Contents

List of Figures, Schemes and Tables

Figures

Schemes

Tables

Acknowledgements

I would like to thank Marten van Meurs and Jens Hölscher who commented on draft versions of this book. I would also like to thank the State Engineering Academy in Zaporizhzhya. The ACE programme of the Commission of the EU provided support for field research during 1996 and 1997 in Zaporizhzhya.

1
Introduction

When Ukraine gained independence in 1991, many Ukrainians assumed that the country would perform relatively well if the ties with Russia could be severed. Most nationalists were convinced that Ukraine, a country of 51.9 million inhabitants in 1991 (49.8 in late 1999), was exploited by Russia and that, with independence, the new country would be able to profit from its rich natural resources. These beliefs were fuelled by a report from Deutsche Bank (1991) that gave Ukraine the best economic development prospects of all the ex-Soviet republics. In particular, the country's rich soil and its expertise in machine building and heavy metallurgy were mentioned as great assets. These factors, together with the lack of faith in the ability of the authorities in Moscow to govern for the benefit of Ukraine, especially after the aborted coup of 1991, led the Russian-speaking half of the population to support independence.

In 1999, eight years after the proclamation of independence, the transition to a market economy and parliamentary democracy, the Ukrainian economy and society were in a disastrous state. Registered industrial production in Ukraine had declined to less than one-quarter of its pre-independence level and (registered) agricultural production had more than halved since independence. Per capita GDP, based on purchasing power parity, fell to US$2000 in 1998, half that of Russia (US$3950), and between that of India and China.[1] Ukraine is the only transition country to have known nine consecutive years of economic decline. At the turn of the millennium the economy is not yet on a growth path and stabilized, privatization is far from complete and the overwhelming majority of the population is living below the official poverty line. One of the major achievements of the Ukrainian government has been the consolidation of the Ukrainian state. However, even this accomplishment is fragile given the country's economic dependence upon Russia and the large disgruntled Russian minority.

Ukraine has one of the worst economic records of all transition countries. In the 1997 Transition Report from the European Bank for Reconstruction and Development, in which progress towards a market economy was assessed, Ukraine was rated 23 on the transition index, which encompassed 25 countries.[2] In the Global Competitiveness Report 1999, under the heading 'overall competitiveness' Ukraine occupied position 58 out of 59 states. Even compared with Russia, the economic situation is gloomy.

What is the background to this abysmal economic record and where is the Ukrainian economy heading? To what extent can the economic performance be blamed on transitional or external factors or is it related to more structural factors? In this respect the question arises as to what kind of socio-economic system is emerging in the Ukraine. Why shouldn't a market economy develop and attain a critical mass as in many Central European countries? Why can reform forces not gain the upper hand? Why is the vicious downward economic spiral perpetuated? What constitutes the blocking mechanisms in the Ukrainian economy? Is the continuing economic disintegration and decline simply a reflection of a phase difference, compared to more advanced transition countries?

Many observers of contemporary Ukraine, especially those attached to international organizations advising the Ukrainian government, make the naive assumption that Ukraine has only one option, namely to move further on the continuum from public and plan to private and market and accomplish the transition to democracy. They assume that the medicine of the market will prove to be irresistible for policymakers in Kyiv and that, sooner or later, lagging Ukraine will follow other transition economies in their transition from plan to market. In this respect, every step the Ukrainian government takes to comply with recommendations from the International Monetary Fund (IMF) is considered a step towards introducing a market economy.

In this book, the transition process is seen as open-ended.

Many factors influence the economic performance of Ukraine. Some factors are external and transitional, such as (i) the economic impact of the dissolution of the Soviet Union, leading to a loss of trading partners for Ukraine; (ii) Ukraine had to pay more for Russian energy; and (iii) the dislocations inherited from Soviet times (emphasis on heavy industry, no rational spatial division of labour). For example, Ukraine is dependent on energy imports from other former Soviet republics for

40 per cent of its energy consumption. Energy costs have increased rapidly, from 15 per cent of the world market price to the world market level between 1991 and 1995. There are historical legacies in the distorted economic structure, with an emphasis on heavy industry, a small service sector and a large but neglected agricultural sector. There are also deep-rooted attitudes that are inappropriate under present circumstances. There are demographic factors: Ukraine has a comparatively large proportion of pensioners.[3] There is the environmental legacy, with its associated economic costs. For example, all enterprises until recently paid a Chernobyl tax.[4]

Another factor is the changeover to a different economic system, that has caused in all transitional economies a recession related to systemic change. One problem for Ukraine is the low level of economic competence of Ukrainian politicians and public servants. Here it is relevant to distinguish between the impact of government policies and the constraints posed by the economic system. Policy-makers are limited in the range of choices they can make because of the constraints imposed by the inherited institutional framework.

In this book the focus will be on the question of what economic system is emerging in Ukraine. As the socio-economic situation is still very fluid and both Ukrainian society and the economy are faced with major change, methodological problems arise in answering this question.

First of all, no theories exist that can adequately explain the transition process. Therefore an inductive approach is used, starting from analysing concrete behaviour of economic actors and arriving at generalizations on that basis. In conceptualizing transition, an eclectic approach towards theory is used, to generate a theoretical framework for better understanding the political economy of Ukrainian transition. It will be a 'disciplined eclecticism', i.e. 'the controlled and systematic use of complementary ideas drawn from different orientations'.[5]

The emphasis is not so much on actors or structures but rather on the structural constraints faced by economic agents. It is about to what extent actors in the Ukrainian economy are trapped by the past.

A multidisciplinary approach is used. For example, the assumption is that in order to understand the process of economic policy-making and policy implementation it is essential to understand how questions of power and influence are resolved in the Ukrainian polity. It is argued that an understanding of a set of deep-rooted social practices is necessary for understanding why people in Ukraine accept the way in which they are ruled and the way they work. The economic system in Ukraine, even more so than in developed capitalist countries, is socially embedded and cannot be understood outside its social and political context.

The main thesis is that economic and social development in Ukraine is blocked by a set of parasitic mechanisms at all levels of the economy that prevent profitable and productive value-added economic activities to emerge. This has led to the emergence of an economic system that devours its own economic base. Ukraine has developed into a blocked and paralysed society.

The parasitic mechanisms developed under Soviet rule, when 'beating the system' by extracting and redistributing resources from the state and spreading disregard for the public good, created the foundations for the grab and run practices in independent Ukraine.

In Chapter 2 the legacy of the pre-Soviet and Soviet past is analysed. The fact that Ukraine has almost no previous experience of a market economy and has, for the most part, been part of a despotically ruled empire, constitutes a liability in the transition to a market economy. The most important obstacles inherited from the Soviet period do not appear to lie in the distorted economic structure but rather in ingrained social practices and institutional weaknesses. In particular, the gradual process of privatization of the state proved to be a phenomenon that paralysed the economy. The forced industrialization and urbanization of the Ukrainian peasant society has led to a partial modernization. The communists neglected the complex social fabric of industrial society. The Soviet economy missed the complicated horizontal organizational differentiation, so characteristic of modern industrial economies. With the demise of Soviet socialism, a world that was hitherto hidden came to the fore.

Chapter 3 analyses the Byzantine labyrinth of the Ukrainian polity. The transformation from a developmental to a predatory state is linked to the rent-seeking inclinations of a ruling élite that sees the state primarily as a feeding ground. Many elements of the institutional set-up of the centrally planned economy are still in place. Division of competencies between executive, legislative and judiciary power is unusually diffuse. Many state institutions produce legislative and quasi-legislative acts that are often not published. This has created a legal jungle and has given the bureaucracy a high discretionary power.

The state bureaucracy is a paralysing and major antireform force. Corruption is rampant and bureaucrats often consider themselves free to exploit their domain for private purposes.

Although the base of the redistributive state is subject to erosion, and there are conflicting interests between feuding factions of the ruling élite, no powerful reform constituency is discernible. The impact of international pressure groups upon the Ukrainian polity is mixed. In many respects, IMF policies have strengthened the predatory ruling élite.

Economic reform is analysed in Chapter 4. It appears that the concept of 'reform' is used by the Ukrainian government to denote improvement of the present system rather than market-oriented reform, although the legal infrastructure for market-oriented reform has certainly improved. Although hyperinflation has come under control since 1995, monetary stabilization had a fragile basis. Advances in one field were usually cancelled out by failures in others, and by mid-2000, the state still intervened heavily in the sphere of production. Huge resources are still channelled from the value-adding to the value-subtracting sectors of the economy.

In Chapter 5, changes in the area of production are examined from a macro-perspective. The economic structure of Ukraine was fundamentally transformed during the 1990s, as a result of differential decline rather than deliberate government policies. The share of high-value-added production as a proportion of total production decreased sharply, whereas value-subtracting industries like heavy metallurgy and coal increased their share.

The prospects for heavy metallurgy are gloomy because production outlays are obsolete and energy intensiveness of production is very high. Huge fortunes have been made in the energy sector, mainly related to the trading of energy. Although restructuring of the coal industry is progressing, albeit slowly, large subsidies are still channelled into this sector. The development of agriculture and the food processing industry is held back by semi-feudal relationships, the farmers being squeezed by government, middlemen and local administrations.

Chapter 6 shows that hardly any strategic adjustment has occurred in industrial enterprises. This is related to a lack of incentives to restructure. Privatization of state-owned enterprises has had, in most cases, little impact on corporate governance. If industrial enterprises have changed the way they operate, it was often in order to protect against market forces.

Chapter 7 looks at the development of international economic relations. With independence, the institutional framework for foreign economic relations had to be developed from scratch. The share of trade with OECD countries is small while that of the former socialist states is still overwhelming. The commodity composition of exports has become very susceptible to price fluctuations on the world market and is very dependent on exports from value-subtracting industries such as steel and chemicals. Import competition has destroyed enterprises rather than stimulating them to perform better, related to the deficient incentive structure in Ukraine. Direct foreign investment is minimal. Internationalization did not include productive activities. Capital flight meant a drain of resources from the Ukrainian economy.

The inclusion of Ukraine in the world economy has been one-sided, ephemeral and asymmetrical. Although dependent on assistance from international financial institutions, the Ukrainian economy is still to a large extent disassociated from the world economy.

Chapter 8 examines regional and local economies. Regional economies in terms of territorially coherent groupings of related industries are rare in Ukraine. Regional policies have hardly developed at the provincial level. The frequent heavy reliance of regions and localities on one industrial sector hampers industrial restructuring. This is especially the case for company towns. Provincial administrations focus their energies on extracting resources from the centre, i.e. redistribution, rather than fostering endogenous development potential. The centralized redistributive state keeps the provinces dependent upon its subsidies and uses these subsidies as an instrument of control and cohesion.

In Chapter 9 social change is analysed as far as is relevant for economic development. Attitudes such as lack of initiative and lack of accountability, which are rooted in the socialist past, constitute a brake on economic development. It is shown that social practices which developed under socialism, such as 'beating the system' by extracting resources from the state sector and a tolerant attitude towards parasitic activities, have had a negative impact upon economic development since Ukraine's independence. Generalized distrust hampered cooperation for the public good. It seems that a combination of centralized state structures and a weak civil society breeds hierarchical clientelistic networks that undermine the creation of a public–private divide as it exists in Western Europe and North America.

Although human skills, in terms of educational levels, are considerable, organizational capital is at a very low level. The low level of self-organization of society allowed a predatory state to develop and a parasitic bureaucracy to act with impunity. Deep social divisions were able to develop due to the passivity of the general population.

Chapter 10 analyses the emerging economic system and alternative development paths. Although at first sight, the Ukrainian economy resembles an archipelago of economic sub-systems that are barely linked, the state with its redistributive mechanisms and paralysing bureaucracy provides a framework that keeps the economy interconnected. The large shadow economy is linked through criminal networks to the state sector. Lawlessness and criminalization of the economy increases transaction costs enormously. Although capitalist elements have emerged in Ukraine, they are largely parasitic upon the (quasi) state sector.

Given the structural constraints and the weakness of agents that act for change, development prospects for the Ukrainian economy are gloomy, both in the short and medium term.

This book analyses the political economy of Ukraine, stating that the roots of the economic decline are social and political in nature and that the emerged socio-economic formation is characterized by generalized parasitism. Here, Ukraine is not unique and similar cases can be found elsewhere in the post-Soviet and developing world.

In the case of economic reforms, there is a crucial role for administrative reform, to change the role of the state from suffocating and predatory to facilitative and developmental. This scenario presupposes a government that is willing to act for the common good. A reform of the state apparatus may further the transformation of social practices in such a way that they sustain modernization of society and the economy. It may lead to the emergence of governance mechanisms at all levels that may foster economic development.

Index