Lessons from the Ukrainian Transition: Reform Driving Forces in a Captured State

Justification of the Study

Brief Overview of the History of Reforms

The initial conditions. Ukraine emerged as an independent country in 1991 as a result of the political collapse of the Soviet Union. Although economic reforms had been initiated four years earlier under Gorbachev's "perestroika" program, these were motivated mainly by populist political ideals which attempted to combine necessary economic changes with a desperate insistence on maintaining the core principles of the existing command system. Founded on a history of accumulated economic distortions, these reforms served mostly to magnify the problem of macroeconomic imbalances and industrial disorganization. Inheriting all of these deficiencies from the former Soviet Union, Ukraine in 1991 faced two stark choices – either completely rebuild all political and economic institutions or manage the orderly conversion of traditional Soviet institutions into institutions more suited to new independent nation-building.

The first period: 1991-1994. Throughout this first period permissive and paternalistic policies toward large industrial enterprises and a non-reformed agricultural sector led to unprecedented hyperinflation accompanied by massive asset tunneling, fiscal mismanagement and fraud. The very limited reforms undertaken during this period resulted in highly uneven and skewed benefits, resulting in increased social tensions throughout Ukraine. Some privatization and enterprise restructuring projects were initiated during this period; however, the first comprehensive national program for privatization proposed in 1992-93 was deeply flawed and, never actually implemented. This period ended with pre-term presidential and parliamentary elections in 1994.

The second period: 1994/5-1998. A more active program of reforms characterized the second period, even though the scope of reform was still limited and only partially successful. Nevertheless, this increased activity did result in gradual liberalization of domestic and external markets, a relative stabilization of exchange rates and a slow-down in the overall rate of inflation. All of this was based on a comprehensive program of reform developed in mid-1994 with the cooperation of IMF consultants and the support of the World Bank and a number of bilateral donors. A voucher-type mass privatization program was launched in 1995. In September 1996, a new currency – "hryvna" – was successfully introduced.

At the end of 1996 a program of far-reaching structural and institutional reforms was prepared under the direction of Deputy Prime Minister Victor Pynzenyk. However, many specific features of this program were simply blueprinted from the reform legislation of other countries and little attention was paid to the actual institutional structures of Ukraine and the political-economy problems. As a result, even though the reform policies themselves clearly approached accepted European standards, the new reform program was very selectively implemented and, thus, introduced significant distortions. In particular, the actual implementation of the reform program failed to address the problem of fiscal imbalances, caused mostly by paternalistic treatment of "sweetheart firms" and by the proliferation of non-monetary regimes of payment. High fiscal deficits financed by commercial borrowing and IMF credits led ultimately to a debt trap and a financial crisis of September 1998.

Overall, positive developments in reform were not accompanied by a level of structural reform sufficient to guarantee a return to real economic growth (GDP continued to decline) or to eliminate widespread distortions, non-payment and barter transactions and rent-seeking, particularly in the energy sector and in energy-intensive industries. Moreover, the government tolerated, and even encouraged, non-monetary transactions and even, to some extent, non-payments. Government sanctioned "netting-out operations" accounted for almost one-half of all transactions in 1998 alone and resulted in very substantial deadweight losses in the ways similar to these in Russia (described at Pinto et al., 2000).

The third period (1999-present time) The third period began with the triple crisis of 1999. First, even after the debt payments re-scheduling of 1998, almost 4.5 billions USD were to be paid in 2000, of then almost 1.5 billions in the first quarter, while the official foreign reserves barely reached 1 billion, and the trade balance, although became positive, was still just 1.8 billions USD, at the same time the country lost access to international financial markets. Second, the electric power-supply system was on the verge of collapse due to a lack of liquidity caused by heavy indebtedness and non-monetary regimes of payment (less than 20% of total receipts were in cash). Third, the great granary for the Soviet Union, Ukraine, was forced to import wheat for the first time in its history. The significance of this triple crisis was quite clear: fiscal imbalances had to be reversed to pay back debt; non-monetary regimes of payment had to be restricted, by money; and the agricultural sector had to be radically reformed. In other words, the factual hardening of "external" budget constraints on the national economy had to be translated into effective hardening of domestic budget constraints, particularly in the energy sector. Netting-out operations had to be restricted, barter transactions and other forms of rent extraction had to be reduced and revenue collections greatly improved.

Neither the 1998 Parliamentary elections nor the 1999 Presidential elections had brought the substantially needed national political changes. However, following President Leonid Kuchma's reelection in 1999, Prime Minister Victor Yushchenko's Cabinet was appointed. This was the most reform-oriented Cabinet in the short history of the independent Ukraine. It outlined the essential reforms needed to support the government program of March 2000: "Reforms for the Sake of Welfare." Even though this program did not reach successful completion because of a political crisis in April of 2001, in the year 2000 it drastically curtailed the role of barter, netting-out operations and non-payment regimes; implemented important deregulation reforms in the public sector and accelerated the rate of privatization in sectors considered to be "strategic" (steel, aluminum, oil refining and energy provision, in particular); and radically reformed the agricultural sector. All of this resulted in gradual improvement in fiscal and payment discipline (particularly in the area of energy payments), significant reduction of fiscal deficit, and other specific signs of macroeconomic recovery (see Dabrowski and Jakubiak, 2002). When combined with the mounting record of successful reforms, the program of privatization began to result in an impressive, though fragile, record of growth (Dubrovskiy , 2001a).

Even though the economy began demonstrating sound macroeconomic indicators in 2000 and 2001, political crises in April 2001 significantly weakened the overall project of urgently needed structural and institutional reforms. The political prospects for full implementation are highly uncertain at this point. The political system remains unstable, democracy weakly developed and incomplete, and the actions of the state highly unpredictable. Unhappily, nothing in the current political situation would prevent a return to pre-reform patterns. In 2002, for example, we have observed certain negative developments reminiscent of the early period, such as new increases in non-payment and a return of budget deficits.

In spite of the very real positive developments of 2000 and 2001, the overall economic balance of the past decade is negative (see Babanin et al, 2002; Dabrowski et al, 1999). Over the past decade Ukraine experienced a dramatic GDP decline, much deeper than the declines experienced by all other transition countries not directly involved in military conflicts. However, viewing this problem from a purely economic perspective, structural distortions inherited from the Soviet period cannot fully explain this fact (World Bank, 2002). Moreover, some of the most debilitating of distortions, such as the dominance of energy-intensive economic activity in an energy-scarce national environment, were magnified in the period 1991-98 (Babanin et al, 2002).

Overall, the process of economic transition in Ukraine has been significantly slower, less successful and less consistent in comparison not only to Central European and Baltic countries but also in comparison to some CIS countries. According to many international comparisons, Ukraine's economic institutions are considered to be some of the most unreformed and distorted (see EBRD, 1999; EBRD, 2000, table 2.1; Karatnycky et al, 2001). The same holds true when we conduct international comparisons of the general level of unregistered economic activity, corruption and rent seeking. All of this, of course, continues to result in increasing income inequality and other social distortions and tensions.

Why the case of Ukraine is so interesting: the paradoxes and tentative lessons.

Ukraine appears to be an extreme case in terms of the real discrepancy between its potential (in terms of physical and human capital) and its actual performance (Szyrmer, 2001). For example, although Ukraine was ranked in 1997 as second in the world in the ratio of numbers of new patents to GDP (Babanin et al, 2002), the actual share of intellectual and high-tech products in its total export volume is negligible, and the share of high effort goods in exports was in the same year just 17%; and all but 16% of exported services was transportation, mainly the pipeline. This remarkably stark contrast between a recent history of deep economic decline combined with a great wealth in physical and human capital leads to the conclusion that Ukraine presents the clearest and most instructive example of institutionally-constrained growth ever studied. Not surprisingly, the effects of institutional change, when and where they actually occur, are dramatically visible in Ukraine.

Ukraine presents a very good case for investigating the systematic linkages among economic, social and political institutions in the context of careful examination of the actual micro and macroeconomic consequences of the reform policies. For example, the immediate macroeconomic cause of the currency crisis of 1998 was the depletion of National Bank reserves, but this itself came as a consequence of a dual imbalance caused by low economic efficiency, paternalistic treatment of “sweetheart firms,” and poor governance and enforcement measures. All of them ultimately reflected, in turn, a deep-rooted culture of paternalism and patronage, and the consequent inability to shift from reliance on personal networks to the promotion of impersonal, transparently defined relationships. And to view this from another perspective, the crisis of 1998 also clearly revealed the urgent need for changes that would deeply affect basic political and economic institutions in Ukraine. This became very clear to the population and led, in the end, to substantial changes in the pattern of electoral preferences during parliamentary elections in 2002. In this study we intend to trace out carefully some significant and systematic linkages among economic, social, political and cultural institutions in ways that will shed valuable light on the ways in which this historical process of reform has been both constrained and enabled in Ukraine.

More specifically, we suggest that the case of Ukraine is especially interesting precisely because it is an extreme case clearly demonstrating certain general patterns of the reform process. For instance, the Ukraine case is instructive for the light it sheds on the questions put for the study.

Questions put in the GDN description of the project	**The Ukrainian experience underlines**	**Evidences to be find at**
Why do countries undertake major reform efforts?	the positive role of “hard budget constraints” on the entire domestic economy; crisis and its expectation	the period of reforms in 1999
What is the relation between political reform and economic reform?	the relationship is clear and close: in a captured state the concentration of power obstruct reforms	when examining actual obstacles to reform during the whole period, particularly in most recent years
Can we say anything conclusive about the effect of specific reforms on socio-economic change and poverty alleviation? How can we compare the costs of not reforming with reforming?	the social and economic costs of delays in implementing reform or implementing reform selectively and inconsistently is very high	the first period of reform

Is the end goal for all countries the same-despite a wide variety of paths-or are different forms of capitalism more effective in different countries?	the property rights (titular and residual), transparency and open competition are of crucial importance for the development of a market economy with real potential for growth	comparing the third period to earlier periods
Why have countries that followed similar policy reform agendas had such varied results?	the developing of the reform programs that emerge from the institutional specificities of each country and that seek, therefore, to neutralize country-specific obstacles and build enduring pro-reform coalitions is of crucial importance	the case of Pynzenyk's Reform Package of 1996-97, as well as the policy of macroeconomic stabilization in 1996-98
What are appropriate indicators for measuring short-term and long-term impacts?	the traditional macroeconomic and social indicators (or, at least, the conventional procedures of measurement and assessment) are insufficient for evaluating the success of reforms	the second period
Is sequencing of reforms important? Are there fairly well-defined optimal sequences or does each country have its own optimal sequence?	both the pace and sequencing of reforms is determined by broad political-economic factors and should be considered mostly endogenous	the entire period of reform
What is the role of the provision of information in the reform process?	the role of transparency in communication and the provision of information in the reform process is really crucial	the whole period
Can some types of reform be understood through the lens of a single discipline or is a multi-disciplinary focus always needed?	the developing of a rigorous multidisciplinary approach to understanding the historical process of development and implementation of reforms is necessary	the whole period
What is the role of international public institutions-such as IFIs, the UN system, WTO, etc-in reform programs?	the role played by international financial institutions, outside donors and creditors in the reform process was de facto ambiguous	the second period

At the same time, we would argue that the Ukraine case presents very interesting particularities that would not be adequately captured within conventional paradigms for analyzing general patterns of reform. In general, this is because the formal structures and policies of the Ukrainian state do not necessarily adequately reflect societal-wide informal institutions.

What is the importance of cultural and societal norms in the success of reforms? Alternatively, are changes in cultural and societal norms necessary for reforms to be successful?	Even though very many organizations, rules and actions appear very similar to corresponding organizations, rules and actions in Western countries, they have, in fact, very

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<tr><td>Is there a threshold level of human development-in particular, educational and skill levels, but also including health and indicators of societal organization-that must be reached before reform can be effective?</td><td rowspan="7">different meanings and roles in Ukraine. Thus, the State Tax Administration, for example, performs the function of destroying political challengers of the ruling authorities. In Ukraine, also, policies of macroeconomic stabilization were conducted almost exclusively at the macro level with no corresponding actions taken at the micro level. The election results should be also considered with great caution, since they not necessary reflect the preferences of the voters measured by the surveys, and often caused just by the artificial scarcity of leaders and programs.

Mainly oligarchic, mostly rent-seeking, interest groups closely linked to established centers political and administrative power define the actual political and economic life of Ukraine. Of course, Ukraine is not unique in this respect; however, here one can study the remarkably fast process of change in perception of where their “interests” actually lie, thus leading these oligarchic interest groups to actually promote reforms that paradoxically serve to undermine their own sources of rent. The dynamics of these remarkably quick changes in perception and attitude provide a wonderful opportunity for studying the complex interrelations among institutions, interests, policies and economic dimensions of reform.</td></tr>
<tr><td>How do you build consensus in a society to undertake reforms?</td></tr>
<tr><td>How does effective participation in the reform process by all stakeholders come about?</td></tr>
<tr><td>How can the transaction costs of undertaking reforms be minimized?</td></tr>
<tr><td>Is policy reform or institutional change and development the driving force behind the reform movement?</td></tr>
<tr><td>Does policy reform lead to significant institutional change without other explicit interventions?</td></tr>
<tr><td>When do changes in 'physical' institutions-eg central banks, tax collections, legal systems-result in changes in 'behavioral' institutions-eg corruption, rent-seeking, attitudes towards contracts?</td></tr>
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Objectives of the study and analytical framework

The general purpose of this study will be to answer a critical set of questions, not only about the reform process in Ukraine but about the reform process in general in many transitional and developing countries. The proposed study will cover the period 1991-2001 – the first decade of Ukraine’s independent existence. In order to gain a more detailed, clearer understanding of the dynamics of reform and the critical factors involved in this process, we will divide this ten-year period into three sub-periods (as outlined in section 1 above), examining the specific initial conditions and agendas for a program of reform. This examination will deal both with formal factors (those explicitly depicted in programs of reform) and informal, implicit factors (not explicitly depicted or discussed in programs of reform).

The concept of state ‘capture’ by vested interests (Hellman, Jones and Kaufmann, 2000) seems to be the most relevant framework for addressing many of these questions. As was the case with other countries that failed to alternate the ways of elite selection, and therefore either did not experience at all or lost the initial political window of opportunity, Ukraine found itself in a slow reform equilibrium – or institutional trap (Klein and Pomer, 2001, “Institutional Traps”, by V. Polterovich) -- for many years. The hybrid economic regime helped create new powerful interest-groups – oligarchs – who extracted diverse forms of rent by exploiting high inflation rates, multiple exchange rates, direct and indirect subsidies, tax exemptions, selective trade barriers, widespread licensing, export and import quotas and restricted and non-transparent privatization processes (Gelb, Hillman and Ursprung, 1995). Oligarchs successfully captured most of the basic public institutions – executive, legislative and judicial, including regional and local governments, political parties, trade unions and the mass media[1]. Large disparities in the distribution of wealth and income, denial of equal access to business activity for the majority, widespread poverty, frustration and political apathy constituted the obverse side of this same coin. The interests of losers/voters played little role in this process of reform, which became dominated by the “intermediate winners” (Hellman, 1998).

However, the state capture concept overlooks at least one factor crucially important for Ukraine: both state authorities and big-business elites have the same origins, so the state had been “captured” from the very beginning. The ‘captured’ state seems to be just the natural product of evolution of the Soviet elite. This new arrangement had become a more attractive alternative to the habitual Communist power, and in this sense played a positive role in ‘burning the bridges’. Privatization was probably the best example of this.

The monopolization of power and the economy within the authoritarian state (the ‘capture’ by a single person or small group) was an alternative option for the evolution of such elite. While in some other countries the things did go this way, in Ukraine such an attempt made by Prime Minister Pavlo Lazarenko in 1996-97 was unsuccessful. Lazarenko was finally charged with money laundering by the US authorities. Why has this evolution not ended with a total monopolization of power and wealth by one single group?

Finally, and most intriguingly to us – Why did the ‘captured’ state decided to introduce reforms that help restrain rent seeking in 1999-2000? What was the mechanism within this system that triggered these reforms in order to prevent an economic collapse?

We think that the history of reforms in Ukraine described in terms of a game between the interest groups within the elite may shed a light to these questions and help in explaining the course of events.

The initial preconditions. Ukraine was not unique with respect to the initial conditions for transition. Comparative research has shown that all former communist countries were forced to deal with the same initial challenges. Many of these countries, particularly countries in Central Europe and in the Baltic, launched successful reforms immediately following the collapse of a communist regime, which seem to result in a relatively smooth and successful transition. In addressing the question of why the same did not happen in Ukraine, we want to focus on the crucial importance of some critical features of the initial preconditions.

The decay of the USSR was certainly caused by the economic failures of the Soviet political and economic system. However, we want to argue, the evolution of this system during its last decades of existence cannot be adequately described and analyzed within the all-too-familiar model of the “centrally-planned economy.” This is because the importance of this well-known “command-economic system” was becoming quickly transformed into highly personalized quasi-markets for the exchange of administrative power and scarce resources (Ledeneva, 1998). The evolving system, based on paternalism, rent seeking and non-transparency, resulted in the grave misallocation of resources, perversion of economic incentives and very poor selections of key economic and political actors. In the very end, this evolving system became so inefficient that even the totalitarian, self-interested and arrogant Communist ruling elite finally recognized the urgent necessity for reform.

But the reforms themselves were neither well planned nor ultimately manageable. In contrast to China, discipline within the ruling elite was already very low. Even though Gorbachev and some his allies were looking quite sincere in their attempts to develop and implement reforms, the most powerful elite-groups upon which the success of reforms depended, such as enterprise directors and provincial leaders, already perceived reforms opportunistically – as a means of increasing their rents and consolidating their power. At the same time, many elites who had already attained great power and wealth saw in reforms a mechanism for eliminating onerous ideologically defined restrictions imposed by the traditional communist regime, e.g., the strict traditional limitations on travel abroad; and a tool for protecting their own assets with more rigorously defined property rights. Neither the elites nor any other major group had any desire to see reforms as paving the way for the establishment of a full-fledged capitalist system. Both elites and the population at large were

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[1] Ukraine is ranked third, after Azerbaijan and Moldova, by the overall ‘state capture’ index, and second in the legislative capture (Hellman, Jones, Kaufmann, and Schankerman, 2000).

unwilling to accept some of the painful, inevitable consequences of market reforms and, instead, sought various types of "third way" as the goal of reforms (Ryvkina, 1998). Therefore, all of the early reformers failed to formulate any clear, principled and consistent agenda for reform and invested no effort in developing measures of prediction and control over outcomes. As one conservative critic said of the reformers: "You are taking off in an airplane with no idea whatsoever of how and where you will land it."

Even though we believe we understand the picture of these earliest conditions of reform, we will attempt to develop proxies that would assist us in capturing quantitatively critical institutional preconditions. This would permit us to compare Ukraine with other countries in accounting for these factors. In order to accomplish this, we will try to assess the interrelations between subtle, difficult-to-measure "institutional distortions" and economic and social factors that can be reliably measure with more convenient, traditional indicators.

The first period 1991-1994. The elites described above, who provided the initial impetus for reform, were all concentrated with the same circle of ruling elites. In contrast to the experience of Central European and Baltic countries, when Ukraine achieved independence in 1991, it inherited the same elite and the same structural mechanisms for its selection and reproduction as a ruling elite. At the same time, the collapse of the USSR magnified the effects of such macroeconomic imbalances as the "money overhang" (suppressed inflation) and the many problems of microeconomic disorganization. The need for reforms was then more pressing than ever.

However, the ruling elite was not prepared for this immense task and, under the circumstances, was remarkably inert, passive and incapable of undertaking change (Babanin et al, 2002). Led by the interests of rent-seeking groups interested in the just partial reforms (e.g., liberalization of foreign trade, bolstered by negligible costs for energy), it completely failed to develop any general, viable program of reform. In fact, there were many diverse ways of amassing wealth at this time, but the most beneficial were barely related to the value-creating activities. It is noteworthy of this period that when businesses and entrepreneurial activities did amass a significant amount of wealth they then came under the informal control of state officials or criminals very closely related to state officials. It was clear, in fact, that the new state bureaucracy had completely appropriated the traditional power that once belonged to the Communist Party (Paskhaver, 1999). Such processes of political and economic consolidation actually disenfranchised many of the most potentially progressive pro-reform interest groups, such as R&D specialists and academicians who had been among the most prominent public supporters of Gorbachev's reforms (Ryvkina, 1998). The period of oligarchic control had begun.

From the very beginning, this new elite ignored the general population, the employees and the voters. Failed to replace this elite the people of Ukraine paid a terrible price in the form of a constant worsening of standards of living and the emergence of real impoverishment. But it is important to underscore the fact that neither the worsening conditions of people's lives nor their growing disappointment and anger had any affect whatsoever on the course of reform. What did happen, however, was that the most powerful new interest groups had accumulated enough capital to find the highly unstable hyperinflationary macroeconomic environment threatening now to their own interests. In particular, some of the most entrepreneurial directors of potentially profitable firms eligible for the early "leasing/buy-out" form of privatization were already in de facto control over these firms and now had a great interest in promoting stability. Similarly, inspired by the example of their Russian colleagues, the possessors of new capital obtained from other sectors were looking for profitable investment opportunities during the earliest stages of privatization. Thus, it was the interests of the elite interest groups that stimulated further reforms.

In spite of the slow pace of reforms characterizing this period, the negative changes in the economic environment for the population were truly shocking, probably more shocking than they would have been under alternative, imaginable "big bang" reforms. We will consider in this study the full range of changes in informal institutions (societal and cultural norms) that occurred as a consequence of these dreadful shocks, as well as the impact of these changes on future reforms in Ukraine. We will also compare Ukraine with other post-Soviet countries that were more (as Russia and Baltic States) or less radical and decisive in the reforming during this period.

The second period (end of 1994-end of 1998). This period began with sound disinflation. However, the major sources of rent had not been eliminated – neither those of the "traditional" industrial-agrarian lobby nor those of the "new" rent-seekers recruited and nurtured by the ruling elite. Open (explicit) subsidies were partly eliminated, but then mostly replaced by hidden (implicit) ones (Lunina and Vinzentz, 1999). In fact, forms of commercial borrowing that increasingly resembled Ponzi-type pyramid schemes had largely replaced the older pattern of inflationary financing of the budget deficit. Small-scale privatization was completed, but large-scale privatization had become very heavily insider-oriented as a result of significant amendments introduced by the industrial lobbyists. Even as large-scale privatization proceeded, many blocks of shares remained in the hands of the state.

Although following from more general programs for reform, most reforms during this period continued to be inconsistent, questionable and weakly conceptualized if assessed from the perspective of a benevolent government interested in the welfare of its people. In some cases, it is apparent that shortcomings were due to basic lack of knowledge on the part of the government and its foreign or international advisors. However, many reform policies during this period were driven by the vested interests of an unchecked bureaucracy (or, more precisely, the executive branch of the state) and they were actually designed to proliferate rent seeking and forms of corruption both by expanding discretion and selectively over regulating business activity (Shleifer and Frye, 1997). Other policies, even generally positive policies, were implemented selectively: those not coinciding with well-established informal institutions and vested interests were simply ignored. As a result, the overall program of reform lost its consistency as probably good but selectively implemented policies only resulted in further distortions. For example, the European-type law on Value Added Tax (VAT) approved in 1997 implies the uniform rate of 20%, however after more than 200 amendments made to it, the effective rate varies from six to eight percents from year to year, mostly due to the various exemptions.

The attempt of explaining all these developments just with a deliberate rent seeking may look as an oversimplification. Probably, the officials responsible for these outcomes were not necessary just the servants of oligarchs, and we can assume that their decisions were sometimes driven by habitual paternalism toward the firms they sincerely considered as important for the state. Although it is quite hard to imagine a pretty smart and knowledgeable person to be that much blind and naïve for so many years, we could agree that such sincere paternalistic inclinations played their role. But even in this case, wrong policies were definitely a source of rent for their objects. And even when they did not use them to corrupt the officials immediately, these rents went to the political support of respective policies, and, hence, the officials persuading them, so the positive feedback worked anyway. However, the extremely high positions Ukraine has in the international ratings of perceived corruption and state capture suggest that most often these sincere paternalistic attitudes just helped the corrupted officials to make peace with their elastic consciences.

Throughout this period, the various rent-seeking groups within the elite were engaged in a war with each other; however, the basic system of relations changed very slowly, if at all, still being dominated by a pattern of paternalism and ill-defined property rights. With these means the new oligarchs and their counterparts in the state administrative bureaucracy divided up the rents that had been collected at the expense of the general domestic economy or external financial sources. An important supporting role was played here by paternalistic international financial organizations (IFOs), Russian aid, the efforts of other bilateral donors, as well as the ease with which the Ukrainian government could become an irresponsible borrower.

Nevertheless, the population was adjusting to the new conditions and many important social indicators began showing improvement. Quite substantial changes at the grassroots' level of society throughout this period began altering the economic and political behavior of the people. In contrast to most other countries, during this period in Ukraine it was the elite who appeared to be the most immobile, not the general population. The general labor market, in fact, appeared to be much more dynamic. In about 10% of the general workforce are self-employed or initiating entrepreneurial activities, 10% had found employment abroad and many others changed jobs or started working in the unofficial sectors. In spite of greater administrative obstacles and a greater bribe burden, small business development in Ukraine at least not less successful that in other CIS countries (World Bank, 2002). In great contrast to this mobility, however, in 1997 70% of the directors of industrial firms had not changed positions for eight years (Pryor and Blackman, 1998).

Analyzing these two major periods we will attempt to answer the following crucial questions –

- Why did economic reforms in Ukraine move so slowly, bringing such unsatisfactory results when compared to other countries in the region?
- What types of social and political forces hampered the reform process and distorted its course?
- Given the relatively high development of the country's human capital, why did it fail to establish sound public institutions?
- What were the specific flaws in the process of reforms in each major stage of transition?
- Why did very substantial foreign financial and technical assistance fail to accelerate the reform process?

But the main question should be addressed to the end of this period: Even accounting for the obvious unsustainability of the economy based on rents – How did rent-seeking interest-groups finally "make a decision" to destroy a large part of their well-established sources and mechanisms of gaining rents, with the result that reforms were given new stimulus at the end of the 1990s? Which mechanisms played the role so reminiscent of Adam Smith's "invisible hand": which force made selfish oligarchs effectively "benevolent"? Can these positive developments, providing new stimulus to productive reform efforts, be considered to be a sustainable process or are they fleeting consequences of temporary crises?

There is not much we can add to these questions when we consider the last period of reforms (1999-present time). Of course, we will analyze the main patterns of this period, as well. Some of the patterns of this period, particularly steady changes in the balance of power in favor of more consistent reformers, are extremely interesting because they could lead to radical changes in the political and economic landscape of Ukraine. On the other hand, we still see power concentrated in the hands of oligarchs continuing to seek rent. We have already mentioned the failure of attempts at administrative reform. Now we are witnessing an intriguing struggle over majority control of Parliament, as well as scandals creating new crises for the ruling elite. We intend to observe and analyze further developments occurring in these areas over the coming year.

Main hypotheses

The captured state phenomenon (Hellman, Jones, Kaufman, 2000):

- Is a result of the weakness in domestic civil society and appears at an initial stage of transition (a path dependence phenomenon) as a continuation of previously emerged relationships;
- It may solidify transition-related changes (powerful vested interests may prevent the return to the old system);
- It may be sustainable and hinder further advance of reforms is a resource-rich country (under a country-level soft-budget constraint condition);
- It may end up being monopolized by one single person or tightly connected group (Azerbaijan, Kazakhstan) or remain under control of the fighting groups (Ukraine) depending on the main sources of rents, and also cultural and societal norms;
- Yet, it may be forced by economic hardship to undertake reforms (stimulate a collective action reform strategy).

The state is captured by the former nomenklatura if no significant alternative grass root opposition exists at the initial stage of transition. A new group of transition "winners" (Helman, 1998) emerges that takes advantage of liberalization and market reforms. This group is interested in advancing reforms to a no-return point at which their gains from transition will solidify. The absence of such a group of winners could weaken reforms and lead the country back to a soviet type economy (Belarus). In this sense a powerful oligarchy may play the role of a guarantor of reforms and effectively prevent any attempts of reversing them. In an economy is supported by a certain kind of rent (natural resources, large foreign aid or other amenities), the state may remain in "captivity" under the rule of some reform-obstructing vested interests for a long period of time (Azerbaijan, Kazakhstan and also Russia to some extent), while the absence of such rent creates the necessity for improvements in economic efficiency promoting reforms without which the state can barely secure its existence (Ukraine). State capturers may end up making reforms. They may also be interested in an easy access to western goods and markets facilitated by the reforms which otherwise may be quite difficult.

Conclusions:

1. In a weak or 'captured' state both pace and subsequence of reforms are determined mostly endogenously by the interplay of interests and balance of power between the social groups. In particular, if the people's participation is low, there are mostly elites and especially oligarchic groups that determines the course of reforms.
2. When the replacement of the ruling elite is not possible, the "captured state" may become an unavoidable "second-best"-type arrangement that under certain conditions may support rather than thwart the reforms. A gradual reform initiated and implemented by the socialist state, as supported by many authors (Klein and Pomer, 2001) could have failed in the same way as many previous attempts to reform the soviet type economy. In this situation a powerful oligarchy with strong vested interests in the "new order" may be able to implement the reforms.
3. The final outcome of this process may be positive, under a condition of painful economic hardships which enforce a greater economic efficiency enabled by a competitive market development.
4. Badly designed foreign aid may provide resources that play a role of "life support" devices and slow down rather than speed up the reform process (as in the case of international aid provided to Ukrainian agriculture). A well designed aid, focused on capacity building and increasing the flow of information (supporting a greater transparency in a broad sense, may greatly speed up the reforms.

Methodology

The research team wants to adopt the interdisciplinary approach involving macroeconomic, microeconomic, social, institutional, and political economy analyzes.

The model of a 'captured' state formulated within the game theory framework will be in the core of our study. This model will be used to test our main hypothesis concerning the strategy of help us in formulating explicit conditions for the emerging, existence and decay of such societal system. We intend to find out which of them were met at the each particular stage of reforms, with a special attention to those forcing a 'captured' state to undertake the reforms subversive for the rent seeking. Basing on this model we will write the narrative history of reforms identifying their driving forces and outcomes at each stage. Looking for evidence we will start from the history of the most important reforms, and review the already existing literature and research results on related topics, including our own, CASE and CASE-Ukraine, previous analyzes. Depending on results of this review, the next steps will involve review of the subsequent government programs and other program documents, memoranda signed by the Government and National Bank of Ukraine as a basis for the IMF and World Bank loans applications, legislation related to economic reforms, economic and social statistics, press materials, etc. In addition, we are going to interview a number of policymakers and experts who actively participated in the reform process in Ukraine at its various stages working on high-level expert and executive positions (as the former advisor to

President Alexander Paskhaver, the former Vice Prime Minister Vladimir Lanovoy, the former Chief Advisor to the Head of National Bank and former Cabinet's Cancellor Viktor Lisitsky, the former Head of the State Property Fund and former Vice Prime Minister Yuri Yekhanurov, and some others).

Analyzing each sub-period we will attend to the following specific characteristics of the reform process:

- Government programs of economic policy and economic reforms
- Legislative activity and its implementation, especially the structure of priorities in the state budgets
- Professional debate about economic problems and economic reforms
- Economic policies and institutional changes actually implemented by subsequent governments
- Interests of the various political, economic and social groups within the ruling elite, as well as their relative impact on the specific components of reform listed above
- Macroeconomic, institutional and social indicators of both speed of transition and economic and social effects
- Domestic political events and institutional changes in relation to the dynamics of economic reform
- Attitudes of various social and regional groups to economic and political transition
- Role of external factors, such as country's geopolitical location and interests, multilateral and bilateral financial aid and assistance, IMF and World Bank conditions

The proposed case study will have mostly qualitative character. However, when possible it will be supported by relevant quantitative analyzes. Where possible, we will use the quantitative data for assessment of the relative wages that should be attributed to the possible factors explaining the observed phenomena. In particular, we suppose to perform a quantitative analysis of the Ukrainian legislation, similar to those made in [Babanin, et al., 2002] for the energy-related issues. This method involves the counting of legislative documents dealing with certain topic and dividing them into categories depending on the approach they take, or the other important characteristics. In such a way one can estimate the attention authorities paid to the respective topics and assess their attitudes. In this study we would apply similar methodology to the analysis of legislative activity dealing with some basic problems of reforms, like the macroeconomic stabilization, price liberalization, non-monetary payments and nonpayments, privileges of various kinds, paternalism, etc. This method also allows analyzing of the roles of different branches of power in the legislative activity related to economic reforms.

Another source for quantitative evidences will be the analysis of the budget's structures for different years, in terms of the relative shares of revenues and expenditures by sectors and sources. Also, as soon as the budget was poorly executed for many years, the comparison of actual and planned budget expenditures and revenues should be very speaking.

When necessary, we can provide evidences based on the econometric analysis of the data of nationwide business survey conducted by IFC in 2001 and, presumably, 2002; sociological polls (large database available); extensive databases of macroeconomic and micro level indicators; and the open data concerning the results of elections.

Research output and dissemination

The research output will be summarized and presented as the country study. It can be also translated into Ukrainian and Russian languages (in full or shortened version) in order to facilitate its wider dissemination among Ukrainian and CIS audience (We expect that our findings and conclusions may be at least partly relevant to other CIS countries).

Apart from dissemination process organized by the GDN authors and research institutions, which they represent, are ready to conduct the following activities on their own:

- local seminars for Ukrainian researchers, policymakers and journalists;
- publishing press articles, giving interviews, participation in radio and TV programs (both in Ukraine and other CIS countries);
- using CASE and CASE-Ukraine websites for presentations of project intermediate and final output;
- publishing project output in CASE "Studies & Analyses" and "Reports" series.

The research team

Team composition

The research team will contain the following researchers:

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7) Oksana Nonoseletska, CASE-Ukraine, novoseletska@case-ukraine.kiev.ua

Why is the research team well suited for this work?

All the team members have been engaged for many years in analyzing the former communist economies, transition process and political economy of Ukraine's reform what is reflected in their CVs. They conducted policy oriented researches and they were involved in policy advising to the subsequent Ukrainian governments. In addition, some of team members have a great experience in similar research and policy advising activities in other transition countries, in organizing and conducting cross-country comparative research and participating in big international research projects, including those organized by the GDN.

The same can be said about the research institution – CASE-Ukraine that is the successor of HIID[2] Group on Macroeconomic Reform in Ukraine that operated in Ukraine since 1996, later the Harvard/CASE Ukraine Project.

Research Institution

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[2] The Harvard Institute for International Development

CASE-Ukraine is Ukrainian independent non-government non-profit organisation registered in early August 1999. Even though CASE-Ukraine is a relatively young company, it possesses a substantial experience in the field of academic research and policy advice. For instance, CASE-Ukraine was actively participating with CASE-Warsaw, its founder organisation, and Harvard Institute for International Development (HIID) to one of USAID projects on macroeconomic policy reform. This experience was crucial to build-up an independent institutional capacity able to conduct substantive analysis of macroeconomic environment, establishing contacts with Ukrainian public authorities and developing comprehensive reform packages, such as, for example, the Programme of Action of Government of Ukraine "Reforms for Prosperity".

At the meantime CASE-Ukraine is working on a number of smaller-scale projects related to monetary policy, bankruptcy problems and developing business tendency surveys in Ukraine. Current field of research covers the impact of privatisation on investment activity of Ukrainian enterprises and aims at identifying major bottlenecks in attracting bank credits and loans.

During almost a three-year period of its existence CASE-Ukraine elaborated up to 110-125 working papers in the fields of monetary and fiscal policies, macroeconomic forecasting, financial sector, social policy, liberalisation and privatisation of the domestic economy, investment, trade policy, and supervision of commercial banks. Among the clients of CASE-Ukraine are, for example, the Cabinet of Ministers of Ukraine, the National Bank of Ukraine, the Ministry of Economy of Ukraine, the Ministry of Finance of Ukraine and other public organisations.

Apart of that, CASE-Ukraine possesses a good network of Ukrainian and foreign experts working on transition related problems in CEE and CIS countries. The core of its experts have been working in a number of joint analytical projects with experts from CASE-Warsaw, Harvard Institute for International Development (HIID), the Soros International Economic Advisory Group (SIEAG), the Barents Group and other institutions. This allows CASE-Ukraine to maintain corporate culture and experience gained from previous involvement to the diverse economic research projects.

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