

The Reform Driving Forces in a Rent-Seeking Society: Lessons from the Ukrainian Transition

Third draft

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1. Introduction

During the 1990s Ukraine underwent a dramatic 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 quite comprehensive reforms undertaken after the 1998 crisis that have mostly accomplished the country’s transition to a market economy. By 2004 Ukraine has become one of world’s leaders in growth of per capita GDP nonetheless this transition is still incomplete and burdened with pervasive rent seeking.

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 reforms raises controversies. The question “Why to reform?” is therefore a key to understand the Ukrainian transition, as well as, perhaps, similar historical processes in the other post-Soviet countries and maybe some other rent-seeking societies (Krueger, 1974) too. Providing the right answer to this question turns out non-trivial and mostly overlooked in the literature.

For the purpose of this work we define a rent-seeking society as a two-sector economy, where the rent-seeking sector initially prevails over the value-adding one. As the rent we understand any kind of income originated from the explicit (e.g. subsidies) or implicit (e.g. protectionism or monopoly power³) involuntary re-distribution of the value created by others; or appropriation of already existing wealth (e.g. natural rents or historical legacies)⁴. Respectively, three kinds of institutions are needed to eliminate the rent seeking defined in such a way.

- property rights, hereinafter understood as residual rights of control over any kinds of property, including the public funds
- market competition, and
- effective state governance able to prevent private appropriation of the natural rent, socially inefficient allocation of budget spending, or ill regulation of the natural monopolies.

These institutions are interrelated to each other.

³ In the case of natural monopolies, when a “market” value cannot be defined by competition, the definition of a monopoly rent is vague

⁴ all kinds of market distortions, including the restrictions on competition (like protectionism, collusion, and protected monopolies), are sources of rents. The major ones include also any gains from the forced deals, such as open or hidden redistribution through the state budget (in both cases the State’s coercive force is used); and the natural sources, including natural monopolies.

A protected monopoly actually violates the control rights of consumers by limiting their choice, as well as the rights of the would-be competitors in using their assets for entering the protected markets. But even more important for our consideration, weak property rights are inconsistent with competition.

By Demsetz (1967), the private property rights can be regarded as a special sort of restrictions on competition protecting the potential sources of rents from overappropriation (known as “the tragedy of the commons”) by restricting the use of them to the owners, and in such a way internalizing the respective externalities. Should the property rights are weak, some other institutions emerge to control and coordinate the rent seeking in order to protect the vitally needed rent sources (as production assets) from overappropriation. But a market niche can be equally considered as exhaustible source of monopoly rent subject to overappropriation. Unlike the private property rights, which, as a rule, selectively protect those rent sources increasing the social wealth, any kinds of alternative institutions tend to restrict the market competition too.

On the other hand, sufficient contraction of the rent seeking is therefore a necessary condition for establishment of the property rights, as well as for emergence of a truly reformist government. Sonin (2003), 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 opportunities associated with weak rule of law persist. If also those voters having little stake in such rents are politically underrepresented, the state may become “captured” by oligarchs (Hellman, 1998; Hellman, Jones, and Kaufmann, 2000), thus unwilling to undertake the reforms potentially subversive for rent seeking.

However, historically similar kinds of ‘bad’ long-run equilibrium (Sonin, 2002) can be found in different countries, including those nonetheless managed to become the mature market democracies nowadays. So, there should be some way out of the above-described vicious circle. On this way a rent-seeking society should undergo essential changes occurring nevertheless no major political force is interested in them. We argue that this is exactly what happened in Ukraine in the second half of 20th century. Here all major changes took place not as deliberately sequenced market reforms conducted by a benevolent government (as considered in the normative literature), but instead were 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 encompassing rent seeking ruler should still provide some amount of public goods to ensure

the economic efficiency, thus restrain the rent-seeking, in order of maximizing his⁵ own rent. Dixit, Grossman and Helpman (1997) show how he can accomplish this by playing divide-and-rule even while being “captured” with diverse rent-seeking interests. But these models taken alone 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 the critically important questions arise:

When and Why a rent-seeking society remains relatively stable for some periods of time? What should change to make it reforming? Which forces may eventually drive a rent-seeking society out of the ‘bad’ long-run equilibrium of the above-described kind? How do they do that?

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 1990^s as a sort of revolution that he defined 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 try to identify right policies to enable a rent-seeking society of similar kind to undertake and implement reforms in order to establish modern competitive market and procure economic growth.

In the second part we analyze some political and societal dimensions of a rent-seeking society allowing us to formulate the respective conditions for its sustainability.

We describe a political economy of a rent-seeking society in terms of a hierarchical “arbiter-clients” model. We argue that at least at certain stage of societal evolution, a rent-seeking society may need an authoritarian ruler (“arbiter”) as a second best arrangement able to prevent the overappropriation or dissipation of rents. Such arbiter, in turn, suppresses or crowds out social capital (Putnam, 1992 \\), 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 as “oligarchs” or “clans”) become clients of the arbiter.

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, and hence fail to realize the advantages of market reallocation over the coerced redistribution. But such

⁵ 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.

perception reflects the fact that the rent – as opposite to efficiency gains stemming from the market transactions – is prevailing source of above-average wealth in a rent-seeking society. Besides, deadweight losses from the limits on competition are intuitively unobvious, while the ones incurred by overappropriation resulting from unconstrained competition for rents are easily visible. These factors legitimize arbiter's coercive control and coordination.

Combining these arguments with above-cited description of a 'bad' equilibrium we state that a rent-seeking society led by 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) begets a "gap of control", which leads to overappropriation of rents⁶, 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 went too far, partial implementation of the market institutions in certain sectors becomes "second best" for the rent seekers in power as long as they fail to control these sectors anyway.

Meanwhile, before such reform takes place, the intermediate non-encompassing rent-seeking arrangements mushroom in the uncontrolled sectors. They are often persistent and resisting to implementation or completion of reforms, thus preventing closing of the gap of control. The described mechanism determines both the particular way in which the reforms in transition went out ("How?"), and their outcomes ("How well?").

From this perspective, in the Section 3 we analyze the main institutional and politico-economic patterns of the late Soviet society. We argue that the economic and administrative elites of at least late Soviet times were predominantly rent-seekers tightly controlled and coordinated by the power-maximizing arbiters, mostly associated with the Communist *nomenklatura*. This approach helps us identifying the roots and nature of '*nachal'niks*', "red directors" and "business-administrative groups" ("oligarchs") that further played key roles in transition. We can also trace the connection between societal evolution and deterioration of control in this particular case: disappointment in the communist ideology has undermined the legitimacy of the Communist Party, which was the main arbiter in charge of control and coordination.

In the Section 4 we argue that erosion of totalitarian control in the USSR that has led to the reforms under our consideration started at least with Stalin's death, almost forty years before the reforms actually begun. This long-term decay, not the first wave of reforms (1992) themselves, created the gap of control, which resulted in deep initial recession that we describe in the Section 5. Then, this

⁶ Possible decrease in sources of rent caused by both internal and external factors may have similar effect

gap was mostly closed in two further waves of reforms that occur in the years of 1994-96 (Section 6) and 1999-2001 (Section 7).

When the gap of control is considered, it becomes clear that the drastic nature of price liberalization in Ukraine was inevitable outcome of the avalanche-like destruction of Soviet system, not just implementation of some radical reformers' ideas. Rather the reformers were called up to power in Russia and Poland because they were better prepared for managing of such drastic but unavoidable measures. The Ukrainian government had to lift the price controls simultaneously with the Russian one regardless to its initial intentions. But in Ukraine those times the reformers were even weaker politically, than they were in Russia, so the institutional and structural reforms needed for closing the gap of control were delayed even further. As a result, in the early 1990s in Ukraine a sort of "market 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 crediting, open subsidies, and cheap energy imports from Russia. Five-digit hyperinflation and severe economic recession were outcomes of this arrangement. We attribute these shortfalls to overwhelming political domination of red directors lacking the arbiters able to prevent overappropriation.

In the Section 6 we show how the overappropriation of the major initial sources of rent – primarily, increase in relative prices of energy, and exhausting of the revenues generated from "inflation tax" – has brought about a relatively strong authoritarian arbiter (President Kuchma) that has partly restored the control and coordination. But full restoration (i.e. return to the totalitarian regime) was impossible; and the Ukrainian *red directors* in mass appeared hardly manageable clients for him as an arbiter. So, Kuchma has to undertake the first wave of reforms including monetary stabilization and mass privatization – even contrary to his initial intentions and electoral pledges.

We demonstrate how these reforms have partly closed the gap of control by some strengthening of 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 the collapse, these measures appeared insufficient for jump-starting of the economy. Instead they resulted in an arrangement often referred to as the "virtual economy" (Ickes and Gaddy, 1998) – an obscure pseudo-market economy 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 stem from irresponsible external borrowing facilitated by paternalistic treatment of Ukraine by international donors.

But these external sources were soon overappropriated too, which caused the crisis of 1998-99, as described in Section 7. Similarly to the situation of 1994-95, this crisis, although less severe, has brought about a second wave of reforms: fiscal stabilization and dramatic reduction of state

paternalism towards the enterprises. These reforms resulted in economic growth and improvements in well-being of broad population, which made them popular. 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.

The Section 8 sums up the intermediate outcomes of these changes. We show that as a result of reforms the gap of control was mostly closed, so the country has returned to the path of growth. However, the deepness of this gap, and procrastination with necessary reforms at the late Soviet times resulted in proliferation of the malicious temporary arrangements that largely contributed to creation of Polterovich's (2001) *institutional traps* preventing the establishment of property rights and market coordination, thus further magnifying the social cost of the whole process of this dramatic change.

The 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 from high social cost incurred 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.

2. The Model

2.1 The problem of coordination in a rent seeking society of Ukraine

Uncoordinated rent seeking leads to the overappropriation of sources of rent (“overfishing”), or dissipation of rent for counterproductive fighting (as described by Tullock, 1980). Here are few examples particularly important for the case of Ukraine.

Poorly controlled production assets (e.g. the state-owned ones under a weak or docile government) become swarmed with parasite firms competing in their stripping. The state budget becomes overappropriated by uncoordinated interest groups. As a result, either inflation or overtaxing deteriorates the tax base, as described by Tornell and Velasco (1992). So does the “mirrored” phenomena of tax evasion and lobbying for tax privileges studied by Kaufmann, et al. (1999). The uncoordinated complementary 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).

The well-established and allocated property rights⁷ could either solve these problems completely, or open the way for efficient reallocation of ownership (as in the case of complementary monopolies). But if they are weak or fuzzy, a socio-economic system, to be sustainable at least in a short run, needs some other source of coordination. Such coordination is Pareto improving, thus both the society and the rent seekers are expected to accept any viable alternative. For example, a strong archaic tradition can forbid any kind of competition at all and set up strict quotas for the rent appropriation; or sufficient social capital can help the potential competitors to reach an agreement.

Ukraine has inherited another kind of coordination arrangement that we called “arbiter-client hierarchy”. Here the coordination is secured by a third party player akin to Mancur Olson’s *stationary bandit* unable to extract the rent by himself, but instead endowed with a monopoly on coercive force. We call him an *arbiter* because it is empowered to (a) divide the “quotas” on rent *arbitrarily* at his own 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), or trade some of it for the political loyalty. In such a way he becomes a paternalistic principal (patron) “employing” the non-coercive rent seekers as his agents (*clients*) collecting the rent for him¹. In effect, an arbiter acts like a landlord that owns⁸ the rent sources but allows his clients to take away some rent as a reward for bringing the revenues 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.

2.2 A rent-seeking society as a system

Once empowered to protect the natural sources of rent and public property, an arbiter gets an interest and means to expand his power and enhance his rent by suppressing competition (e.g. by enforcing the cartels) in the other sectors. Noteworthy, in such a way he creates the Cournot’s complementary monopolies, thus has to become engaged in the coordination of them too. Unlike the arbiter’s initial role, such interventions decrease the peoples’ well-being, so the truly rational people should resist to them. Proliferation of the rent seeking also violates the property rights, so the competitive firms should oppose to it. In this struggle they might rely on people’s support, since they are wealth enhancers. However,

⁷ in the above-described meaning, hence including the ones of control over the government spending

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

- as long as an arbiter provides alternative source of coordination, his very existence undermines necessity in the social capital needed for collective actions (Olson, 1965). This can explain why the latter remains weak under authoritarian and totalitarian regimes (as observed by Putnam et al., 1993).
- the archaic public consciousness treats an economy as a sort of zero-sum game of “cutting a pie” (the perception known in anthropology as a “limited good” one (Foster, 1965)). Such a consciousness fails to distinguish between economic profits⁹, and rents stemming from the forced redistribution; and hence treats any above-average wealth as a result of “theft” unless it is granted by the authorities as a “fair” reward. The people endowed with such kind of perceptions actually support the rent seeking in two ways.

On the one hand, they see no virtues in the market coordination comparing to the one conducted by an arbiter. Moreover, 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.

On the other hand, firms are not interested in abstaining from the rent seeking, since their property is equally illegitimate regardless to its origin. Thus, even a truly honest firm cannot appeal to the public for the protection of its property rights abused by an arbiter or even by another firm. Under such circumstances, the overwhelming majority of business seeks the rent as long as it brings higher returns, so the “perception of limited good” becomes self-fulfilling.

These feedbacks make such political-economic system self-sustainable during a certain period of time despite its numerous deficiencies (among all, studied by Shleifer et al., 1993; Murphy et al., 1991). Moreover, this 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 overappropriation. If the public consciousness remain unchanged, another “stationary bandit” gets welcomed to come and “restore an order” in the same manner. If, on the contrary, some particular source of rents disappears, an arbiter has vested interest in finding a substitute.

2.3 Reforms under the rent seeking

Similarly to Coase’s theory of a firm, a rent-maximizing (authoritarian, an even plutocratic) ruler being an arbiter in the above-described meaning would expand his controls only as long as the gain (marginal rent) from an additional “unit” of control would exceed its cost (including both the one-

⁹ The ones stemming from market reallocation and efficiency gains, which increase the well-being

shot cost of seizing, and the cost of operation). Likewise, a rational power-maximizing (totalitarian) ruler can go as far as the total rent he gains covers the total cost of control and coordination. These constraints rein in the size of a rent-seeking sector, thus leave some room for the property rights and economic freedom. Both existed to some extent even under the deliberately and ideologically totalitarian Soviet regime.

Furthermore, the arbiter's control and forced coordination tend to deteriorate with time. The long-term tendencies in public consciousness (like erosion in the patrimonial norms of implicit obedience to the authoritarian rule and tradition) undermine the arbiter's control. Technical progress increases the range of goods, and brings instant technological change. Both these effects complicate the coordination¹⁰. Therefore, the cost of control and coordination tends to increase with time. On the other hand, the same tendencies aggravate arbiter-client difficulties, thus increase clients' bargaining power in their negotiations with an arbiter. This, in turn, further decreases the rent in his disposal.

Such changes in the cost-benefit balance make the arbiter's control and coordination in certain spheres less effective in preventing from overappropriation, unjustified (for an authoritarian ruler), or unaffordable (for a totalitarian one). As "second best", an arbiter becomes interested in partial abandoning of his control and coordination – we classify such move as the first phase of reforms. Notably, these reforms occur as at least partly "passive" acceptance of realities (ineffectiveness of control and coordination), rather than deliberate move towards the market economy.

An authoritarian arbiter is also interested in maximization of efficiency of the residual value-adding sector (as in Olson and McGuire, 1994), because at least part of this value, although indirectly, can contribute to his rent. Thus, a rational arbiter would also deliberately promote replacing of the abandoned part of his control and coordination with the market and democratic institutions, which should constitute the second phase of reform. Therefore, the complete reform downsizes 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, so destroy the whole system of rent-seeking society described above.

Should the successful piecemeal reforms be always possible, a rational arbiter would undertake them instantly, accordingly to the change in above-described fundamentals. However, in reality:

- An arbiter operates with imperfect information, and not always can assess his real capacities properly;

¹⁰ as Von Mises (1924) has shown, the problem of optimal allocation of sufficiently large number of production articles cannot be solved within the reasonable time frame and with the necessary precision.

- He is not always strong enough to overcome the resistance of those of his clients that are afraid to lose from such reforms;
- Public consciousness formed under the rent-seeking society should undergo a time-consuming evolution in order to make the market and democratic institutions effective. This evolution starts only with the first phase of reforms.
- Partial implementation of market and democratic mechanisms is often counterproductive¹¹. But their full-fledge establishment (e.g. universal protection for the property rights) is undesirable for the rent seekers, including the arbiter. Therefore, unlike a “benevolent” reformist government, arbiter as a decision-maker is more afraid of completion of reforms, than concerned about their failure;
- Finally, a totalitarian arbiter being self-constrained with ideological dogmas may fail to find an ideological justification for reforms.

As a result, the reforms become delayed¹². Consequently, certain spheres 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 social practices (like corruption, smuggling or black market activities) and respective structures (like mafia).

These practices and structures fill 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. Those parasitizing at the part of the rent-seeking sector that an arbiter fails to control often support the first phase of reforms, because they win from deepening of the gap of control caused by lifting of the remnants of arbiter’s control and coordination. But such *intermediate winners*¹³ (Hellman, 1998) have vested interests in suspending of reforms after the first phase, thus preserving them *partial*. The longer is initial delay, the deeper and lasting the gap of control, the stronger become intermediate winners and the more established and embedded arrangements they create, the more difficult is implementation and completion of the second phase, the higher total cost of change. Noteworthy, unlike the case of reforms conducted by reformist government, as usually considered in the normative literature, in a rent-seeking society the main

¹¹ For example, partial price liberalization can magnify the distortions, thus may lead to increase in rent seeking.

¹² these reasons for delayed reforms seem to be more relevant to the case of Ukraine (described with our arbiter-client model) than the ones described in the literature on Latin America, like the war of attrition

¹³ 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 first phase of reforms itself, but the gap of control created by procrastination in these reforms.

losses are caused (directly and indirectly) by deterioration of arbiter's control and coordination **not** accompanied by the reforms.¹⁴

Stiglitz (1999) argues that reversing of sequence of above-described phases of reforms could prevent from partial reforming. But the formal market and democratic institutions can be effective only when they are backed with the informal ones (North, 1990), which, in turn, emerge only in response to the societal demand for them. This process takes time, and usually starts only when the arbiter's control and coordination are formally removed (Paskhaver, 2003). Although such first phase of reforms may further deepen the gap of control, unlike deterioration of arbiter's control and coordination it opens the way for development of the competitive market's players and institutions. Thus, the intermediate winners play initially positive role by providing a payable demand for launching of the reforms, but then make them stalemated in the 'bad' equilibrium of partial reforms described in the literature cited above.

Our main argument is that such equilibriums **are unsustainable in a long run**. Unlike an arbiter, the intermediate winners are not encompassing, therefore behave predatory. In the most cases, they lack the internal mechanisms of coordination, because initially their rent seeking activities were anyway constrained by the arbiter's residual control. If the alternative sources of coordination, like social capital, are weak (as they are under the arbiter's rule), nothing prevent intermediate winners from overappropriation or dissipation of rent. The resulting crisis, on the one hand, weakens the intermediate winners; while on the other hand makes an arbiter interested in implementation of the second phase of reforms. Thus, in-line with Drazen and Easterly (2001), crisis does facilitate further 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. 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. It 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 second phase of reforms produces immediate welfare gains, and therefore can become popular. In this way the systemic reforms can get a posteriori public support resulting from a sort of learning-by-doing process. Eventually it transforms into the active civic movement in support of the property

¹⁴ Although overappropriation of the monopoly rents brings immediate welfare gains, they usually can just partly offset these losses. The short-term welfare losses from monopolization are rather low (Leibenstein, 1966). The losses caused by insufficient competitive selection may be much higher, but they do not disappear immediately with breaking up of the monopolies

rights, market competition, and democratic control over the state. Starting from this point, the public vote can become an engine for the further reforms; the reforms become proactive, so the new institutions already emerged in the market sector can crowd out the arbiter's control and coordination with no gaps of control.

2.4 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 deepness and longitude of deterioration in the direct control and coordination, which precedes the reforms. The longer the procrastination of reforms, the higher costs. The faster the market institutions take place of direct control and coordination, the lower social costs. Thus, (1) the delayed, slow and inconsistent reforms are more costly; (2) the availability of rent can ultimately increase the social cost of reforms instead of mitigating them, unless this rent goes directly to the broad population.
4. External factors (like foreign aid) facilitate the reforms when and where they help strengthening of the property rights and competition, and restraining of the rent seeking. But they can do harm while providing 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 they establish universal protection of the property rights, promote the market reallocation, competition, etc., and improve the public (democratic) control over the natural rents.
6. Evolution of public consciousness largely determines the course of reforms. Particularly, deterioration in the patrimonial norms undermines the direct control and coordination; while its specific part – a “zero-sum” view on the economic activities, along with paternalism, prevent from establishing of the market institutions. Together these factors indirectly determine the social cost of changes.

3. Initial preconditions: institutional patterns and major political-economic players

Within our framework, the Soviet state was a specific kind of totalitarian arbiter-clients hierarchy pretending to be a rationally ruled lawful state. Its main informal institutional features persisted over time and largely shaped the institutions of post-Soviet period.

Soviet legislation was based on Marxism, which is the follow-out system of “zero-sum” views on society, polity, and economy. Market transactions, except retail, were prohibited and replaced with redistribution; while all kinds of official earnings were strictly regulated with little, if any, connection to the value added¹⁵. 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 groups¹⁶, dissipated for coordination and control; and used for maintaining and increasing of the military power.

But the control and coordination of such encompassing rent-seeking sector appeared infeasible from the very beginning. Meanwhile, the communist regime could not coexist with any substantial market sector, because the latter have been “permanently begetting the capitalism” (Lenin) by questioning of the necessity in central planning. Fortunately for the communists, Russia has a deep-rooted tradition of “soft” rule of law. According to this tradition, legislation is often impracticable (excessively severe, obscure, contradicting, incompatible with the natural law), or ambiguous. As long as everyone has to break such a law, everybody should be penalized – which would be, of course, absurd. Therefore, the law can be enforced and implemented only at the discretion of state executives (*nachal'nik*), which, in distinct to Weberian bureaucrats, have discretionary power (*vlast'*) making them **arbiters**, while those susceptible to this power become **clients**.

“Soft budget constrains” (hereinafter – SBC) (Kornai, 1986) were the most important economic manifestations of “soft” rule of law. Marxist theory overstated the role of capital accumulation, while completely denied competitive selection, entrepreneurship, and incentives. Accordingly, the state endowed the enterprises with investment funds on the basis of plan tasks they were supposed to fulfill, regardless to their efficiency. Moreover, less efficient enterprises often were able to

¹⁵ the opposite, according to the labor theory of the value, the value added was defined as total cost of labor that was employed, directly or indirectly (in the form of the value of consumed fixed capital) in the process of production.

¹⁶ as the workers in defense industry that earned twice as much as an engineer; or the coal miners that earned four times as much

squeeze out more funds if they succeeded in proving that they only lack investment to catch up. Such **paternalism towards the enterprises** contributed to **vague and asymmetric property rights**: while the people formally held the “title” on 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 vague, thus subject to permanent “hierarchical bargaining” (Gaidar, 1999). This problem largely determined the agenda for the whole period of reforms under consideration.

On the other hand, ‘soft’ rule of law is unsustainable without an effective arbiter-client hierarchy, because vague and asymmetric property rights typically result in overappropriation. But, by Klitgaard (1988), “monopoly + discretion – accountability = corruption”, which undermines the 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’ 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. On the other hand, this made the pseudo democratic lawful state just a cover-up for 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.

Marxism has also required elimination of the material incentives, and replacing them with the moral ones. But the artificially imposed equality has been largely reducing the labor incentives (Ryvkina, 1998), while the “strong” (e.g. entrepreneurial) ones were banned completely. The Communist ideology attempted, sometimes successfully, to substitute them with ideologically-based incentives combined with career opportunities.

Finally, the Communist party was an instrument providing the feedbacks for the higher levels of hierarchy.

Thus, it was a core of the whole system.

Control over the appointments was the main instrument for these critically important tasks. The Communist party officials were the main kind of arbiters at each stage of hierarchy, because they

had 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-abeyant individuals, or the ones just insufficiently loyal to the boss, were rarely promoted. Some lawbreakers were weaved 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 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 reputation-based 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, 2002). 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. But although being horizontal rather than vertical, these networks are still not basis for social capital, because the providers of complementary favors rarely have common interests to defend. Thus, this kind of rent seeking remained uncoordinated.

Due to the number of reasons that we are going to address in the forthcoming work, the communist ideology steady eroded, and control capacities of soviet system started perishing soon after Stalin's death. At the same time, complication of technologies has 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.

Box 1. 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 arbitraging, 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 | nomenklatura members in charge with some valuable assets | <p>The main category of clients, and the first-wave intermediate winners.</p> <p>Although relatively more pragmatic (including the</p> | <p>Aspired emancipating of the <i>nachal'niks'</i> control and enhancing of rent incomes. Meanwhile, all but the most entrepreneurial</p> |

| | | | |
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| | | <p>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 compensating themselves for lesser official privileges with the illegally gained rents.</p> | <p><i>khosyaistvenniks</i> wished to maintain paternalism that was the main source of such incomes.</p> |
| <p>director corps – the main part of <i>khosyaistvenniks</i></p> | <p>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.</p> <p>Heads of the <i>kolkhoz</i> collective farms.</p> | <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</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'niks</i> did. But the latter largely felt lost and demoralized after the crash of Communism. (Table 1)</p> <p>Since the last years of the</p> |

| | | | |
|-----------------------------------|--|--|---|
| <p>other khosyaistvenniks</p> | <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>responsible for the finance Intermediate winners.</p> <p>of an industrial enterprise Were closely tied to the "the directors were rest of groups within <i>blat</i> organizers rather than networks, since they immediately ruled with the production, but lacked the flows of goods that were skills of company the most valuable source management, had no idea of the favors of access. On of marketing, finances, the other hand, they had and other things needed in limited access to the a competitive market property that could generate rents. Besides, instead, they used to subjectless bargaining clearer, than the Soviet “producing” in the goods goods dictating the terms to</p> | <p>USSR <i>directors</i> widely Were best suited and used their power for rent equipped for the seeking through lobbying, unconstrained rent-seeking, inspiration of strikes and so had particular interest in political blackmailing, getting rid of arbiters. Instead of improving the control, while much less competitiveness, <i>directors</i> paternalistic. However, they engaged in bargaining with still were against the government liberalization for paternalistic “support of that could undermine the production” in exchange for arbitraging as a permanent control rights and political source of rent.</p> <p>Later on their dependence on paternalism was actively used for subjecting them to the BAGs.</p> |
| <p>former underground</p> | <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>"push things through" in Intermediate winners. many instances.</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,</p> | <p>The <i>directors'</i> professional The "underground" sector, association, the Union of of Soviet economy was not Industrialists and too powerful¹⁸ yet gave Entrepreneurs (USPP), is rise to a number of quite influential: its heads prominent figures in post- (L.Kuchma, A.Kinakh) Communist business and occupied the positions of politics. Prime-ministers, it has its own party and a faction of parliament.</p> <p>Active involvement of shadow market operators and criminal bosses in Finally, the directors economic and political succeeded in soliciting the processes at the initial election of one of them as stages of reforms added to the president of the country the atmosphere of – under whom, ironically, lawlessness during the first they will lose their years of transition. influence.</p> |

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| | | <p>enforced by violence, became substitute for contract enforcement and guaranties of loyalty under conditions where the formal laws were slowly issued and poorly enforced.</p> | <p>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 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 patronage¹⁹, immunity from legal persecution, and the like. Later on the outright racketeering was limited and crowded out by the law</p> |
|--|--|--|--|

| | | | |
|------------------------------|---|--|---|
| | | | <p>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 'vlast', 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 also desired more freedom and independence.</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 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.</p> |
| "independent" entrepreneurs | entrepreneurial people not | The only relatively less paternalistic group. | along with the most entrepreneurial |

| | | | |
|--|---|--|---|
| | <p>belonging to any of above-described categories and not included into the most powerful <i>blat</i> networks.</p> | <p>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.</p> | <p>khosyaistvenniks, 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.</p> <p>The rest, either remained at the level of small and micro business, or gave up – emigrated, became employees again, and so on.</p> |
|--|---|--|---|

4. 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 massive oil and gas trading supported with sharp increase in the world energy prices in 1970th. But sharp decrease in rent brought about by the decrease in oil prices, Afghan war, arm race, and some other factors in 1980th, along with the notorious inefficiency have ultimately made the totalitarian control and coordination unaffordable. However, despite the deepening gap of control that fed *blat* networks, *nachal'niks* were reluctant to adjustment of the rent-seeking sector. They rightly pointed out the vital importance of ideology, which forbade both the private property over the production assets, and the economic freedom.

Meanwhile, rents provided by the widening gap of control became lucrative alternatives to the ones officially granted by authorities, which further distorted the incentives. In the early 1980th the societal values based on communist ideology have mostly eroded, so the ideological reasons were unable to constrain the rent seeking and paternalism, and provide the labor motivation (Table 2). Giving to the role of the communist party and its ideology analyzed in the Section 3, such a shift in public consciousness made the crash of the USSR just a question of time²⁰.

In 1991 the state socialism has ultimately lost its attractiveness (Table 3) and the trend was highly negative. In the November of 1991 56% agreed with the “Western part”, while just 12% disagreed. Already in January 48% suggested 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. According to another opinion polls, in 1990 the population in large supported the market reforms and institutions, including the private property, competition, etc. (Golovakha and Pakhomov, 1993). Noteworthy, the price liberalization has got the lowest 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. The severity of shortages at the consumer market increased in the late Soviet times due to the populist policies conducted on the pattern of decreasing rents. As a result of these developments, 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, the most of them²¹ 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. Solnick (1996) compared this process to the bank run. In combination, all these processes led to the avalanche-like destruction of the whole system of centralized control and coordination. The main 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 hint 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 independence²².

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. By the end of 1991 deterioration of control and coordination went so far, that he had to undertake the first phase of reforms regardless to his own views and intentions.

The most of 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 the Gaidar's reform Cabinet to apply its favorite approach – lifting the state control over prices on majority of goods and services altogether. In Ukraine 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” first-phase

reform described in Section 3. On January 2, 1992, the Government Decree “On the System of Prices in National Economy and Consumers’ Market of Ukraine”²³ 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. Although the Ukrainian government of this time deserves the credit for its common sense, in Ukraine both reforms were not that radical, and thus granted more rent-seeking opportunities to the members of *blat* networks connected to *nomenklatura*. Despite explicit inability to continue the price control, the Cabinet of Vitold Fokin comprised of Soviet time functionaries 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 (Table 4). However, these attempts of official price limitations did not have any effect at all on the inflation rate, because the control was already ineffective.

Directors appeared the main winners of this phase 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 “uncovered” 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. The *directors* actually took over the enterprises. 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 (because of their power over the employees, and the vast representation in the Parliament) power augmented with informal influence on decision-making. But nonetheless they comprised an allegedly “encompassing” (Olson, 1982) group (Table 1), *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. While the first of these sources was purely external, the rest two partly served for spreading this rent over the rest of enterprises, although mostly benefited the directors at the expense of population.

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

The crash of communism along with consequent price liberalization have further deepened the gap of control, but opened the way of closing it 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 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 (Ryvkina, 1998). No direct measurements were done, but the indirect empirical data suggest that “zero-sum” perception was strongly dominating. The situation in Ukraine was similar. 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”²⁴. In 1993²⁵, 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 Box 1). 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 just intermediate winners benefited from the gap of control, thus interested in procrastination of the further reforms.

In particular, directors, as well as BAGs (see Box 2), took advantage from asymmetry in the initial trade liberalization: negligible prices on energy were maintained, while exporting of the outputs 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 (Figure 1).

Box 2. 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 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 bosses²⁶.

BAGs provide alternative sources of rent for the *nachal'niks*, criminals, and other categories of post-soviet elites lacking direct access to the property. On the other hand, 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 group meets the same problem of

coordination and control, and 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 1990th 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 industries²⁷.

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 influence²⁸. In 1991, Vyacheslav 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 1990th, 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.

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 partial²⁹. Although never could form a majority, the lefts in the unstructured Parliament took a position to bargain for political advantages in exchange for their votes. This allowed their representatives to head the Parliament during 6 years. But in this way they have lost the trust even of the protesting voters and remained supported mostly by dwindling nostalgic adolescents. The rest of major political parties are 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 (see Tables 5-6).

Therefore, the second phase of reforms was procrastinated for three years, which led to disastrous overappropriation of rents resulted in deep economic decline and hyperinflation in the first half of 1990th.

5.1 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 (Dabrowsky and Antczak, 1995), just for the first month of free prices, CPI increased almost twice as much (286,2%) without any substantial monetary emission. 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 (see Section 3) that led to sharp increase in price, fall in output, and general "disorganization" observed (but misinterpreted) by Blanchard and Kremer (1997)³⁰. Sundakov et al., (1994) have found that many enterprises chose to maintain excess demand for their goods and see prices for their products rising – just as the monopolies do.

For the year of 1992 the overall producers' prices increase for the whole year (42.2 times) was twice as much as consumer prices' increase (21.0 times)³¹. Such 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. In fact, the producers (directors) have set markup prices. When increase in stocks compelled them to cease the production they appealed to the government with pseudo-Keynesian arguments demanding the monetary expansion to boost the "scarce demand" (Table 7).

According to Vladimir Lanovoy, the market-oriented Minister of Economy of those times³², during the few months of 1992 the Ukrainian government resisted to the pressure of directors, but soon had to start the emission according to the law adopted by the Parliament. Of course, as long as the above-described "demand restrains" have nothing to do with the business cycle, this monetary expansion 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. Very soon they have seen their liquid assets devalued, and started pressing for credit emission.

R.Kravchuk (1998) examined what were the roots for the 1992-1996 inflation, treating the growth of money supply as the intermediary cause. He showed that the main factor aggravating inflation in Ukraine at this time were the large quantities of cheap credit extended to the enterprise sector. As a result of industrial lobbying pressure, off-budget subsidies and directed credits to enterprises amounted to around 16% of GDP (Kravchuk, 1998: 14). According to research of Babanin (1994, after Kravchuk, 1998), credits to enterprises 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 funding the budget deficitⁱⁱ (Table 8).

However, in 1992 the budget (consolidated, including the Pension Fund – hereinafter, by UEPLAC) deficit to be financed by NBU monetary emission was 6.3 mln UAH, but the credit to government increased for 17 mln. The money base meanwhile remained at the level of just 6 mln despite the negative interest rate. In 1993 the deficit was 85.1 mln., the credit increased by 96 mln. But the money base went up for 263 mln., three times higher than the budget deficit – which means that the emission mainly went not to the financing of the budget deficit (of course, huge and unsustainable), but to other purposes, mainly the soft crediting.

Still, soft crediting could be driven by populism (here – the rent seeking by the broad groups of population), and thus cause the inflation through increase in consumers' demand, as it was during the last Soviet years.

However, the wages were strictly regulated, and their indexation was limited by the law at the level of 80% of the growth in CPI. Despite massive violations of the wage restrictions, during 1990-1993 real wages has dropped by 44% approximately. At the meantime, despite obvious inefficiency, so called “breaking the business ties” with the rest of the former USSR, and the problems caused by inflation, the share of profitable enterprises exceeded 90% in 1992-93, while normally (for the whole forthcoming decade) it was about 50%. Despite severe depression, priority was given to upholding of the investments rather than consumption (Figure 4).

Giving these facts, there is no surprise that wage restrictions did not prevent the acceleration of inflation. There was mostly paternalism toward enterprises, not a broad population, which drove inflation both through the financing of the budget deficit, and the direct “soft” crediting of the enterprises. It benefited the directors and some nachal'niks at the expense of the population.

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 almost³³ vanished³⁴. But Leonid Kuchma,

who as a Prime Minister in 1992-93 bears the responsibility for boosting of the massive dispensing of negative real interest rate credits to enterprises, has gained political support among the directors.

5.2 Depression

Just as inflation, the official GDP decline (almost 60% cumulatively) in Ukraine was the highest among the post-soviet countries not engaged in the wars. Its overwhelming part occurred in 1992-95. In 1993 volumes of consumer goods retail trade reduced by almost 52% compared to 1990. Moreover, while in 1990 the retail trade was dominated by non-food products (about 56% of retail trade volumes), in 1993 non-food products constituted only 39%³⁵. Eventually, this tendency was to the major extent conditioned by a reduction in households' incomes. According to statistics, the average annual income in USD PPP reduced by 18.5%: from 6372 in 1990 to 5192 in 1993 (Figure 5).

Of course, the mechanical comparison to the Soviet GDP of 1990 is incorrect, since this base is measured in the gravely distorted non-market prices. Besides, the military production and the like components essentially contributed to the GDP of 1990. As well, the real purchasing power of the household incomes in 1990 was much lower than it appeared in the official statistics. Finally, large portion of GDP and incomes has just moved to the unofficial sector. Yet, even the alternative estimation provided by Aslund (2002) with accounting to these factors accounts the cumulative decline as 15%. This lower bound is still very high by any means.

We see this drop not associated with the inflation only, since GDP decline started already in 1991 or even earlier, hence before any reforms occurred. And, of course, its in-deep and long-term cause, the gap of control, emerged and started widening a few decades before. We point out at least two other sources of decline stemming from our model.

Breaking-up of the complementary monopolies that constituted the most of industrial sector.

In-line with the Cournot's theory, 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, in deed they were mostly alleviated by the web of *blat* networks that allowed not only for quick recovering of the most of production links, but also for successful organization of the very sophisticated multilateral non-monetary transactions. Notably, later on the restoring of production links in 1992-95 did not lead to recovery of output, as one should expect basing on the Blanchard's and Kremer's (1997) hypothesis; but so did the vertical re-integration within the BAGs after the crisis of 1998.

Massive embezzlement and “tunneling” of assets of state-owned enterprises caused by vague property rights. Although the directors have largely seized the residual control rights, their rights were illegitimate, thus too weak to prevent them from assets’ shedding. As the government committed to prevent disinvestment, the directors, being used to paternalism, relied on state intervention to cover the losses from asset’ shedding. Enterprises lacking owners’ control became common resources for the rent seekers. From the anecdotal evidence we know that the SOE were usually swarmed with intermediaries (mostly established by the directors, but also sometimes imposed by *nachal’niks* or criminals) that served for assets’ shedding. Perhaps, the most flagrant affaire was the one of the Black Sea Shipping Company (BLASCO) that has leased almost all of the Ukrainian ships for suspiciously low rents, and then lost practically all of them in favor of the suspicious firms.

Besides, **the directors appointed during the Soviet epoch were gravely inefficient managers** (see Box 1) 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 all of these problems. But the directors benefited from the asymmetry in property rights that allowed them converting the public losses to private benefits. They were also afraid of losing their control over the enterprises, and thus formal and informal power that they often valued higher than money – among all, because in many cases this power protected them from the 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, their interests were pretty influential those times³⁶ and successfully opposed (in the block with the lefts) to any legislative initiatives aimed at privatization. Finally, the BAGs those times were too weak to gain from privatization.

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

6. Emergence of an arbiter: Disinflation and Privatization

6.1 Disinflation: initial attempts

Ukrainian government did not try to combat inflation³⁷ until the inevitable overappropriation of inflationary rent put the disinflation on the agenda in the late 1993 (Kravchuk, 2003). At the final stage inflation has 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 another sources of rents, keep their capitals in tax heavens, and so forth, which made them less vulnerable to disinflation. Therefore, in spirit of Tornell's (1998) model of "reform from within", they could support this 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 that received tremendous open subsidies, so had an alternative source of rent. Moreover, inflation was rather subversive to this source since it reduced the real value of subsidies. On December 29, 1993 President Kravchuk created the commission on financial stabilization in Ukraine. 3 of 6 its 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 the monetary policy, with little attention to the institutional and structural reforms necessary for alleviation of the causes described above. However, questionable as it appears, this plan was never implemented in full.

Some reduction of the inflation rate began in January 1994³⁸. As a result, the year of 1994 became the first one without any hyperinflationary episodes. But the state-owned enterprises responded to the lack of liquidity with ceasing the payments (non-payment) for the already supplied commodities and utilities. In particular, they did not pay for the energy resources (mostly imported), and this debt, according to the 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%. Although in fact these figures partly reflect the decline actually occurred before but previously covered by inflation, the pressure for “supporting the domestic producers” with new credits arose.

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

6.2 Appearance of an arbiter

Quite unexpectedly, Kravchuk had miscalculated the influence of support that directors provided for 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 his 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 economy and exposing it to the market forces.

L.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 level (often the police servants) took their place.
- established the strong and powerful Presidential Administration;
- has “restored the vertical of *vlast*” – an arbiter-client hierarchy of regional and local State Administrations responsible to him unilaterally;
- 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). The present Ukrainian Constitution, adopted in the night of 27-28 June, 1996 under the tough pressure of Kuchma had mostly reinforced these provisions³⁹.

- has established the State Tax Administration (STA) as effective instrument of 'vlast' essentially based on soft rule of law, in particular the SBC.

It became a separate government body subordinated to him directly, and further augmented with tax police. Supplementary to the vast budget funding, the STA accumulated 30% of exhorced fines and penalties in off-budget fund assigned for bonuses to employees – which provided them with very specific kind of incentives. At the meantime, in-line with tradition of the soft rule of law, the tax rates were exorbitant for such a poor country⁴⁰, and the legislation was punitive, contradictory, and often dubious. Furthermore, the STA was put in charge of development of tax legislation and endowed with a right to interpret the laws in the form of elucidative letters, often restricted for internal use only.

- Finally, Pavlo Lazarenko, Kuchma's compatriot and closest ally of those times, has nearly monopolized the gas and energy sector with his crony firm UESU⁴¹.

In these ways L.Kuchma managed to become a really strong authoritarian arbiter. Although being elected under the anti-reform and populist slogans, he realized that undertaking of the urgent market reforms that could at least partly close the gap of control is the only way for him to survive as a leader of 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 (as energy supply and natural monopolies).

Those times 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 not paid back. Babanin, Dubrovskiy, and Ivashchenko (2002) argue that irresponsible borrowing, as a sort of "virtual" rent, became at least temporary substitute for the diminishing rent. Some media resources also plausibly suggested that Russia colluded with IMF in forcing the indebted post-Soviet countries to borrow from IMF and pay full price for the energy in-time. But to make the massive borrowing possible, Ukraine had to demonstrate its commitment to the market reforms.

The directors, as intermediate winners, were inappropriate alias for this task. Soon after they have got rid of Communist party, and the centralized control and coordination, the most of directors disappointed in liberalization and became the major anti-reform force. Also, they were inconvenient as arbiters' clients: their multiplicity and diversity incurred high cost of coordination. Thus, Kuchma had to rely on the BAGs. Initially, the Dnipropetrovs'k BAG and some particular oligarchs (like A.Volkov) hoped for his help in competition with the other ones in exchange to the support they provided during the 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 3), a rational ruler is

better of playing “divide-and-rule” than of being closely tied to a single player. Although Kuchma still favored some old cronies for a while, he has soon started rotating his favorites.

His reformist policies have not expressed the voters’ will too. A.Paskhaver, a liberal advisor to Kuchma in his first tenure, was quite surprised when in a few weeks after the victory Kuchma called him up; and even more when he saw the basic points of the program that had nothing to do with the election pledges. Three months after, in October of 1994, Kuchma made a speech in the parliament on the strategy of economic reforms in Ukraine that included financial stabilization, mass privatization (declared but not pushed by his predecessor), and structural reforms, with a purpose of creation of a “socially oriented market economy”. Moreover, he involved the IMF and the WB⁴² into active operations in support of reforms.

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

In the October 1994 decree on “setting prices in the 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 very far from the famous Polish example, and even Gaidar’s reforms in Russia. Still, V.Lisitsky testifies that a body promoting disinflation was the National Bank under V.Yushchenko. Being protected by the President, it gradually became less dependent on the government, and by late 1994-early 1995 could afford to refuse emission to the Cabinet. Ukraine received total \$763 within the STF program in 1994-95 that essentially helped to calm down the inflationary expectations and finance the current account deficit. As a result, the inflation was brought down below 20%.

6.3 Privatization

Kuchma as an authoritarian arbiter was interested in personal control over just a handful of the most lucrative enterprises, mainly the monopolies; and enhancing of productivity of the rest of economy, in order to increase the common pool of rent 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 to his power. But among the sources of decline only inflation was curbed, and this success was permanently endangered by paternalism towards the enterprises. Privatization was necessary (although still not sufficient) for restraining of paternalism, and closing the gap of control

at the micro level (see Section 5) that still caused economic decline, which constituted about 10% in 1995 despite 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 BAGs.

But the directors dominating in politics those times were not, as a rule, interested in mass privatization (Paskhaver). In addition to the general reasons described in Section 3, the most entrepreneurial and capable of them have already seized the opportunity of privatizing 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, not mentioning the numerous shortcomings of such way. 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.

BAGs, in they turn, were interested in the title property rights. They had 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 the cash flows” was too much vulnerable to political risks, while after disinflation some investment opportunities became lucrative comparing to the alternatives abroad. Some nachal’niks and their crony firms also gained a one-shot rent from buying the assets below their market price. Thus, unlike the most of other reforms, privatization was supported by the vested rent-seeking interests. These interests augmented another driving forces by large, however shaped the whole process in a rent-seeking way.

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

1. Contagion effect of Russia, where the mass privatization was already completed at this time.
2. Support of 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 the Russian companies.
3. Effective support by the IFOs, primarily the World Bank. In particular, they deserve large credit for explaining the straight causality between paternalism towards the enterprises and macroeconomic instability to the Ukrainian government.

According to the concept adopted in 1992, the mass privatization should immediately follow the price liberalization. But it was postponed by the Parliament vote – in our view, 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 those times. 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 (Tables 9, Figure 6). These schemes were restricted to the small enterprises in 1994. However, even later on some sectors, as agricultural processing factories, and individual enterprises, as Illicha steel mill, were privatized to insiders by the 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 those times 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 pretty 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 restricted them to one-buyer deals, as it happened in the notorious (but certainly not the worst) case of KrivorizhStal’ steel mill. Nonetheless the privatization was a few times interrupted with moratoria, and a number of enterprises were kept state-owned by the law, the most of entities went to the private sector by the end of 1997ⁱⁱⁱ. 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 minority outside shareholders are insignificant.

| | 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 | + | | | | + |

More detailed data on privatization of industrial enterprises are provided in Table 11.

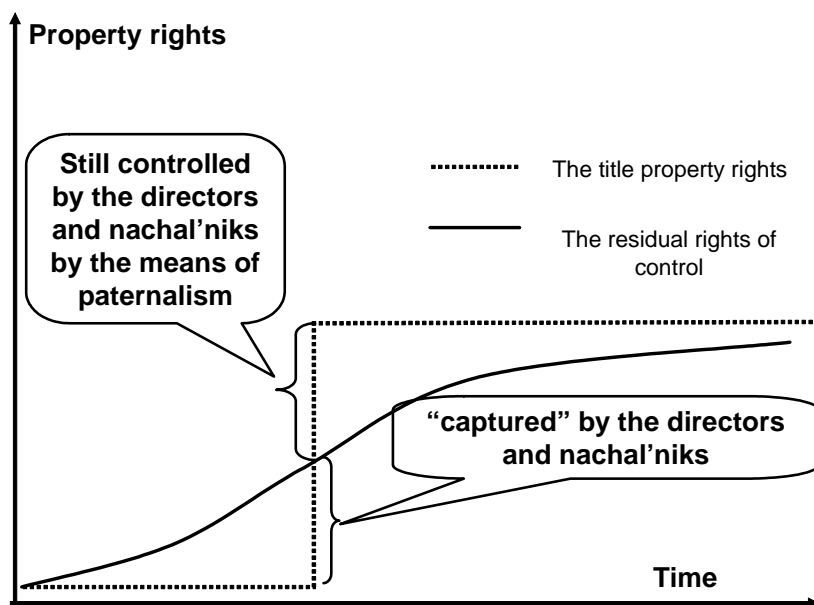
From the institutional viewpoint, privatization was a shift in the formal institutions, while the informal ones could not change so quickly. This means that its outcomes should roughly reflect the distribution of informal residual property rights existed at that moment; and only marginal shifts could 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 actual shares in the property rights 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 surprising, the broad population came out disappointed (Table 11). 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.

Nachal'niks, although not officially endowed with any title property rights, still had vast stake in "state property". It has also been reflected in the resulting allocation of residual property rights: They to large extent preserved their informal 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, whatever unfair it looks, in fact the privatization in Ukraine has just revealed the existed institutional arrangement. From the perspective of social welfare and efficiency, it was a "second best" solution that, despite all its shortcomings, still has 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 necessary (although not sufficient) precondition to the enterprise restructuring, and first of all changing in management: While before 1997 the average tenure of a director was more than 9 years (hence, the absolute majority were appointed already under the Soviet regime) (Pryor and Blackman, 1998), another data testify that after privatization 38% percents of the directors changed by 2002, of them 70% after 1997 (Akimova, 2004). Privatization has also opened a way for the consolidation of industries and vertical integration. Due to these reasons, the mass privatization appeared a point of return in the decline of the labor productivity (Figure 7).

These reforms have strengthened the BAGs and ultimately established L.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. On the other hand, as a former soviet *khosyaistvennik* he used to be subordinated to some paternalistic *nachal'nik*. Moreover, L.Kuchma appeared a common agent (Dixit, Grossman and Helpman, 1997) in respect to his international senior partners, like the leaders of Russia, USA, EU, and the IFOs, whom he treated as a sort of “*nachal'niks*”. As long as they behaved paternalistically, providing Ukraine with a sort of SBCs, Kuchma traded their support in exchange to some parts of sovereignty, and wherever possible cheated them in favor of the rent pool he controls (not necessarily his own rent) – just as a smart *khosyaistvennik* should. Until 2000 this favorable position gave him plentiful political choice, and helped in maintaining the rent pool despite disastrous economic decline.

The year of 1996 appeared the point of return in many other social and economic parameters, like innovation rate (Figure 8). 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. When partly filled the gap of control, L.Kuchma started using his power of an arbiter for suppressing the 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 business, and later (in 1999) even released it from the discretionary power of the STA by introducing of the simplified taxation. This was done under the pressure of the SME lobby (a part of emerging civil society) augmented 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 one and only case when the market reform in Ukraine was driven by political-economic mechanism of the kind studied in mainstream literature. It has promoted the SME development (Figure 9).

7. The second wave: reforms without interests

7.1 “Virtual” stabilization and the role of IMF

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

Enterprises, especially the SOE, 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, 2002, 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 (Figure 10). 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 rather to 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 in supporting the fixed⁴³ exchange rate regime, which created the illusion of stability. Although cheap IMF loans constituted a minor part of total crediting, they

served as signals to the rest of creditors by creating an illusion 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^{iv} were well-targeted and played positive role⁴⁴, the standard macroeconomic benchmarks set by the IMF failed to restrain the rent seeking.

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 of the pool of rent by cheating of 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) (Table 11).

Second, the IMF, by very its name, used to deal with the monetary transactions. However, in Ukraine (and even more in Russia) the *blat* networks were already well-established and widely used for barter transactions. Under the pressure of monetary constrains 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 (Figure 11), although necessary from the macroeconomic perspective, further stimulated the proliferation of barter⁴⁵.

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 – unchangeable. In this way this arrangement known as “virtual economy” (Ickes and Gaddy, 1998) inhibited enterprise restructuring and first of all it's most necessary component – 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 not 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 to Kuchma, and certainly – to his son-in-law Viktor Pinchuk.

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 represented, unable to arrange a collective action, and largely supporting the paternalism (see Table 12). 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 on making the tax system more structured and coherent. In particular, these laws mostly eliminated the tax exempts, and abolished *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, instead providing 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.

7.2 Curbing the paternalism, and fiscal stabilization

By the end of 1990th 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 "incomplete stability". It took the form of currency crisis, which, however, revealed mostly the fiscal problems, in turn caused by paternalism towards the enterprises⁴⁶.

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 dollars⁴⁷, of them over one billion in the first quarter. 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 “institutional trap” described in Section 5, 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 tremendous arrears (Figure 13), comparable to the total assets of the banking system, in the energy sector; and the worst harvest after the Second World War.

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) (Table 13). His main possible right-wing rival, Vyacheslav Chornovil, has died a year before in the very 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 problem⁴⁸. 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 (Table 14). In the late-1999 and 2000 his Cabinet successfully conducted a series of reforms addressing all of the problems described above⁴⁹.

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 (Figure 12). 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 (Figure 13). 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% (Figure 14).

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 8).

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 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 (Figure 15) is evidences for massive enterprise restructuring. The share of respondents reporting that they are employed at the private companies doubled in two years, despite actual decrease in the share of such employees (Figure 16), which indirectly confirms strengthening of the property rights⁵⁰.

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, 2002, 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 oligarchs 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.

8. Social consequences of reforms

During the late Soviet epoch, economic efficiency was rapidly decreasing, but the social outcomes were offset for a while by the inflows of rents. But such relative prosperity was unsustainable. Already in 1991 (before the reforms) the GDP started to decline, the inflation increased, and actual accessibility of goods dramatically fell. Breakdown of the USSR, dissolution of the COMECON, and ultimate failure of central planning, legalized by the formal liberalization, had further deepened the gap of control and aggravated the problems of coordination. This led to severe and rapid GDP decline described in Section 5 followed by respective deterioration in social standards. During 1991-1992 the per capita household income decreased by 24%, so about 30% of Ukrainian population became poor in 1992.

But the most of social indicators started improving since after the second wave of reforms. The ratio of incomes of the highest income quintile to the lowest income quintile increased from 3.6 in 1993⁵¹ to 4.8 in 1996 and then reduced to 2.8 in 2000⁵². Infant mortality constituted 20 cases per 1000 live

birth in 1995, comparing to 18 in 1990, but has reduced to 17 in 2000. Tertiary enrollment (Figure 17) and many other indicators reached their bottom values in 1995-96 and started improving soon the institutional and structural reforms, whatever inconsistent and ineffective, have partly closed the gap of control.

Still, some important indicators have been stagnating, or even continued deteriorating, although in slower pace, between second and third waves of reforms (1996-99). Per capita GDP that has almost halved from 1992 to 1996 then almost stagnated until 1999, when it has started growing (Figure 5). In 1999, at the lowest point of the GDP decline, and soon after the currency crisis, the poverty reached its peak of alleged 45.7% of population having the daily incomes lower than \$2, which is 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). The main part of this fall in occurred in the beginning of 1990th. In 1990 the average person consumed 3597 Kkal per day, in 1999 – already 2505 Kkal⁵³, which is very close to the physical minimum. In 1998-1999 the self-assessment of social satisfaction reached its bottom value (Figure 18).

Why the decline appeared so deep in Ukraine? We see the following reasons.

1. Both factors complicating the arbiter's control (complexity of production, and erosion in archaic public consciousness) were strong in Ukraine – unlike, for example, 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 very limited responsibilities mostly boiled down to implementation of the decisions adopted in Moscow⁵⁴. 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 blat networks attached to the USSR leaders originated from Ukraine (Khrushchev, then Brezhnev) (Babanin, Dubrovskiy, and Ivaschenko, 2002). Ukraine is also five times larger (in terms of population) than Belarus', and far more diverse – both factors are usually associated with the lower quality of governance.
3. Ukraine was the most industrialized republic of the USSR, so inherited the strongest first-wave intermediate winners (directors) that procrastinated the second phase of reforms.
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 Russia⁵⁵. Just as in Russia they were related to export of cheap energy, immediately or in the form of energy-intensive commodities, like metals and

chemicals. But unlike Russia, the primary sources of these rents are abroad 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, and nonetheless sharp increase in inequality. In-line with our model we attribute this mostly to two main factors.

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 and huge lines of Soviet times, dramatically increased the consumer choice, and provided lucrative job opportunities. Even more important, 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”: “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 have done it explicitly 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 not punished for a while) in exchange to social peace.

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 1980th and continued till the mid-1990th⁵⁶. 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 official compensations, like 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. The share of self-reliant individuals started increasing along with satisfaction with the social status (Figure 18).

Inequality, although dramatically increased comparing to the extremely low values characteristic to Soviet times⁵⁷, 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 2001⁵⁸; which is higher than 4.6 in Canada, 2.7 in the United Kingdom, and 1.4 in Norway⁵⁹; but still less than 6 in Germany, and 6.7 in Russia. In 1999 the Gini coefficient in Ukraine constituted for almost 29, while in Morocco and Tunisia (2000) it was almost 40, in Egypt (2000) – 34.4, and in Bolivia – more than half as much (44.7).

Although the second wave of reforms brought just partial success, the third wave of 2000-2001 has ultimately reversed the most of negative trends at least for several years.

The official incomes and well-being of population became growing (Figure 5 also World Bank, 2004) along with satisfaction with social status, which has by now (2004) reached the values characteristic to the normal social situation (in opposite to crisis). Thus, we can state that as a result of reforms, the deep crisis caused by decay of the Soviet system has been mostly overcome. Although formally the GDP per capita is still lower (in 2004) than it was in 1990, in reality giving to enormous fictitious component of the Soviet output and pervasive shortages, at least by the year of 2003 we can state that real incomes of the population are not lesser than they were under the best Soviet times. But, unlike those times, they are growing in a more or less sustainable pace.

Indirect measurements show that while some groups of goods decreased in their availability (primarily the foodstuff, books), others, primarily durables, increased (color TV sets, automobile, audio and video equipment) (Table 15)⁶⁰. The availability of housing clearly improved: from about 18 sq m of living space per person in 1990-1991 to 21 sq m in 2001⁶¹. Besides, consumers enjoy plentiful choice; citizens enjoy civic rights and freedoms – although, still limited, but far more than under Soviets; and despite persistent problems the human development is in progress. Some other indicators also became already advanced of the Soviet times (Figures 7,8, and 17).

Still, the living standards remain low, even comparing to Russia (which, however, enjoys vast natural rents). The property rights are still quite weak and susceptible; capital markets are still slack that prevents efficient allocation of the production assets. The people's control over the state assets is still insignificant⁶², which leads to massive embezzlement.

Unemployment was one of the few indicators that started deteriorating during the second wave of reforms (Figure 19). However, this was attributed mostly to 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 7). But, quite surprisingly, the paternalistic attitudes did not result in the marches of unemployed. Instead, people try to implement a number of innovative strategies.

If in 1994 8.2% and 1.9% of respondents reported to change their place of employment once and more than once, in 1998 their number increased, respectively, till 11.3% and 4.3%⁶³. After the initial impulse given at the beginning of 1990th labor market mobility decreased slightly from almost 25%⁶⁴ till 18.8% in 1997 and then, following 1998 crisis, increased again till 28.8% in 2001⁶⁵. Industrial sector exhibited even higher mobility rates (23% in 1997-1998 and 34.6% in 2001), which could signal about the effective outsourcing of labor from state sector to the private service sector. The new sector, whatever weak, had mostly absorbed the excessive labor, so unemployment has never reached the extreme values, and became decreasing right 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. In 2003, 12.1% of respondents reported having personal or their family members' experience of working abroad (of course, those working permanently were not surveyed). Therefore, what has clearly changed is the labor moral.

Contrary to widespread laments, crisis did not significantly affect the long-term demographic trends (Figure 20). Moreover, after the second wave of reforms the long-term upward trend in the mortality rate was reversed.

Therefore, apparently the reforms appeared the right remedy from economic crisis. Nevertheless, they remain mostly unpopular.

Initially the population mostly supported the reforms. However, at this time the *nomenklatura* was not ready for these reforms. At the time the reforms were finally undertaken, they have mostly lost the public's support. Even in 1996 the respondents pointed out the "strengthening of discipline"⁶⁶, and "fair remuneration" (in a sense of "equal compensation for the same work") as the major components of market reforms. Meanwhile the development of banking and market infrastructure, and bankruptcies of the loss-making firms, are listed the rest. About 40% responded that they are not at all familiar with the basic principles of a market economy. Noteworthy, some of these attitudes have further aggravated in 2000 (Table 12).

The people (most often, rightly) perceived state officials and politicians as totally corrupted or persuading their own agenda (e.g. *vlast'*-maximizing); and the business as totally rent seeking. Such views were fortified with disappointment in reforms that allegedly have made the things worse. Thus, people considered both the state and business unworthy of their support, and call the ruling elites "mafia" (Table 16).

We attribute these attitudes to reforms to the remaining ambiguity of public consciousness (Table 17). But, notably, those who are familiar with principles of market economy, as well as the younger, wealthier, and having the experience abroad, have much more positive attitude to entrepreneurship

than average (Table 18). This brings a hope that learning, especially the learning-by-doing, will eventually alter the anti-reformist inclinations.

Therefore, the social costs of crisis were huge. 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 the primary cause of these losses. The opposite, we did not find evidences of the social costs incurred by the third wave of reforms. The second wave also had clearly positive impact on the most of social indicators (at worst, their deterioration has slowed down), while only the evidences on unemployment remain ambiguous. Only the passive “reforms” of the first wave (first phase, according to the definition given in Section 3) were followed by immediate deterioration of social standards. But we emphasize that these “reforms” were just a corollary of the long-term process of decay.

Probably, if there would be a possibility to make the inevitable crash of Communism less destructive and less procrastinated; and then the necessary second-phase reforms more resolute, better planned, and generally more consistent and comprehensive, then they perhaps could bring the better results with lower costs – but, unfortunately, this is mostly wishful thinking. As the first Ukrainian President Leonid M. Kravchuk use to say: “We have got just what we have got”.

9. Conclusions

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

- A rent-seeking society can hardly be truly democratic, even despite the formal institutes. The necessity of preventing the overappropriation and rationing the rent begets an authoritarian (or even totalitarian) ruler even despite the formally democratic polity. In turn, the dictatorship most often, but not necessarily, brings the rent seeking. Thus, curbing the rent seeking can indirectly promote the democratic developments, but not necessarily vice versa.
- Despite the lack of democracy, economic reforms can do occur without a clear public mandate or the interest group pressure. They can be driven by the interplay of rent-seeking interests that occurs under the threat of a crisis, or when such crisis comes. So, in a rent-seeking society, diminishing of rent eventually promotes the reforms that lead to expansion of the competitive market sector, strengthening of the property rights and the rule of law, and indirectly facilitates democratization.
- Deterioration of the authoritarian control and coordination caused by erosion of the patrimonial norms and/or totalitarian ideology, and the technological progress; as well as

decrease in rent caused by the overappropriation (in turn, resulted from the ill control and coordination), or external factors can beget the driving forces for reforms in a predominantly rent-seeking society.

- Abandoning of control can be excessively costly if it occurs too early, when the people are not ready to replace it with the property rights and market coordination. On the other hand, social costs of changes are determined mostly by deepness and longitude of erosion in the direct control and coordination, which precedes the reforms. The longer procrastination of reforms, the higher costs, and impediments to the establishment of market institutions. The faster the market institutions take place of the weakening direct control and coordination, the lower social costs. Thus, (1) the delayed, slow and inconsistent reforms are more costly; (2) the availability of rent can ultimately increase the social cost of reforms instead of mitigating them, unless this rent goes directly to the broad population.
- Democratic changes not backed with abandoning of the “zero-sum” perception and paternalistic consciousness does not immediately lead to the result. However, weakening of the authoritarian control can start the chain reaction of reforms that can ultimately lead to establishing of a market democracy.
- There are some ways to help the reformers and alleviate the severity of reforms. External factors (like foreign aid) facilitate the reforms when and where they help strengthening the property rights and competition, and restraining the rent seeking. The main efforts should be put on (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 (cf. “discipline to the old sector” by World Bank, 2002); (b) facilitation of establishing of the property rights (through altering of the public’s perceptions, especially the one of a “zero-sum”; and restriction of the rent seeking opportunities); (c) encouraging of the sector based on the property rights and market coordination (World Bank, 2002).
- At the same time, the facilitators can do harm by providing the authorities with sources of rents that can be used as a substitute to reforms. One should strongly avoid the paternalistic treatment of allegedly reformist governments, especially if it is conditioned by macroeconomic benchmarks only. In particular, the credits for “financing of the budget deficit” can help delaying the reforms, and in this way eventually increase their social cost. Aid, if provided, should be channeled directly to the population under the tight control of international organizations.

- Macroeconomic constraints, like the IMF standard benchmarks, are important, but far from sufficient tools for shaping and facilitating of systemic reforms. Privatization of the assets, especially those that the state cannot control effectively, is vitally important, but also insufficient, especially if not accompanied with the reduction in state paternalism towards the enterprises.
- Unlike the welfare state, the reforms most urgently needed in a rent-seeking society are often popular, since they include mostly restraining of the rent seeking of oligarchs, and can immediately improve the well-being of the broad social groups.

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9.1 Appendix

Table 1: The relative force of different components of "party of power" at the initial stages of independence is represented in the composition of the Communist majority of the 1990-1994 parliament:

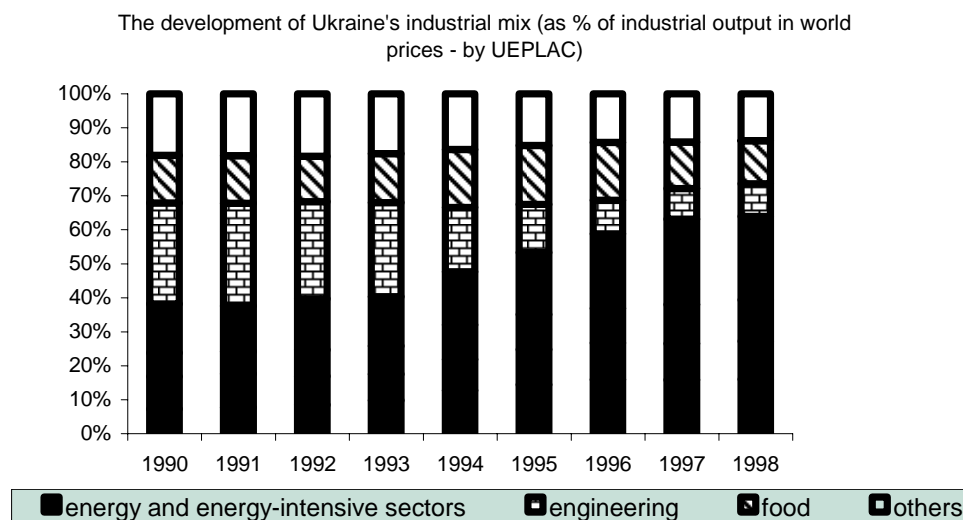
Communist majority in Rada of 1990 (381 members of parliament)

| Social status | Number of members of |
|---------------|----------------------|
|---------------|----------------------|

| | |
|--|------------|
| | parliament |
| Heads of the units of "people's economy" (from directors of plants to ministers) | 97 |
| Party leaders (from the head of kolkhoz's partcom to Central Committee) | 85 |
| Heads of executive committees, heads of departments of executive committees | 48 |
| Heads of kolkhozes | 35 |
| Scientists, heads of educational institutions | 31 |
| Workers | 17 |
| Military commanders | 16 |
| Teachers | 4 |
| Others | 48 |

Source: Haran' O. and O.Mayboroda. The Ukrainian Lefts: Between Leninism and Social-Democracy. Kyiv, 2000

Figure 1. Evolution of Ukrainian industrial mix in 1990-98.



Source: UEPLAC, authors' calculation

Table 2. The hierarchy of values of population of Ukraine in 1981 (according to the data of the public opinion poll, representative for population of Ukrainian SSR, conducted by Institute of Philosophy of Academy of Sciences of Ukrainian SSR, N=5000), %

| Values | Age of 30 years and less | 30 years and more |
|---|--------------------------|-------------------|
| Material well-being | 34.7 | 32.3 |
| Work labour | 29.1 | 22.4 |
| Family | 27.7 | 21.5 |
| Peace between nations | 16.2 | 22.9 |
| Dwelling | 13.8 | 8.2 |
| Health | 12.5 | 20.5 |
| Communication with people | 10.2 | 4.5 |
| Political, ideological and moral values | 4.7 | 4.2 |
| Rest, entertainment | 4.5 | 6.9 |

Table 3. The characteristics of different types of economy made by population of Ukraine in November, 1991 %

| <i>Characteristics of economy</i> | <i>It is characteristic for capitalist economy</i> | <i>It is characteristic for socialist economy</i> |
|-----------------------------------|--|---|
| Freedom | 66.1 | 36.7 |
| Inequality | 72.4 | 62.1 |
| Technological advance | 86.1 | 39.8 |
| Wealth | 85.0 | 29.6 |
| Selfishness | 63.3 | 59.0 |
| Profitability | 85.8 | 43.1 |

| | | |
|------------|------|------|
| Fairness | 38.8 | 28.1 |
| Shortage | 15.0 | 77.9 |
| Humanism | 41.7 | 37.4 |
| Progress | 80.9 | 36.0 |
| Oppression | 55.2 | 46.7 |
| Corruption | 66.8 | 71.0 |
| Efficiency | 77.2 | 29.3 |

Table 4. Price control in 1992-1993

| Type of prices | Beginning of 1992 | | Mid-1993 | |
|---------------------|-----------------------------------|--------------------------|-----------------------------------|--------------------------|
| | Share in total wholesale turnover | Share in retail turnover | Share in total wholesale turnover | Share in retail turnover |
| Administered prices | 17% | 12% | 11% | 10-12% |
| Regulated prices | 57% | 67% | 30-40% | 30-40% |
| „Free” prices | 26% | 21% | 50-60% | 48-60% |
| Total | 100% | 100% | 100% | 100% |

Source: Dabrowski (1994: 7, 9) after IMF (1993: 18) and Swiecicki and Wellisz (1993)

Table 5. Ukrainian parliament and president elections results.

| Structure of Ukrainian Parliament (1994-1998); First-Past-the-Post electoral system | | |
|---|----------------|-----------------|
| Party or Group | Representation | Number of Seats |

| | | |
|-----------------------|--|------------|
| Communist party | <u>Party</u> of "dissatisfied" orthodox Communists | 96 |
| Constitutional center | People's Democratic <u>Party</u> of Ukraine; many members hold posts in contemporary executive power | 56 |
| Socialist party | Former middle-rank technocracy communists; possible future "Euroleft" <u>party</u> | 36 |
| Reforms | Intellectuals, pro-reform economists | 31 |
| Agrarian | Agrarian <u>Party</u> of Ukraine | 27 |
| Yednist` ("Unity") | Dnipropetrovsk-based industrial directorate | 27 |
| Independent | "New Ukrainian" economists and businessmen | 25 |
| Rukh | People's Movement of Ukraine <u>party</u> , first opposition movement, now center- right | 25 |
| Social market choice | Donetsk-based businessmen and industrial directorate | 25 |
| Interregional group | Directors and some liberal politicians from Russified regions | 23 |
| Other | Failed to find cleavages appropriate for themselves and/or small parties | 43 |
| TOTAL | <i>Due to the complicated conditions and low turnout, some seats were not filled</i> | 423 of 450 |

Table 6. Structure of Ukrainian Parliament (1998-2002) – after the elections;

| | | |
|--|--|------------------------|
| Mixed electoral system (50%/50%; 4% threshold for parties) | | |
| Party or Group | Representation | Number of Seats |
| Communist party | orthodox Communists | 123 |
| Independent | <i>businessmen</i> (mainly first-past-the-post constituencies) | 97 |
| Rukh | national-democratic | 46 |

| | | |
|---|--|-----|
| Socialist party+Peasants' party | Former middle-rank technocracy communists; Socialists-possible future "Euroleft" <u>party</u> ; "Peasants" - the lobby of former collective farms' heads | 35 |
| People's Democratic Party | “party of power” (many members of the <u>party</u> hold posts in contemporary executive power) | 30 |
| Hromada ("Community") | Political wing of the BAG of United Energy System (Dnipropetrovsk) associated with former Premier P.Lazarenko | 25 |
| The Green party | Conglomerate <u>party</u> that used the slogans of the Green movement and financial resources of industrial <i>business</i> and commercial banks | 19 |
| Progressive Socialist Party of Ukraine | Former "radical-orthodox" wing of Socialist party; now populist ultra-left <u>party</u> | 17 |
| Social-Democratic Party of Ukraine (united) | political wing of Surkis-Medvedchuk (“Kyiv-seven”) BAG | 17 |
| Agrarian party of Ukraine | Agrarian lobby's <u>party</u> , affiliated with the executive power | 9 |
| "Forward, Ukraine!" | Intellectuals,pro-reform economists (electoral bloc; former group "Reforms") | 4 |
| National Front | Bloc of right nationalist <u>parties</u> | 3 |
| Other | Failed to find cleavages appropriate for themselves and/or small parties | 25 |
| TOTAL | <i>The turnout threshold of 50% of the electorate was abolished</i> | 450 |

Table 7. Consumer price inflation, monthly changes, 1992-1996

| | 1992 | 1993 | 1994 | 1995 | 1996 |
|---------|-------|------|------|------|------|
| January | 252.4 | 73.2 | 19.2 | 21.2 | 9.4 |

| | | | | | |
|--------------------|--------|---------|-------|-------|------|
| February | 15.3 | 28.8 | 12.6 | 18.1 | 7.4 |
| March | 12.1 | 22.1 | 5.7 | 11.4 | 3.0 |
| April | 7.6 | 23.6 | 6.0 | 5.8 | 2.4 |
| May | 14.4 | 27.6 | 5.2 | 4.6 | 0.7 |
| June | 26.5 | 71.7 | 3.9 | 4.8 | 0.1 |
| July | 22.1 | 37.6 | 2.1 | 5.2 | 0.2 |
| August | 8.3 | 21.7 | 2.6 | 4.6 | 5.7 |
| September | 10.6 | 80.3 | 7.3 | 14.2 | 2.0 |
| October | 12.4 | 66.1 | 22.6 | 9.1 | 1.5 |
| November | 22.0 | 45.3 | 72.3 | 6.2 | 1.2 |
| December | 35.1 | 90.8 | 28.4 | 4.6 | 0.9 |
| End-year inflation | 1821.7 | 10155.0 | 401.1 | 181.7 | 39.9 |

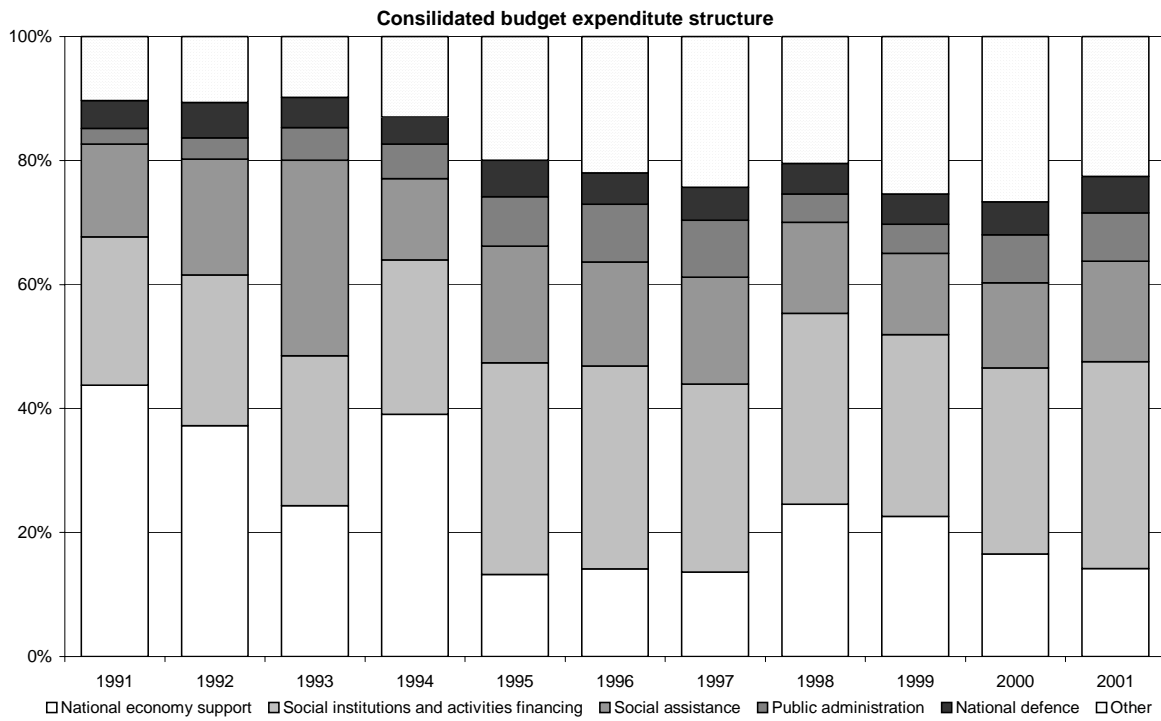
Source: IFS IMF and Dabrowski (1994: 22; data for January 1992)

Table 8. Financing of the consolidated budget deficits, in percent of GDP, 1992-1996

| | 1992 | 1993 | 1994 | 1995 | 1996 |
|------------------------------|-------|-------|-------|-------|------|
| Budget balance | -12.2 | -6.5 | -10.5 | -8.0 | -4.5 |
| General govt. balance | -21.4 | -14.0 | -13.4 | -10.8 | -5.2 |
| Budget deficit financing: | | | | | |
| NBU and bank credits | 6.4 | 8.2 | 12.2 | 5.4 | 1.7 |
| Government bonds sales (net) | n.a. | n.a. | n.a. | 0.4 | 2.0 |
| Other internal debt | 0 | 0 | 0.2 | 0 | 0 |
| Foreign financing | 0 | 0 | 1.0 | 1.6 | 1.5 |
| Errors and omissions | 15 | 5.8 | 0 | 3.4 | 0 |

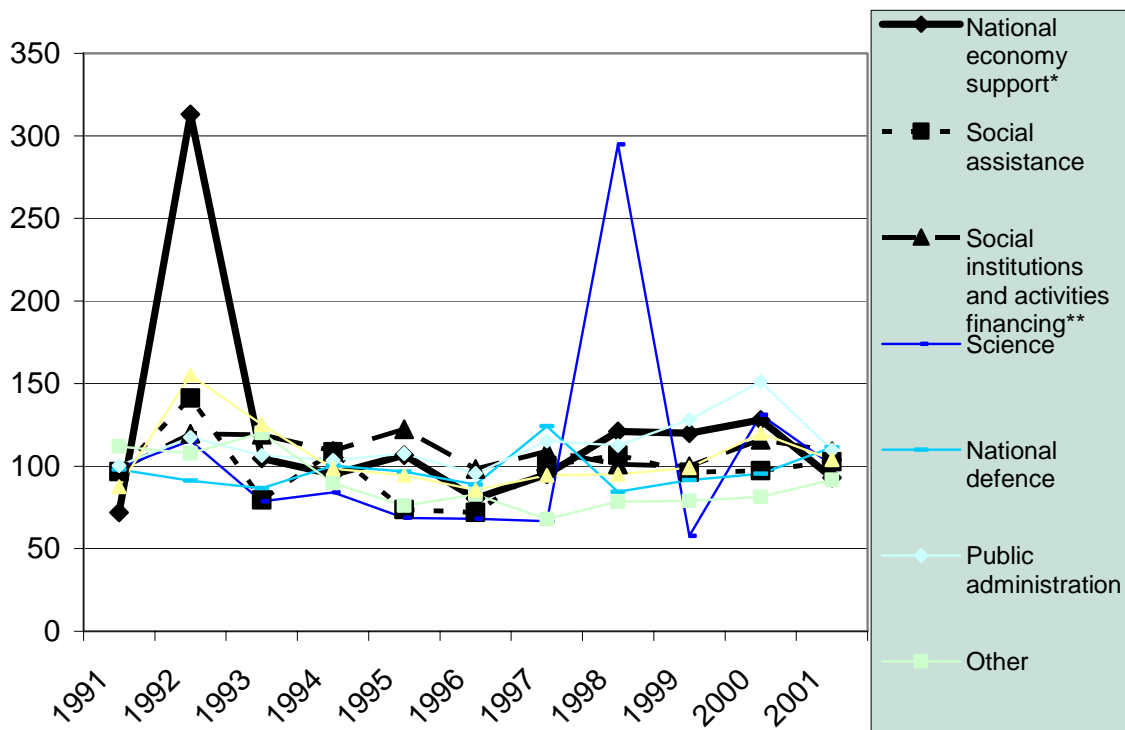
Source: Kravchuk (1998: 13)

Figure 2. Structure of consolidated budget by years



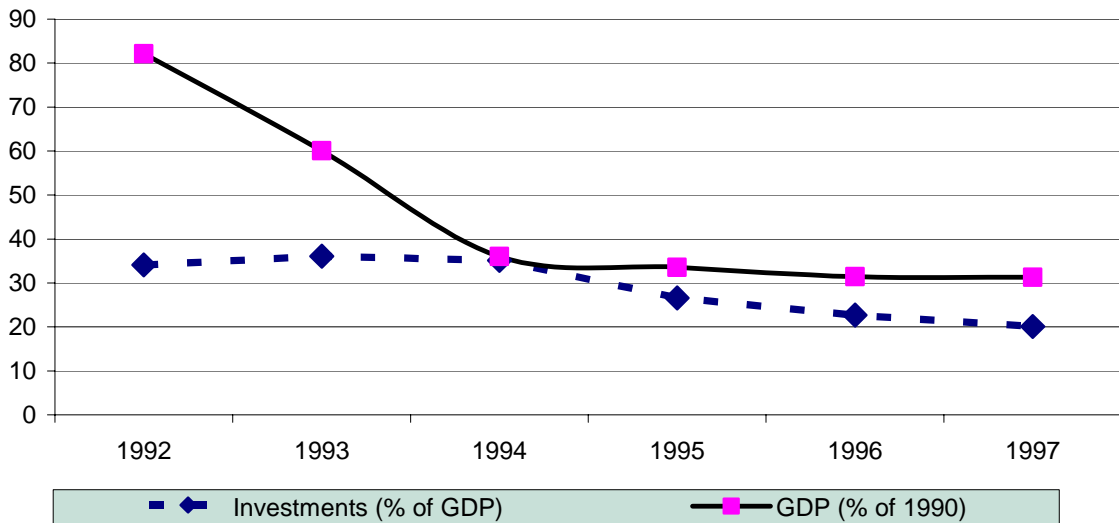
Source: State treasury of Ukraine, own estimates

Figure 3. Actual execution of the consolidated budget



Source: MoF, authors' calculations

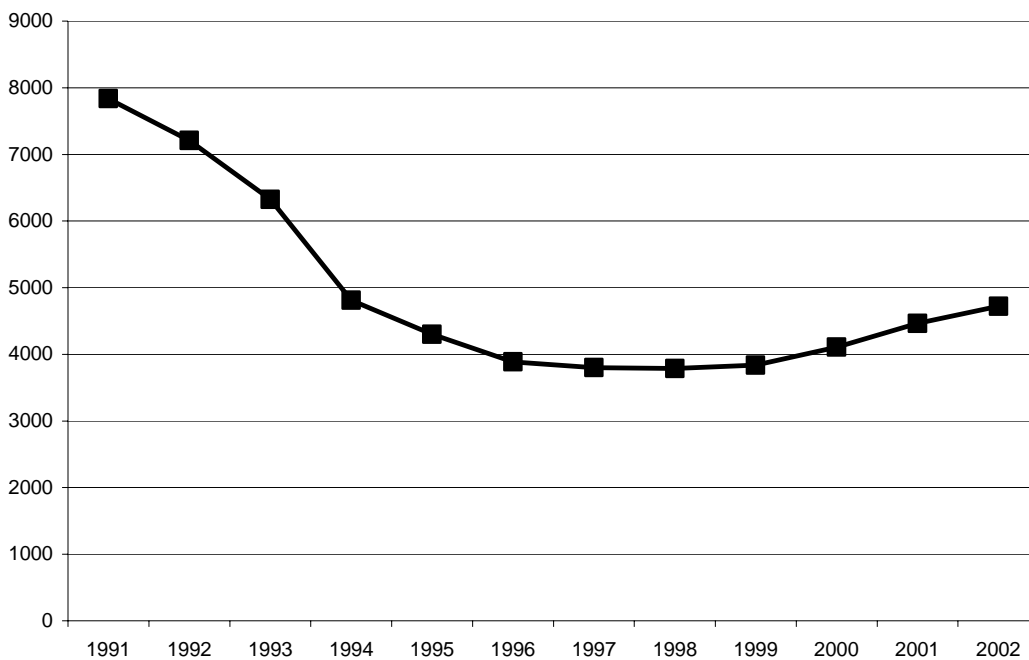
Figure 4. The real GDP decline and the share of investments in GDP.



Source: national statistics (DerzhComStat), author's calculations

Figure 5. Evolution of the GDP per capita (in constant 2000 PPP US dollars)

So



Source: World Bank (through www.gdnet.org)

Table 9

People’s attitude towards the privatization of small enterprises (%)

| How do you regard the privatization of small enterprises? | 1992 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|------|------|------|------|------|------|------|------|
| Rather negatively | 13.6 | 18.3 | 19.0 | 19.3 | 22.0 | 20.9 | 22.9 | 18.7 |
| Difficult to say | 28.8 | 24.4 | 25.1 | 27.2 | 27.5 | 24.9 | 27.2 | 28.6 |
| Rather positively | 56.2 | 54.8 | 55.4 | 53.4 | 50.4 | 53.7 | 49.2 | 52.0 |
| Not answered | 1.4 | 2.5 | 0.6 | 0.0 | 0.1 | 0.4 | 0.7 | 0.8 |

Figure 6. People’s attitude towards the privatization of large enterprises (%)

The people's attitude to the privatization of large-scale enterprises

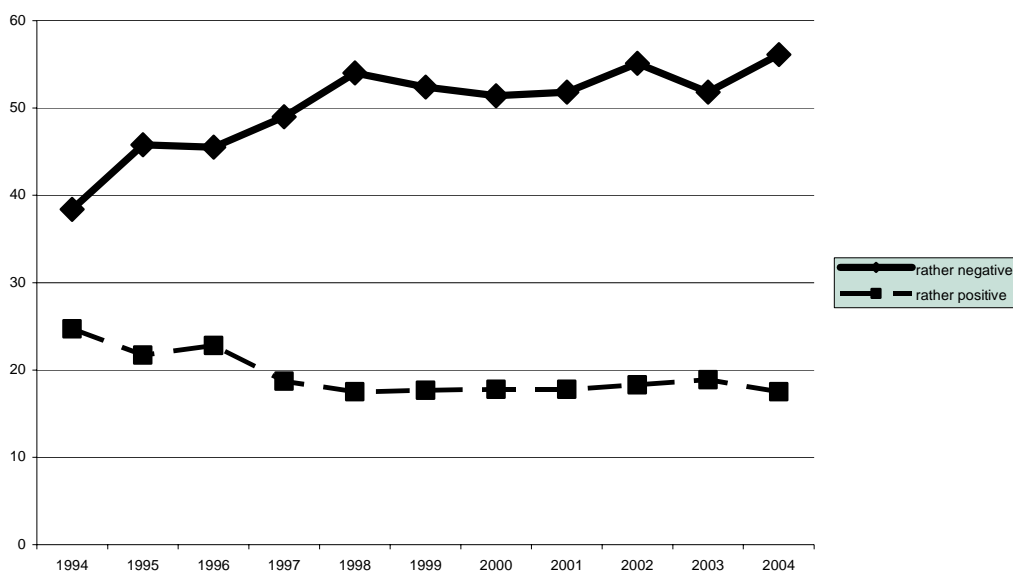


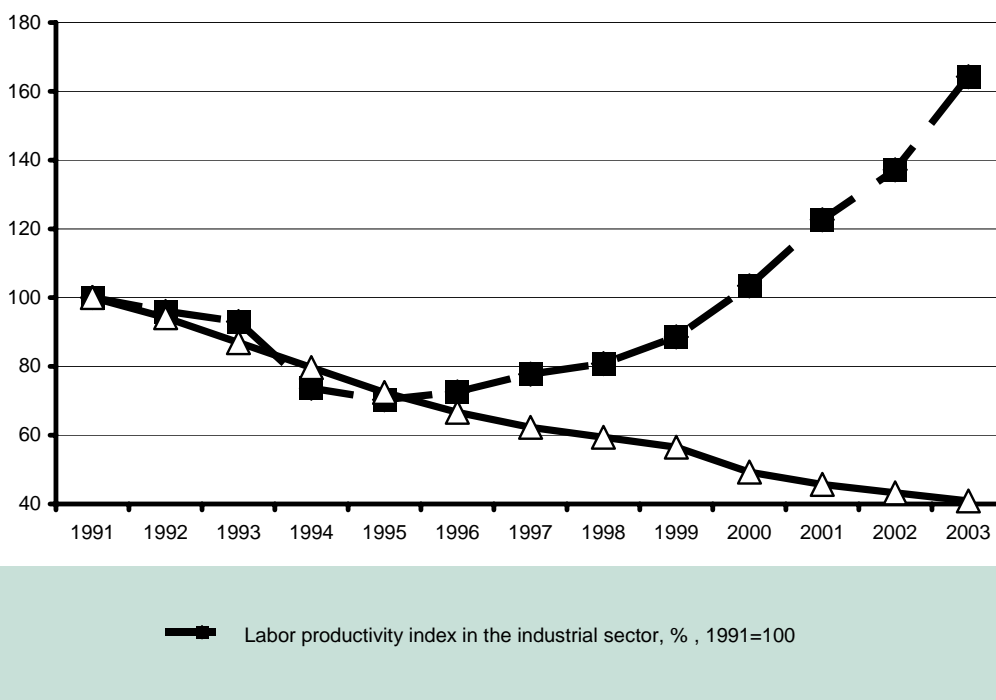
Table 10. Methods of Privatization by Industries of Ukraine as of January 1, 2000

| <i>Industry, branch</i> | <i>Number of privatized entities</i> | | <i>Privatized by method</i> | | | | | | | |
|-------------------------|--------------------------------------|------------------------------------|-----------------------------|-------------------------------------|---------------------------|-------------------------------------|-----------------------------|-------------------------------------|---------------------------|-------------------------------------|
| | <i>Total</i> | <i>Share of the overall number</i> | <i>non-competitive</i> | | | | <i>competitive</i> | | | |
| | | | <i>buyout</i> | | <i>lease with buyout</i> | | <i>auction, competition</i> | | <i>sale of shares</i> | |
| | | | <i>number of entities</i> | <i>share within the industry, %</i> | <i>number of entities</i> | <i>share within the industry, %</i> | <i>number of entities</i> | <i>share within the industry, %</i> | <i>number of entities</i> | <i>share within the industry, %</i> |
| Ukraine — total | 6670 | 100.0 | 2848 | 42.7 | 1316 | 19.7 | 1494 | 22.4 | 1011 | 15.2 |
| Industry | 6974 | 10.5 | 934 | 13.4 | 1331 | 19.1 | 472 | 6.8 | 4237 | 60.8 |
| Transport | 1346 | 2.0 | 118 | 8.8 | 154 | 11.4 | 73 | 5.4 | 1001 | 74.4 |
| Construction | 3293 | 4.9 | 706 | 21.7 | 868 | 26.7 | 272 | 8.4 | 1447 | 44.6 |

| | | | | | | | | | | |
|-------------------------------|-------|------|-------|------|------|------|------|------|------|------|
| Trade and public catering | 29917 | 44.8 | 14130 | 47.2 | 7571 | 25.3 | 7785 | 26.0 | 431 | 1.4 |
| Housing and municipal economy | 3137 | 4.7 | 1499 | 47.8 | 644 | 20.5 | 891 | 28.4 | 103 | 3.3 |
| Consumer services | 11859 | 17.8 | 6742 | 56.9 | 2079 | 17.5 | 2915 | 24.6 | 123 | 1.0 |
| Unfinished construction | 1597 | 2.4 | 212 | 13.3 | 12 | 0.8 | 1366 | 85.5 | 7 | 0.4 |
| Agriculture | 3072 | 4.6 | 1656 | 53.9 | 48 | 1.6 | 45 | 1.5 | 1323 | 43.1 |
| Other industries | 5512 | 8.4 | 2490 | 45.2 | 455 | 8.3 | 1128 | 20.5 | 1439 | 26.1 |

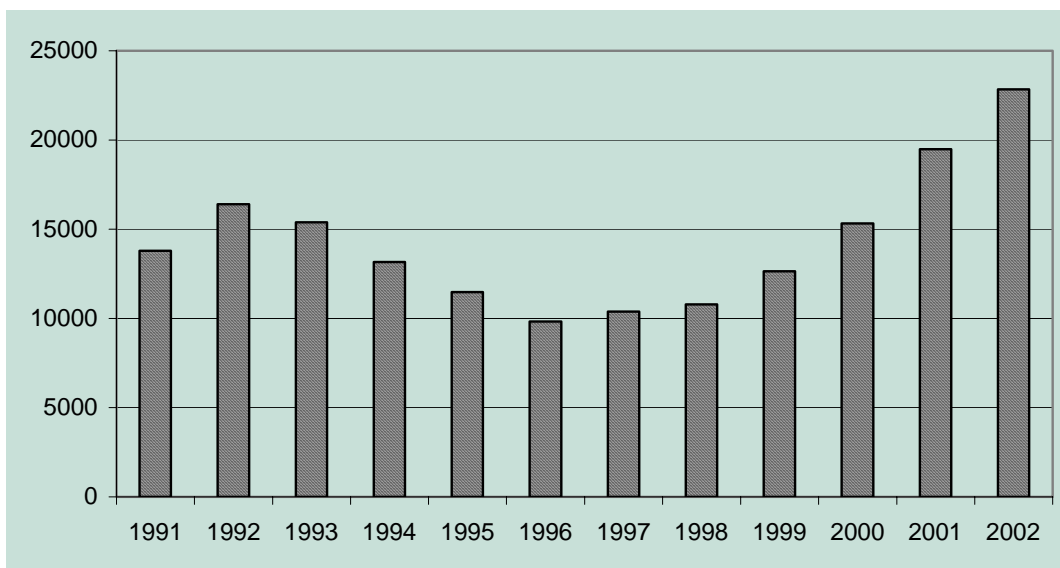
Source: Voronkova, 2000

Figure 7. Labor productivity and employment in the industrial sector of Ukraine for 1991-2003 (before and after mass privatization)



Source: DerzhComStat

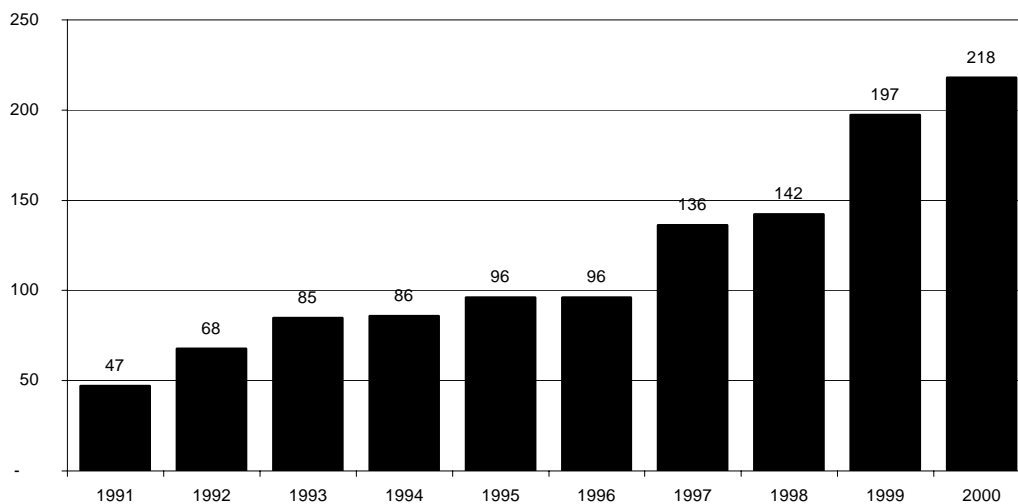
Figure 1. The number of new articles of production commercialized during a year



Source:

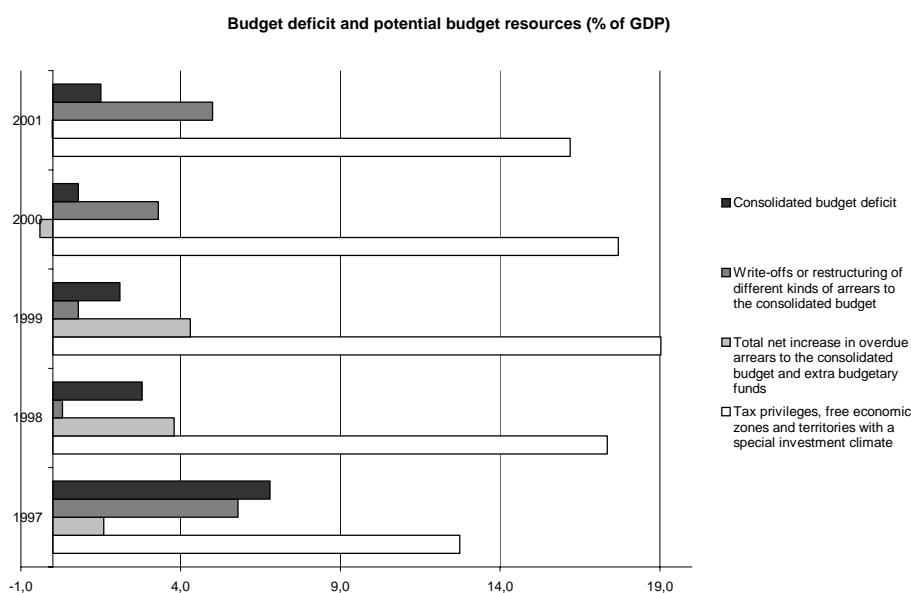
Derzhcomstat. First published by: World Bank, 2004.

Figure 9. The number of small businesses in Ukraine in 1991-2000, thousands of entities*



*Source: State Committee of Statistics. Before 1996 – “small enterprises” + ”cooperatives”, author’s calculations.

Figure 10. The budget deficit appeared due to paternalism towards the enterprises.



Source: State tax administration of Ukraine, State Treasury of Ukraine, own estimates

Table 11. Subsidy estimates (% of GDP)

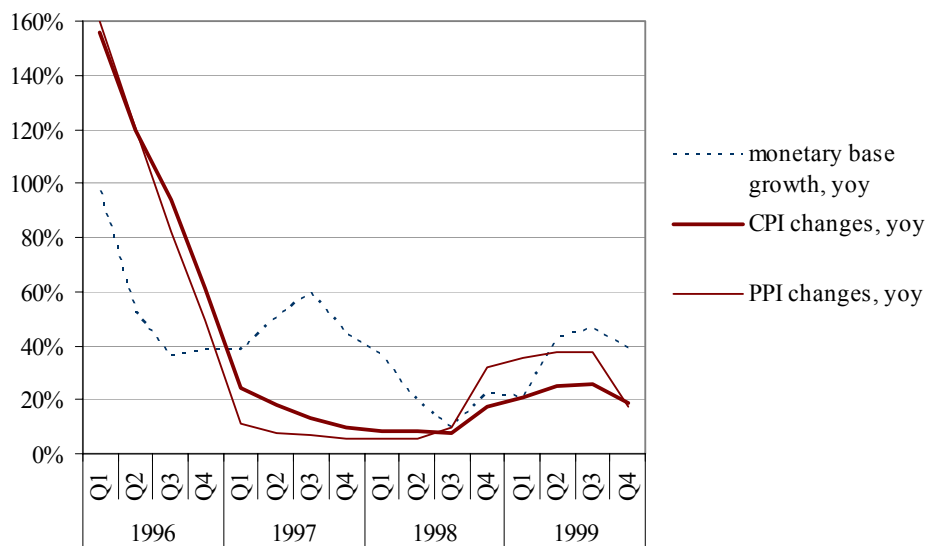
| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|--|------|------|------|------|------|------|------|
| Explicit (direct) subsidies | 7.5 | 5.6 | 7.0 | 5.6 | 4.8 | 3.8 | 3.7 |
| Industry and energy | 5.1 | 3.2 | 4.2 | 1.6 | 1.5 | 1.3 | 1.2 |
| Construction | 0.8 | 1.1 | 0.7 | 1.6 | 1.2 | 0.6 | 0.7 |
| Agriculture, forestry and fishery | 1.4 | 1.2 | 0.7 | 0.6 | 0.4 | 0.5 | 0.5 |
| Transport and communication | 0.1 | 0.0 | 1.2 | 1.7 | 1.6 | 1.1 | 0.9 |
| Other services related to economic activity | 0.1 | 0.1 | 0.2 | 0.1 | 0.1 | 0.3 | 0.3 |
| Implicit subsidies | 0.8 | 0.7 | 20.1 | 21.4 | 24.1 | 20.6 | 21.2 |
| Tax privileges, free economic zones and territories with a special investment climate | 0.0 | 0.0 | 12.7 | 17.3 | 19.0 | 17.7 | 16.2 |
| Total net increase in overdue arrears to the consolidated budget and extra budgetary funds | 0.8 | 0.7 | 1.6 | 3.8 | 4.3 | -0.4 | 0.02 |
| Write-offs or restructuring of different | 0.0 | 0.0 | 5.8 | 0.3 | 0.8 | 3.3 | 5.0 |

| | | | | | | | |
|---|--|--|--|--|--|--|--|
| kinds of arrears to the consolidated budget | | | | | | | |
|---|--|--|--|--|--|--|--|

Source: State tax administration, State treasury of Ukraine, own estimates

Figure 11

Growth of monetary base and inflation, 1996-1999



Source: own calculations based on NBU data

Table 12. Understanding of the contents of economic reforms by population of Ukraine, %

| | | |
|--|--|------|
| Judgments about the contents of reforms* | The percent of those people who agree that this judgment reflects the contents of economic reforms | |
| | 1996 | 2000 |
| Rise in living standards of majority of population | 53.0 | 65.4 |

| | | |
|---|------|------|
| Strengthening of discipline at enterprises of all patterns of ownership | 35.7 | 28.1 |
| Implementation of principles of fairness for remuneration of labor: equal remuneration for equal work | 30.9 | 38.2 |
| Reform of tax structure | 21.8 | 29.4 |
| Wide-ranging privatization (of enterprises, land, dwelling houses, etc.) | 14.6 | 7.8 |
| Maximum development of competition at the markets for commodities and labor | 11.6 | 11.5 |
| Increase of state assistance to those enterprises for which it is hard to survive in new conditions | 10.0 | 26.2 |
| Development of banking system | 5.5 | 4.0 |
| Development of market infrastructure (of stock exchanges, investment funds, etc.) | 5.5 | 4.6 |
| Bankruptcy of unprofitable business | 4.5 | 3.4 |
| I don't know | 16.3 | 10.8 |

*It was possible to choose not more than three judgments

Table 23. 1999 Presidential elections

| Main candidates | Party affiliation | Percentage of votes won (election) | Percentage of votes won (runoff) |
|-------------------------|-------------------|------------------------------------|----------------------------------|
| Center and Center-Right | | | |
| Leonid Kuchma | Non affiliated | 36.49 | 56.25 |
| Yevhen Marchuk | N/a | 8.13 | - |
| Left | | | |

| | | | |
|------------------|--|-------|-------|
| Petro Symonenko | Communist Party of Ukraine | 22.24 | 37.80 |
| Oleksandr Moroz | Socialist Party of Ukraine | 11.29 | - |
| Natalia Vitrenko | Progressive Socialist Party of Ukraine | 10.97 | - |

Table 14

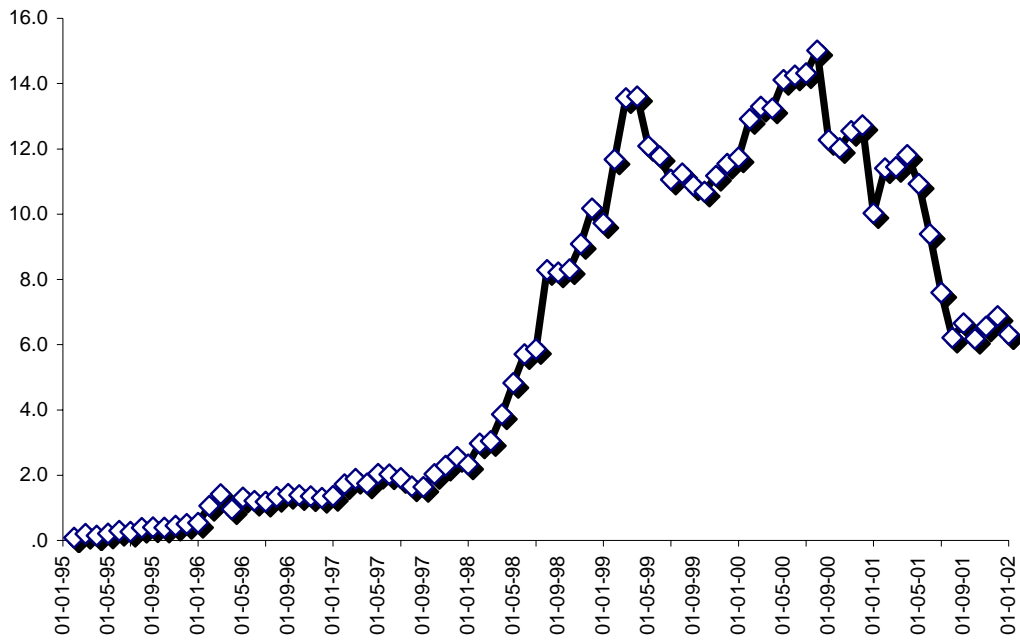
Evolution of the Parliament elected in 1998.

| Factions | Percentage of votes won (29/03/1998) | Number of deputies (as of 12/05/1998) | Number of deputies (as of 31/10/2000) To be academically correct here we should include figures of the end of 2001 |
|---|--------------------------------------|---------------------------------------|--|
| Left | | | |
| Communist Party of Ukraine | 24.68 | 123 | 114 |
| “Left Center” (Socialist Party of Ukraine) | 8.56 | 35 | 16 |
| Progressive Socialist Party of Ukraine | 4.05 | 17 | - |
| Center | | | |
| “Hromada”/in 1999, after Lazarenko's escape, replaced by Yu.Tymoshenko's “Fatherland” | 4.68 | 39 | 31 |
| “Solidarity” | - | - | 28 |

| | | | |
|---|------|-----|-----|
| “Apple” | - | - | 15 |
| “Labor Ukraine” | 3.06 | - | 48 |
| Social-Democratic Party of Ukraine (United) | 4.01 | 25 | 34 |
| Green Party of Ukraine | 5.44 | 24 | 17 |
| “Renaissance of the Regions” | - | - | 37 |
| People’s Democratic Party (NDP) | 5.01 | 89 | 20 |
| Center-Right (National Democrats) | | | |
| Ukrainian People’s Movement (“Rukh” led by Yuriy Kostenko)* | - | - | 21 |
| People’s Movement of Ukraine (“Rukh” led by Hennadij Udovenko)* | 9.40 | 47 | 19 |
| “Reforms-Congress” | 3.13 | - | 15 |
| Non-aligned | | 49 | 34 |
| <i>Total</i> | | 448 | 449 |

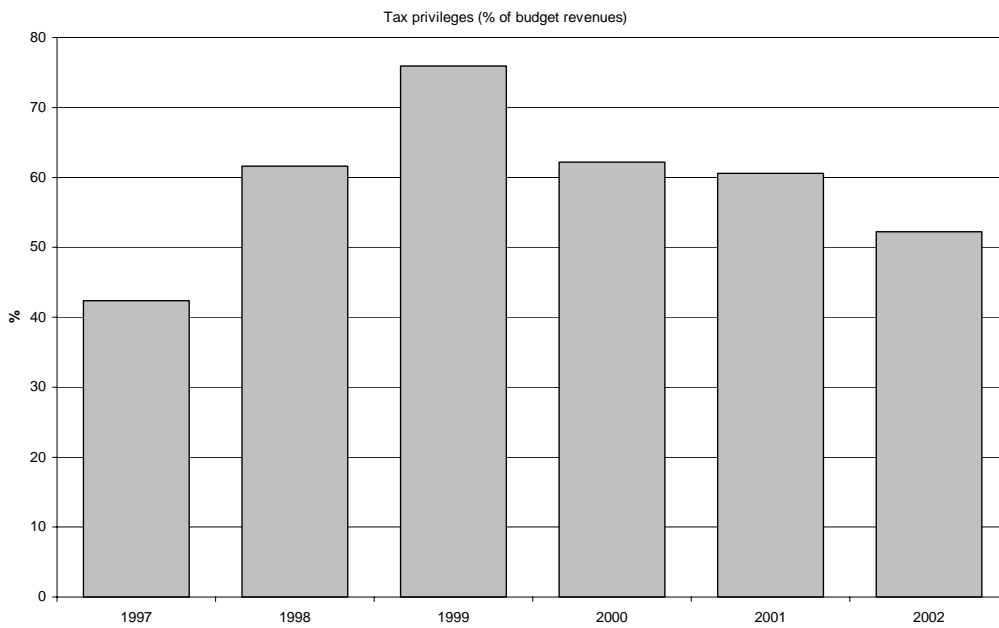
* In spring 1999, main national-democratic force "Rukh" split up in two.

Figure 12. Tax arrears in Ukraine before and after the crisis of 1998.



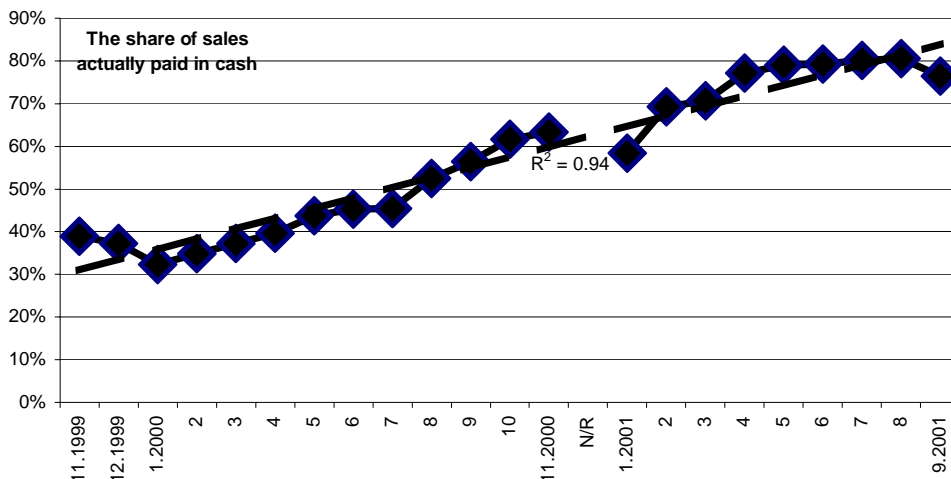
Source: World Bank, 2004

Figure 13. Evolution of tax privileges during the second wave of reforms²



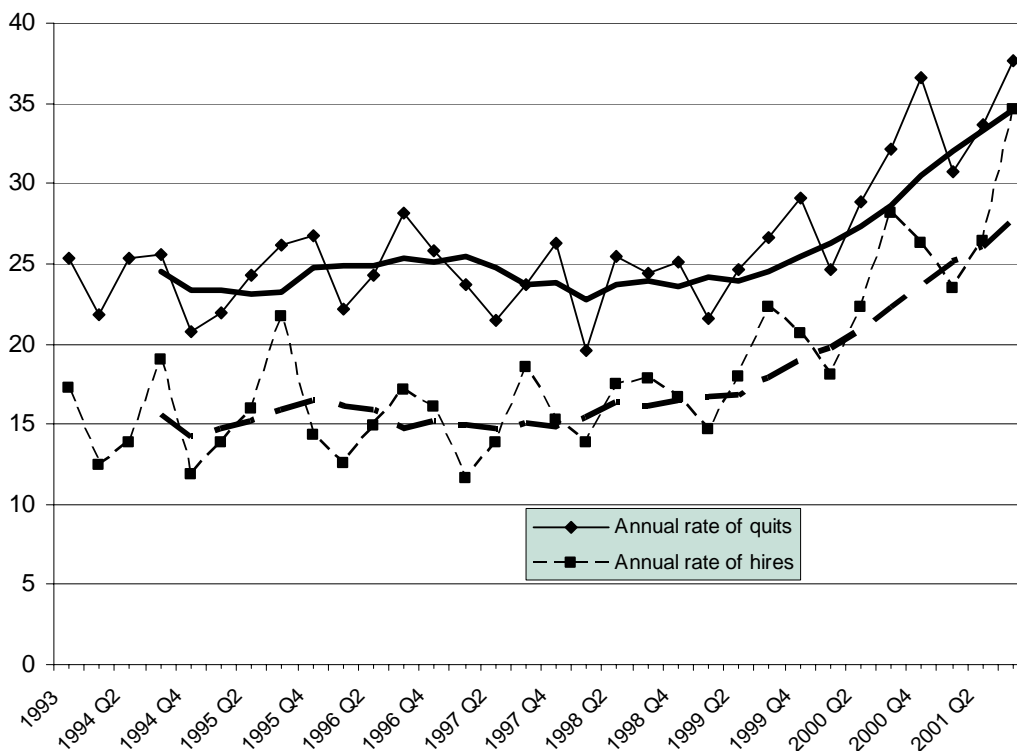
Source: State tax administration of Ukraine, own estimates

Figure 34. Level of payments for electrical energy (average on 18 energy distributing companies among 31), 1999-2001



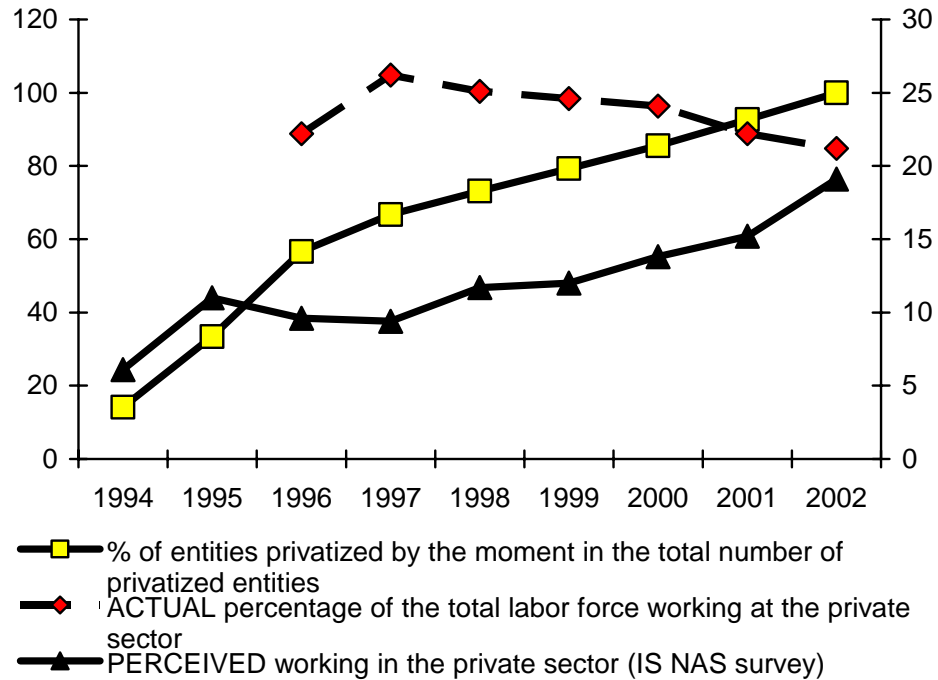
Source: Dubrovskiy, 2002 (based on the State Committee of Statistics data).

Figure 15. Annual rates of quits and hires in the Ukrainian industrial sector. Source: UEPLAC. Bold lines are trends (with a correction for seasonality).



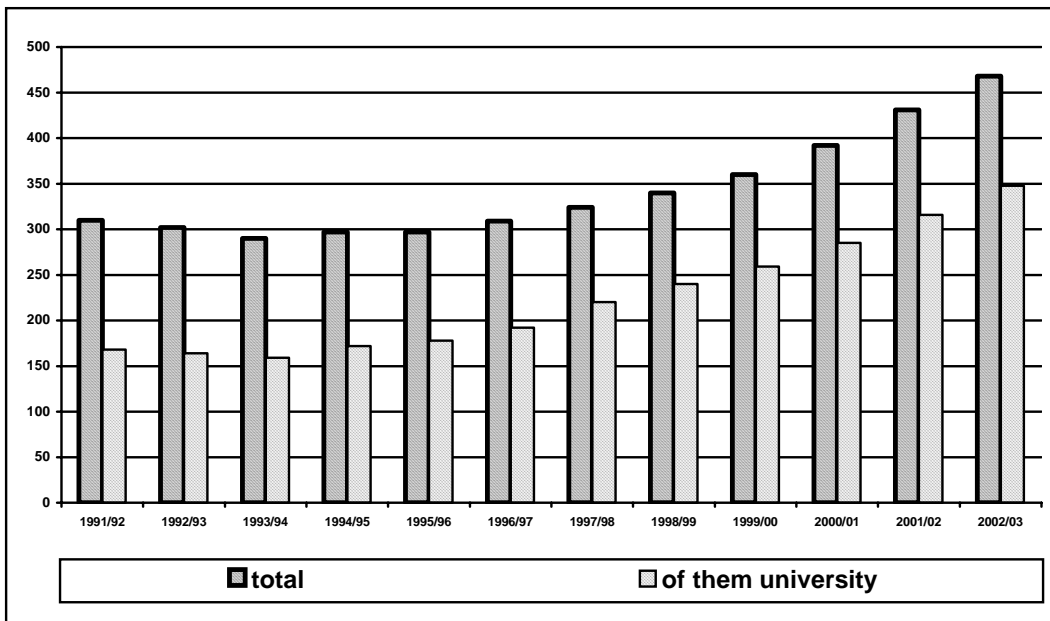
Source: DerzhComStat, author's estimations. First published: World Bank, 2004

Figure 16. The number of respondents reported that are employees in the private sector (by survey of the Institute of Sociology) in comparison with their actual percentage (by the national statistics).



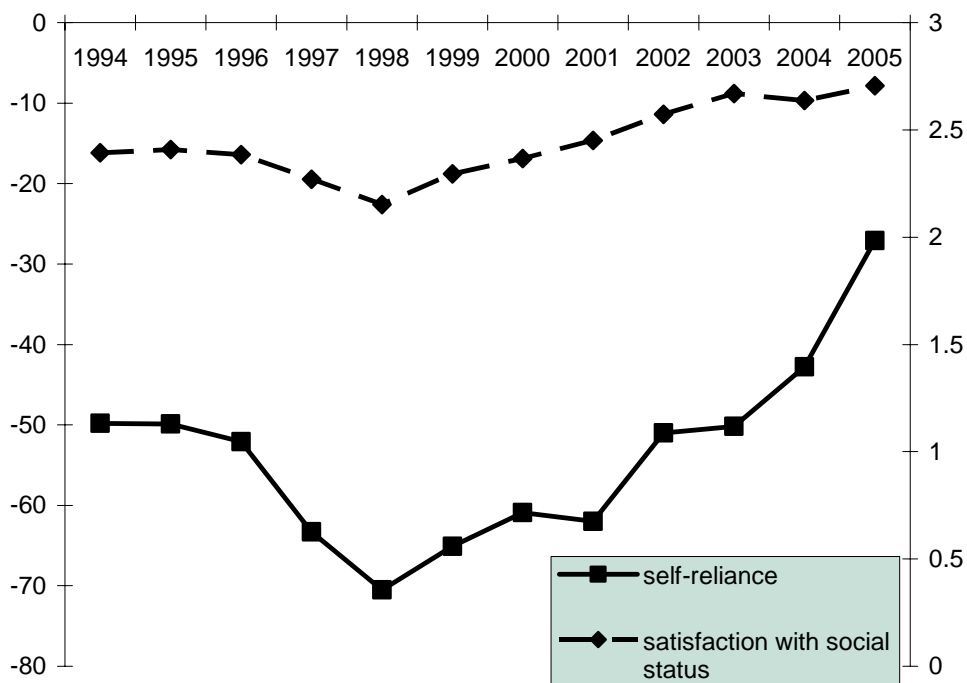
Source: DerzhComStat, Panina (2005), author's estimates

Figure 17. The number of students studying in Ukraine (thousand persons). Source: Ministry of education and science of Ukraine



Source: Ministry of education and science of Ukraine. Quoted by: World Bank, 2005.

Figure 18. Evolution of satisfaction with own social status (in the score of maximum 5, right axis), and self-reliance (in the percentage of respondents agreed that their success depends on themselves net of the percentage of respondents agreed that it is determined mostly by the external conditions – left axis).



Source: Panina, 2005, author's estimations

Table 15. The changes of material well-being of a family in Ukraine (according to the data of the public opinion poll in 1981 and 2003), %

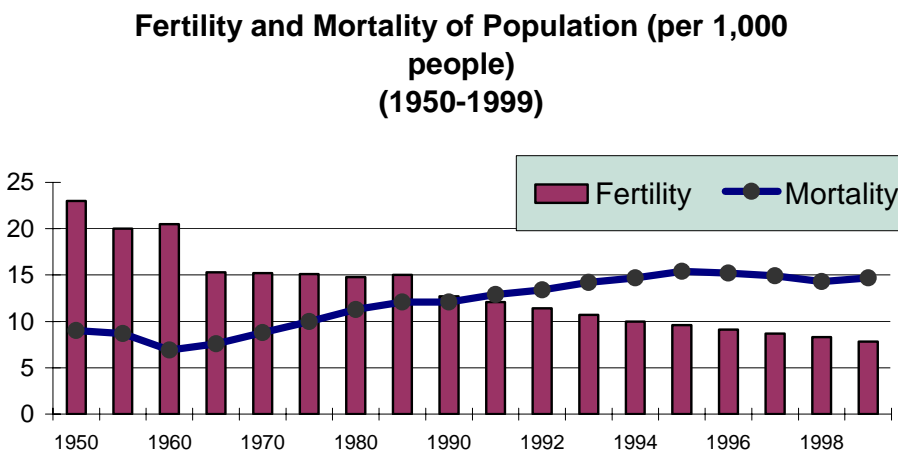
| What does your family have among the above mentioned? | 1981 r., N=5000 | 2003 r. , N=1800 |
|---|-----------------|------------------|
| Summer cottage, garden-plot | 12.9 | 33.5 |
| Automobile | 9.8 | 18.9 |
| Colour TV-set | 12.9 | 79.7 |
| Fashionable clothes | 19.1 | 10.5 |
| Library (>100 books) | 8.7 | 23.4 |
| Refrigerator | 64.2 | 90.9 |
| Washing-machine | 61.0 | 70.4 |
| Sewing-machine | 46.0 | 46.1 |
| Stereo- and video equipment | 10.2 | 19.8 |
| Tape recorder, record-player, radio set | 53.6 | 56.1 |
| Sport, tourist's, hunting, fishing equipment | 18.4 | 15.1 |
| Cold water | 57.8 | 78.3 |
| Hot water | 24.0 | 41.8 |
| Central heating | 33.5 | 62.3 |

Figure 19. Evolution of unemployment in Ukraine



Source: Laborsta (ILO)

Figure 20. Demographic trends in Ukraine



Source: DerzhComStat

Table 3. The distribution of answers of Ukrainian population to the question «What social groups are very important in the life of Ukrainian society?» in the public opinion poll of Institute of Sociology of National Academy of Sciences of Ukraine in 1995 and 2003, %

| | 1994 г., N=1800 | 2003 г., N=1800 |
|--------------------------------------|-----------------|-----------------|
| Mafia, criminals | 33.9 | 42.7 |
| State bureaucracy, «officials» | 29.1 | 24.5 |
| Entrepreneurs | 24.2 | 28.9 |
| Workers | 23.4 | 19.1 |
| Farmers | 20.9 | 14.7 |
| Intellectuals | 16.3 | 9.8 |
| Managers of state enterprises | 16.2 | 11.9 |
| Managers of agricultural enterprises | 10.7 | 5.7 |
| Police and security service workers | 7.9 | 11.7 |
| Military men | 6.6 | 5.6 |
| Pensioners | 1.9 | 2.9 |
| Other | 0.7 | 0.7 |
| Nobody | 4.2 | 3.1 |
| It is difficult to say | 17.4 | 15.4 |

Table 17. The distribution of answers of Ukrainian population to the question «Now political forces are divided into those who would like socialism to come back, and those who want to build capitalism. What is your own attitude to these forces?» in the public opinion poll of Institute of Sociology of National Academy of Sciences of Ukraine in 1994 and 2003, %

| | | |
|--|------|------|
| Variants of answers | 1994 | 2003 |
| I support socialists | 22.1 | 25.7 |
| I support adherents of capitalism | 12.7 | 10.6 |
| I support both these and those, if only they don't clash | 23.7 | 23.4 |
| I don't support any of them | 20.0 | 22.3 |
| Other | 1.8 | 1.7 |
| It is difficult to say | 19.3 | 16.1 |
| Did not answer | 0.4 | 0.2 |

Table 18. The factors of attitude to entrepreneurship, %

| Factors of attitude to entrepreneurship | Attitude to entrepreneurship | | |
|---|------------------------------|--------------|----------|
| | Positive | Undetermined | Negative |
| Possession of information on the main principles of market economy | | | |
| Well-informed | 85.5 | 9.4 | 5.1 |
| Poorly informed | 60.7 | 24.4 | 14.9 |
| Not informed | 37.4 | 31.7 | 30.9 |
| Age | | | |
| 30 years and less | 74.6 | 17.4 | 7.9 |
| 30-54 | 61.2 | 24.7 | 14.2 |
| 55 years and more | 32.5 | 32.0 | 35.5 |
| Education | | | |
| Primary and incomplete secondary | 38.8 | 29.8 | 31.4 |
| Secondary | 64.0 | | |
| specialized secondary | 62.5 | 24.5 | 13.0 |

| | | | |
|--|------|------|------|
| Incomplete higher and higher | 73.5 | 20.5 | 6.0 |
| Type of settlement | | | |
| Kiev | 65.0 | 30.0 | 5.0 |
| Other city/town | 58.8 | 23.6 | 17.5 |
| Village | 48.9 | 25.1 | 19.1 |
| Region | | | |
| The West | 61.4 | 26.3 | 12.4 |
| The Center | 49.4 | 25.3 | 25.3 |
| The South | 55.8 | 25.1 | 19.1 |
| The East | 54.2 | 23.9 | 22.0 |
| Opportunity to earn additionally | | | |
| Yes, enough to ensure normal life | 85.2 | 3.7 | 11.1 |
| Yes, but not enough to ensure normal life | 68.3 | 20.9 | 10.8 |
| No | 51.6 | 26.6 | 21.7 |
| Going abroad to fill up family budget | | | |
| Constantly | 81.8 | 12.1 | 6.1 |
| Sometimes | 69.2 | 21.9 | 8.9 |
| No | 53.0 | 26.0 | 21.0 |

ⁱ 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.

ⁱⁱ The social expenditures were not prioritized in the budget (Figure 2). 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 (Figure 3) and there was a strong tendency to delay the respective payments, which meant their devaluation giving to very high inflation rate.

ⁱⁱⁱ “... 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)

^{iv} 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 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 Vinzenc (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, 2002). 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.