.5). That is slightly more than Russia's growth despite its oil boom and almost twice Poland's growth. In comparison with Russia, Ukraine's growth has been more volatile.

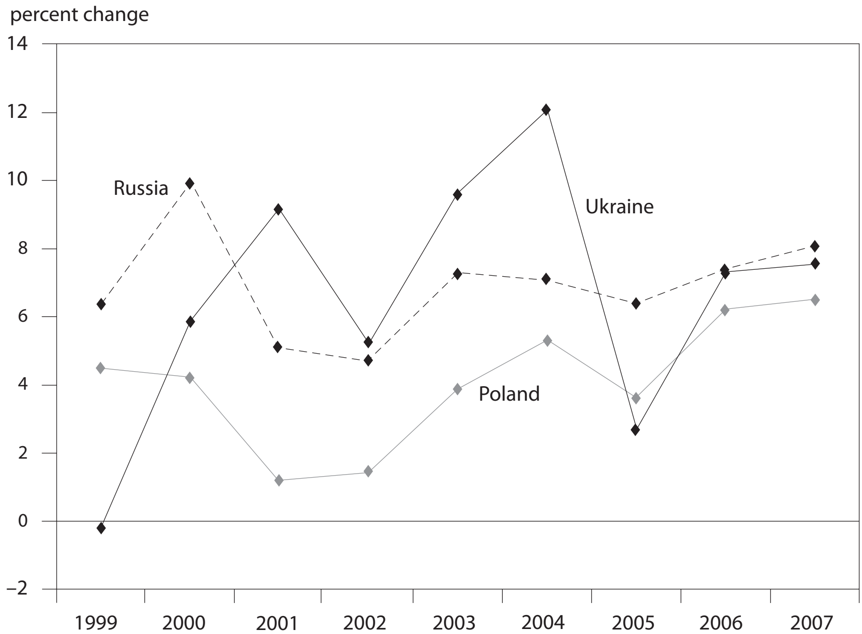
For the electorate, Yushchenko's most important deed was probably that he started paying pensions on time from October 2000 onward, abolishing the chronic pension arrears, and soon afterward eliminating public wages arrears as well. All these achievements derived from his far-reaching structural reforms.

How could Yushchenko's government succeed so well after so many years of failure? Ukraine's fundamental economic problem was that it was an archetypical rent-seeking society, and the surprise was that this seemingly stable system could be disrupted without revolution, although the rule stayed oligarchic. The explanation is that this was highly sophisticated political economy, pursued by Prime Minister Yushchenko.

First, Yushchenko was given the chance to become prime minister with a strong mandate because the risk of external default was great, which the Ukrainian oligarchs understood well after the Russian financial crash. This complies with Allen Drazen and Vittorio Grilli's (1993) argument that a crisis can facilitate reform by undermining the finances and power of opposing vested interests. It also coincides with the Ukrainian national self-perception that Ukrainians go all the way to the precipice but then retract, while the Russians cross into the chasm.

A second factor was the parliamentary elections in March 1998. The new partially proportional electoral system structured the parliament in sufficiently strong party factions to make bargaining possible. The political representation of the oligarchs rendered their dealings more open and transparent. While not accountable, the public perceived them as responsible. The broad center-right coalition facilitated many decisions that had previously been politically impossible, when one or two oligarchic parties usually joined the left to oppose any market reforms for purely corporate

Figure 5.5 Official GDP growth, 1999–2007



Sources: United Nations Economic Commission for Europe (UNECE) online database, www.unece.org (accessed on July 1, 2008). 2007 estimate from World Bank, *Ukraine: Economic Update,* April 2008, www.worldbank.org.ua (accessed on July 13, 2008).

interests. The coalition agreement impeded defection for a few months, which was sufficient.

A third reason for Yushchenko's political success was his political astuteness. He and his collaborators acted fast and hard. They knew that their time was short and that the oligarchs had brought them as an emergency measure to avoid default. Therefore they emphasized their first 100 days. In that brief window of opportunity, they promulgated all their controversial reform laws that had been discussed but blocked for years. Yushchenko wisely dealt the oligarchs an early devastating blow before they could oust him, taking his cue from Machiavelli. His daring stroke of genius was to invite the forceful Tymoshenko to diminish the oligarchs' energy rents. Her actions put two major oligarchs (Volkov and Bakai) out of business, while the others lost money. Since she dared to challenge the major oligarchs, both Tymoshenko and her husband were arrested and prosecuted. Yet, within a year, the nature of the oligarchs had changed. The worst rent seekers, the commodity traders (Volkov, Bakai, Surkis, and Medvedchuk), had lost money and power, while the steel producers (Akhmetov, Pinchuk, Haiduk, Taruta, and Kolomoiskiy) suffered little and gained wealth and power under the new economic conditions.

A fourth, related explanation was the transformation of Ukrainian big business through privatization. Regardless of how Ukrainian oligarchs had acquired property, their ownership of large producing enterprises changed their behavior. Traditionally, they had made their money through commodity deals secured in the corridors of power rather than through production. Because of their frequently shifting alliances, they had to maintain good relations with all. The privileged privatizations before the presidential elections in 1999 separated the oligarchs' interests by connecting them with specific industries. The pure commodity traders (Volkov and Bakai) lost out, while the others went into large-scale manufacturing. The emergence of millions of small legal entrepreneurs provided the market competition needed to reduce monopoly rents, although they played no apparent political role as yet. The creation of a larger private sphere outside of state influence thus contributed to political development (Boycko, Shleifer, and Vishny 1995).

A fifth lesson is much older than Machiavelli, namely, divide and rule. In energy, Tymoshenko took on one oligarch after the other. Robert Ekelund and Robert Tollison (1981) argued that mercantilism in Britain broke down in the 18th and 19th centuries because of protracted rivalry between the royal court and parliament over rents, leading to laissez-faire. Similarly, Andrei Shleifer and Robert Vishny (1993, 1998) advocated competition over bribes as the best way to drive them down. This seems to have cured Ukraine, although the legalization of the new state of affairs is not in sight.

A sixth explanation is that the public was ready. Many understood Ukraine's predicament and a broad consensus had evolved regarding what reforms were needed to cure the economy. The year 2000 brought execution. Hundreds of reform laws had been drafted and were ready to be adopted. Yet no popular pressure was apparent, not least because the oligarchs controlled the media.

Finally, external pressure was important. The IMF defined the threat of external default and made the rulers aware of the dangers. Paradoxically, its pressure was stronger when it provided no credit. The West strongly influenced the government's ideas, notably the German advisory group, but also the IMF and the World Bank. Ukrainian officials were anxious to be respected by the West, and Yushchenko greatly benefited domestically from being considered so highly in the West. That was why the oligarchs chose him.

To sum up, thanks to the right resolve, a great deal could be accomplished in 100 days. All these reforms were important, but the reduction of energy rents was key, followed by the cleaning up of the state budget and payments, because those reforms reduced rents and thus transformed the oligarchic stratum. Yushchenko provided a textbook case for how a rent-seeking society could be broken up through speed, determination, division, and hard hits, focusing on the most important rents, while taking on one oligarch after another. These reforms would not have been possible if they had been introduced more slowly or if consensus had been sought; the breaking up of the previously cohesive elite rendered them successful. Privatization had made the oligarchs more autonomous from the state and one another, which intensified competition among them.

The 2000 reforms were the second round of brief radical reforms in Ukraine, the 1994 reforms being the first. In many ways they were similar. They were comprehensive radical reforms suddenly imposed from above when people had given up hope. Although the reforms were delayed, they were not gradual or piecemeal but swift, radical, and concentrated. Otherwise, they could not have been carried out. International advice and financing were significant on both occasions.

Much of the deregulation in 1994 was reversed, while that was not the case with the 2000 reforms. One reason was that the 2000 reforms were largely legislated, while most of the 1994 reforms had been imposed through decrees. The tenacity of the reform laws was also reinforced by the existence of a majority coalition consisting of party factions rather than only individual deputies. Moreover, the reforms of 2000 led to economic growth, which made them self-reinforcing, especially as they were based on private ownership. Devaluation and rising international metal prices helped but were hardly fundamental causes. The new growth was also facilitated by a prior shakeout of value-detracting industry.

The breadth of the reforms should not be exaggerated, as the reform capacity stayed limited. No social reforms were undertaken, and no tax code has been promulgated as yet. Judicial reform is urgent. Yet the reforms undertaken in 2000 were probably those most needed.