

Part I

Introduction

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The Dilemmas of Ukrainian Economic Reform

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On December 1, 1991, the Ukrainian population voted overwhelmingly for the independence of Ukraine. Hundreds of years of subjugation to Russia or Poland had come to an end. The new Ukrainian government faced all the challenges of a newly independent state at the same time that the country was in a grave and multifaceted economic crisis. (For an overview of key economic data for 1992–99, see Table 1.1.)

Ukraine's Starting Point

Ukraine's choices were predicated on a number of factors. Possibly the most important was that, on the same day Ukraine voted for national independence, an absolute majority of voters elected Leonid Kravchuk as the first president of independent Ukraine. Kravchuk possessed several characteristics that were to be significant for Ukraine's economic choices. First, having previously been second secretary of the Communist Party of Ukraine, he was one of the foremost representatives of the old communist establishment, even though he formally parted with the communists and took the side of Ukrainian independence. Second, Kravchuk had been responsible for ideology within the Communist Party. Hence, having no real understanding of economics whatsoever, he was also singularly disinterested in it. Third, Kravchuk was a man of con-

Table 1.1

Key Economic Data, 1992–1999

	1992	1993	1994	1995	1996	1997	1998	1999 preliminary
<i>Output</i>								
GDP annual growth (percent)	-9.9	-14.2	-22.9	-12.2	-10	-3	-1.9	-3.6
GDP in billions of US\$	24	...	37.6	37.1	44.5	50.2	41.9	30.8
<i>Inflation and budget</i>								
Inflation (percent end year)	2,730	10,155	401	182	40	10	20	19
Budget deficit (percent of GDP)	-24.2	-28.1	-8.7	-4.9	-3.2	-5.6	-2.7	-2.4
General government revenues	34.2	92.8	41.9	37.8	36.7	38	35.6	31.9
General government expenditures	58.4	70.9	50.6	42.7	39.9	43.6	38.2	34.3
<i>External sector (billions of US\$)</i>								
Current account	-0.6	-0.8	-1.2	-1.2	-1.2	-1.3	-1.3	-0.8
Trade balance	-0.6	-2.5	-2.6	-2.7	-4.3	-4.2	2.6	-0.5
Exports	11.3	12.8	13.9	14.2	15.5	15.4	13.7	12.5
Imports	11.9	15.3	16.5	16.9	19.8	19.6	16.3	13
<i>External Debt</i>								
External debt (billions of US\$)	0.5	3.7	7.7	8.1	9.2	11.8	11.7	11.9
External debt (percent of GDP)	—	11.2	20.5	23.6	21.1	23.8	27.9	38.6

Sources: IMF website (www.imf.org); EBRD (1998); National Bank of Ukraine; "Restoring Growth with Equity: A Participatory Country Economic Memorandum"; IBRD (1999). Differences with numbers elsewhere in this book reflect differences in definitions and revisions.

sensus, which was an important reason for his election. He was seen as a man who could mediate between the Russified Eastern Ukraine and the nationalistic Western Ukraine as well as between the communist establishment and liberals. Fourth, in practice, however, Kravchuk tended to turn to his West Ukrainian roots. Finally, Kravchuk was a peaceful man, who prided himself on having become a democrat. At the time of formation of a nation, the leader's nature is greatly significant, and, for better or worse, Kravchuk's personal characteristics are reflected in Ukraine's early economic development.

To the man on the street, the most obvious and worrisome economic crisis was manifested in massive shortages. Toward the end of 1991, Ukraine's shops were virtually empty because prices were kept regulated by the state at an artificially low level, while the central Soviet government had all but given up control over the money supply. It was obvious that prices would have to be freed, but no leading politician was prepared to take responsibility for the inflation that would ensue. In the end, Ukrainian prices were liberalized to a considerable extent in January 1992, but this occurred as an agreement with Russia, whose reform government had advocated extensive price liberalization. Thus, it was received as a Russian imposition, and the new Ukrainian government neither had nor displayed any commitment to free prices and free trade.

In the ensuing disorganization and confusion—which are characteristic of a crisis economy that has been only partially and halfheartedly liberalized—inflation quickly took hold. Even before prices were liberalized, Ukraine probably experienced about 200 percent inflation in 1991. After prices had been freed, they rose by some 2,000 percent in 1992.

Initially, inflation was also largely perceived as a problem stemming from Russia. Much of the early economic discussion in Ukraine focused on how to isolate Ukraine from Russia's inflation and to establish an independent currency. Indeed, as early as January 1992, Ukraine introduced its own coupon—the karbovanets (krb)—a parallel Ukrainian currency to the old Soviet ruble, which continued to circulate.

Instead of bringing reason to public finances and the conduct of monetary policy, the introduction of the karbovanets had the opposite effect. It was as if the authorities thought either that having a national currency was magic because it cost nothing to produce and could be distributed with largesse, or that the karbovanets, because it was a transitory “coupon,” could be abused with impunity. Whatever the mixture of illusion and cynicism, the fact is that Parliament pushed through a distribution

of cheap credits to agriculture and industry equal to almost a third of GDP in 1993. Ukraine's uncontrolled emissions were even larger relative to GDP than Russia's. The predictable result was classical hyperinflation. By the end of 1993, when prices were doubling every month, there was no way that Ukrainian inflation could be blamed on Russia. From December 1992 to December 1993, prices rose by 10,200 percent. Russian inflation in the same period had fallen to 840 percent.

In the midst of this disorder, the leaders of the country were trying to build new national institutions. Although Kyiv had formally been the capital of the Soviet Socialist Republic of Ukraine, it was in reality only a provincial capital. Some national institutions existed in a rudimentary form, for example, the Ministry for Foreign Affairs, while the Central Bank and Ministry for Foreign Economic Relations were missing altogether. For natural reasons, the newly independent state was preoccupied with the establishment of its national symbols and many Ukrainians wanted national institutions to be as strong as possible but they did not give much thought to what this actually meant. Thus, it became a virtue to build up bureaucracy and regulations as long as they were national. The most disturbing example was Ukraine's recreation of Soviet-type foreign trade regulations in an attempt to ensure that the Ukrainian state had control over the country's foreign trade. The stage was set for cementing a massive centralized bureaucracy.

Economic science and the social sciences generally had been weak in Ukraine ever since the founding of the Soviet Union. The principal reason was that the Soviet authorities had (for good reasons) always been particularly afraid of Ukrainian nationalism. Therefore, Ukraine was subjected to much more control and repression than Russia. The natural consequence was that Ukraine suffered from an especially great shortage of the essential skills for building a new state. The country had little real economic education and research, and few economic reformers were coming to the fore. Incredibly, this country of 52 million citizens had only one economic journal, and that was totally dominated by old-style communists. Moreover, as Ukraine had been highly isolated from the outside world, few people in Ukraine spoke English or other foreign languages, which made it more difficult to open up to the West. The situation was so bad that Ukraine hardly had a critical mass of sufficiently well-educated economists for launching radical economic reforms.

The fundamental problem, however, was an overabundance of continuity in the Ukrainian establishment. The transformation of the Com-

minist Party of Ukraine's second secretary for ideology to the first president of independent Ukraine was emblematic of this continuity. The primary problem was perceived as excessive dependence on Russia, while the inheritance of a communist system, although universally recognized, was not given sufficient attention. In effect, much of the old Soviet establishment persisted in Ukraine. The old communist elite or *nomenklatura* simply changed their party cards for the national insignia.

The stage was set for extraordinary rent seeking. Radical reforms had been dismissed as characteristic Russian rashness that was incompatible with Ukrainian peacefulness and moderation. The old establishment, which remained largely intact, wanted to transform its power into material benefits. A cumbersome bureaucracy and regulatory system were being built as a manifestation of the Ukrainian state. Soon enough, these conditions bred severe corruption and rent seeking. In the winter of 1993–94, the Ukrainian government was dominated by a group of so-called red directors, enterprise managers from Eastern Ukraine who had joined the government to maximize their personal revenues through cumbersome regulations that allowed few but themselves to make money. Their head was acting Prime Minister Yukhym Zviahivsky.

In the spring of 1994, a leaked CIA report questioned whether the Ukrainian state could persist, or whether it would break into a Western part and an Eastern part. The coal miners' strikes in the summer of 1993 prompted early elections in 1994. Elections for the Rada—Ukraine's Parliament—were held in the spring in several rounds, and presidential elections were held in June and July in two rounds. The outcome of these elections was the routing of the centrist establishment. President Leonid Kuchma replaced President Kravchuk in July 1994, and Ukraine went through its first democratic transition of power without any particular tensions. Suddenly it appeared as if Ukraine could recover lost ground and undertake serious radical reforms.¹

The Reform of 1994–1995

Many things started happening. An International Monetary Fund (IMF) mission began working on a financial stabilization program as early as August 1994; one month later, Ukraine had adopted its first program with the IMF, a so-called Systemic Transformation Facility, which was less demanding than an ordinary stand-by agreement. Such an agreement was concluded in March 1995. The IMF assisted Ukraine in re-

structuring its foreign debt so that international arrears were partly turned into state debt and partly paid for with international financing.

President Kuchma retained the reformers who were already in government—Minister of Economy Roman Shpek and National Bank Governor Viktor Yushchenko—and gradually appointed a few other serious economic reformers: Minister of Privatization Yuri Yekhanurov, Deputy Prime Minister for Economic Reforms Viktor Pynzenyk, and Deputy Prime Minister for External Finance Ihor Mitiukov. On October 11, 1994, President Kuchma made a major reform speech to the new Parliament. Soon afterward, he put his reform proposal to a vote and a sizable majority adopted it. With a reform team in government, a serious reform program, parliamentary approval, an IMF program, and substantial international financing, Ukraine seemed set for a serious economic reform.

The reform started very well. In late 1994, major price liberalization was undertaken and Ukraine's budget deficit was sharply reduced in line with the IMF program. Viktor Yushchenko consistently maintained a strict monetary policy, which led to a gradual reduction in inflation, and, in 1996, inflation finally fell to 40 percent a year. Privatization was initially slow, but it took off in 1996. Yet, growth remained a distant target, and the focus moved to other problems. The years of slow or no reform had bred a number of problems that were not to go away quickly. One problem was the very functioning of the state, which was haphazard at best and usually corrupt and excessively bureaucratic. Taxes remained higher than in any other country of the Commonwealth of Independent States (CIS). While stabilization took hold, arrears and barter did not go away, but multiplied. In particular, in the energy sphere, a number of monopolies stayed put, generating especially difficult arrears. Privatization was under way but behind schedule, and the quality of privatization was poor in the sense that enterprises went primarily to insiders, which did not promote new, strong owners who undertook serious enterprise restructuring. Although the government continuously spent large amounts on social expenditures, the social safety net was miserable and the "social" expenditures tended to be showered on the wealthy rather than the poor.

While all these problems existed from the beginning of the reforms in the fall of 1994, the new administration failed to get a handle on them. The reasons were many and the causes, naturally, disputed. The government has persistently blamed Parliament, and it is certainly true that Parliament has not pushed for reforms.

Like Russia, Ukraine had inherited a Soviet constitution, which gave Parliament enormous powers (including the power to force the national bank to distribute unlimited cheap credits), and left the relationship between its powers and those of the president in limbo. In Russia, the president asserted control by subduing Parliament with tanks and submitting a new constitution for ratification by referendum two months later. Ukraine resolved the constitutional conflict in a typically more peaceful manner. Presidential threats to conduct a referendum and dissolve Parliament were eventually sufficient to cause the parliamentary factions to pass a new, highly presidential constitution of their own accord. Until that decisive moment in late June 1996, the conduct of reform was hampered by constant constitutional conflict and an unclear sense of the legitimacy of presidential power.

But difficult relations with Parliament were not the only factor to blame for the loss of steam in the progress of reform. Internally, the government was neither organized nor united. The long period of mismanagement bred a large group of government officials who favored corruption and persistently promoted decisions and legislation that would cause more corruption. The average tenure of Ukrainian prime ministers has been about one year and severe tensions between the president's administration and the Cabinet of Ministers has been the rule. Although President Kuchma launched the reforms, his support of reform could have been much stronger and more tenacious. As soon as the reforms began to show positive results in June 1995, the president made his unfortunate Uzhhorod speech, in which he called for a "correction" of the course of reforms, which instantly undermined those reforms. Ever since then, Ukraine has had persistent problems in sticking to its IMF commitments. The consequences have been larger budget deficits and chronic problems with budget financing, and the IMF has time and again interrupted its loan disbursements to Ukraine. The more profound structural reforms have been postponed. Ukraine only returned to economic growth toward the end of 1999.

The Stagnation of Reform, 1995–1999

By and large, reform came to a standstill in June 1995, although some important reforms followed even later. First, Ukraine adopted a democratic constitution in a peaceful manner in June 1996. Second, Ukraine's permanent national currency, the hryvnia (UAH), was introduced at the

beginning of September 1996, as all karbovanets were exchanged at 100,000 karbovanets for one hryvnia. In one sense, the reform was a simple operation in which five zeroes were lopped off every denomination, but it signaled Ukraine's defeat of inflation and the hryvnia's introduction without confiscation or panic. Third, large-scale privatization was undertaken from 1996 to 1998. Fourth, in 1998, rampant financial crisis prompted the government to undertake some long-required, largely fiscal measures, such as substantial cuts in public expenditures, in the budget deficit, and in the payroll tax.

Even so, standstill rather than reform has characterized Ukraine's economic policy since June 1995. While this book outlines a multitude of ideas about how vital aspects of the Ukrainian economy should be reformed, the task is still to be done. In the spring of 1996, it was obvious that Ukraine would see no economic growth that year, but would see a decline on the order of 10 percent. The conviction, which he expresses in this book, that reform was a necessary precondition for growth, led then Deputy Prime Minister for the Economy Viktor Pynzenyk to launch that fall a large and radical program of tax changes, liberalization, and other measures aimed at promoting growth. Detailed drafts of these measures were worked out by a large group of experts, mainly Ukrainians but also some foreigners, working day and night, in October and November 1996.

The program for economic growth faced up to most of the problems discussed in this book. It argued for a limited budget deficit. A major aim was to cut unjustified public expenditures, while diminishing the number of taxes and the highest tax rates, notably the payroll tax. The number of taxes was to be sharply reduced, while the value-added tax and the profit tax were to be normalized. Unjustified tax exemptions were to be eliminated. It was hoped that the whole package would reduce the widespread use of barter. A liberalization of the payment system was supposed to further draw the gray economy into the open and make arrears less attractive. Bankruptcy was supposed to be reinforced. Far-reaching deregulation of enterprises, especially in licensing, was another part of the program. The patently weak Ministry of Finance needed to be strengthened with long-proposed treasury control and real macroeconomic forecasting. The regulation of the natural energy monopolies needed to be improved. The most controversial part of the program was a pension reform that, regrettably, was never completed, even in draft.

In late fall 1996, the government presented its program for economic

growth to Parliament in a large package of draft laws. Parliament discussed the reform package intermittently with great hostility. All kinds of absurd formal objections were raised. President Kuchma pressed hard for it in public, while Prime Minister Lazarenko seemed lukewarm at best, and other ministers let Pynzenyk fight alone. His only apparent supporter in a high place was Governor Viktor Yushchenko of the National Bank. Even other reformers were cool toward Pynzenyk and his reform package, of which they did not feel they were a part. In early March 1997, it was clear that the reform program had been jeopardized and hardly anything of it was adopted. Viktor Pynzenyk resigned in frustration. He was replaced by Serhyi Tyhypko, who pushed to carry the program forward but had no greater success than his predecessor. Ukraine has had one of the worst growth performances in the post-communist world.

On the whole, reforms not only stood still but even went backward. Because no reform of the payments system occurred, arrears and barter proliferated. In 1995, a far-reaching deregulation of agricultural trade took place, but, in the summer of 1996, Prime Minister Lazarenko instigated rigorous regulation of agricultural trade by enticing regional governors to prohibit exports of grain from their regions and by prohibiting exports of grain through ports or by rail. Although Ukraine had put forward proposals for the regulation of energy companies in a market-economic fashion, none of these was adopted, and rent seeking and arrears proliferated, particularly in gas trade. The bureaucratic control of enterprises did not diminish but grew worse. It became the subject of innumerable anecdotes, until people found bureaucratic repression so prevalent that they stopped telling jokes about it. Foreign trade regulations became ever more complex. Naturally, minimal enterprise restructuring occurred under these conditions. Instead of a second phase of economic reforms, Ukraine saw the reversal of market economic reforms.

In the fall of 1996, the IMF actively participated in the reform package designed by the Ukrainian government and the National Bank of Ukraine (NBU), and it made these reforms the basis for its so-called Extended Fund Facility (EFF), a three-year loan program aimed at both macroeconomic and structural reforms. The program document was worked out in early 1997, but, because neither the Ukrainian government nor Parliament displayed serious intentions of adopting the necessary prior actions, the program turned into a dead document. In parallel, the World Bank worked out a number of Structural Adjustment Loans, which were loan programs conditioned on various structural reforms,

but little was disbursed from them because the Ukrainian government rarely complied with the mutually agreed upon conditions. In late summer 1997, it became apparent that the prior actions required by the IMF for the EFF would not be fulfilled. Then, the IMF concluded a minor one-year stand-by agreement, with little money and limited conditions, but Ukraine largely failed to comply even with them. By the end of 1997, the stand-by was dead. Having no approval from the IMF, Ukraine was also blocked from World Bank funding.

In the summer of 1997, Valery Pustovoitenko replaced Prime Minister Pavlo Lazarenko. Lazarenko had made a name for himself as the most blatantly self-seeking politician in Ukraine. Pustovoitenko was seen as Kuchma's loyal chief aid. He had been, for three years, the minister of the Cabinet of Ministers, a bureaucratic apparatus of 700 people that more frequently than not blocked reform.

Also in the summer of 1997, the Ukrainian authorities had been strangely seized by a sense that financial constraints were easing. Rather than trying to comply with the hard conditions set by the IMF, they sold large amounts of short-term treasury bills to foreign investment bankers and placed some large Eurobond issues. The nascent Ukrainian stock market started booming in the shadow of the buoyant Russian stock market. Ukraine's political leaders perceived that they no longer needed to listen to the unpleasant conditions demanded by the IMF and that they could tap private international capital markets instead. The Ukrainian budget deficit rose in 1997 to almost twice what the IMF had demanded. None of the reforms having been adopted, GDP fell officially by 3 percent in 1997, and the paralyzing bureaucratization grew increasingly worse.

The reformist minister of justice, Serhyi Holovaty, attempted a "clean hands" anti-corruption program, strongly encouraged by the World Bank and the United States. However, the program was never really launched because strong interests within the establishment thrived on corruption. Holovaty was soon sacked from the government and a more pliant minister of justice was found.

The miserable economic policies of 1997 can partly be explained by the long-planned parliamentary elections in March 1998, which set the political agenda far in advance. The central stage of the elections campaign was dominated by a vicious struggle between two competitive establishment parties, Prime Minister Valery Pustovoitenko's National Democratic Party (NDP) and former Prime Minister Pavlo Lazarenko's

party, Hromada. They might both be described as centrist, but they really represented competing bureaucratic business groups rather than any ideology. Both these parties thought that the elections were about obtaining as much money, media, and administrative clout as possible, while they paid little attention to the population or economics.

In the end, however, the NDP and Hromada failed miserably. Each party won only about 5 percent of the vote in the proportional half of the elections. The communists also failed to capitalize on the economic misery prevalent across the country. They received 25 percent of the votes. They and the rest of the left—including socialists and agrarians—obtained a total 40 percent of the votes, slightly more than in 1994. The essentially West Ukrainian nationalist movement Rukh received 10 percent of the votes, while the badly split pure reform parties received few votes. The elections did not suggest any clear alternative to the prevalent lack of policy direction.

A few months later, the financial storms that ultimately swept across the developing world began in Asia. The international financial crisis hit Ukraine in late October 1997. Treasury bill yields rose sharply and remained at their new highs. For the next year, Ukraine largely failed to roll over its short-term treasury bills held by foreign investors. As a consequence, Ukraine's international reserves and state finances were severely strained. Month after month, Ukraine appeared to be on the verge of devaluation because of minimal and shrinking reserves. In late August 1998, Ukraine's international reserves had shrunk to \$1.1 billion—less than one month's imports.

Throughout 1998, the Ukrainian government struggled each month to meet its debt service requirements. The year started badly. While the 1998 budget adopted by Parliament foresaw a budget deficit of 3.3 percent of GDP, it was more than twice as large during the first quarter because the government used budgetary disbursements to appeal to various constituencies in the election campaign. After the elections, Parliament proved incapable of acting for two months because it could not agree on a new speaker. Ukraine received no international financing whatsoever in the first half of 1998. Most IMF targets had been missed and private investors had lost confidence in the bureaucratized and free-spending government. Ukraine appeared to have its back against the wall and to be close to default.

Finally, on June 18, President Kuchma decided to break the deadlock over economic reform. In a major reform speech to Parliament, he de-

clared that, in view of the fact that Parliament was paralyzed, he would adopt at least fifteen major legal acts as presidential decrees. These decrees included many of the major reforms from Pynzenyk's reform program. While the budget deficit for 1998 was cut, much of this was accomplished through arrears and sequestration, that is, the government simply did not pay what it had committed itself to pay. Licensing procedures were simplified and several taxes were reformed. A single simple tax for small entrepreneurs was introduced. The value-added tax was reformed so that exemptions were reduced, and the payroll tax was reduced. In Ukraine, presidential decrees become law after a month if Parliament has not revoked them. Parliament protested at first, but in the end did not revoke the decrees and seemed content to let the president take full responsibility for the reforms.

All of a sudden, in one month, Ukraine had adopted many of the reforms that had been discussed for years and drafted in detail in 1996. Somewhat surprised, the IMF recognized the reforms as sufficient for the conclusion of an EFF agreement at the end of July 1998 to replace the aborted agreement of spring 1997. However, the Russian financial crisis erupted in the interim. As the ruble sank, and as prices rose and output fell in Russia, the prospects for financing Ukraine's balance of payments deficit—which had looked reasonable in the context of the reform package—deteriorated again. Additional resources were required to fill the gap. Consequently, final acceptance of the EFF with Ukraine by the Executive Board of the IMF was postponed—but not for long. Ukraine has continued to scrape through. Repeatedly, it has been on the verge of default on its foreign debt service or has faced postponement in credits from the IMF or the World Bank because it has not fulfilled the agreed upon conditions. And economic growth remains evasive.

An Alternative Economic Policy

Was all this economic and social damage necessary? Could something have been done differently? We were working as economic advisors to the Ukrainian government from August 1994 until 1997, and we certainly thought that something more could have been done. All along, Kyiv was bristling with various reform plans and proposals. In June 1996, we organized a major international conference in Kyiv, the theme of which was "The State of Economic Reforms in Ukraine." The con-

ference speakers included all the leading reformers in government: Deputy Prime Minister Viktor Pynzenyk, Minister Roman Shpek, NBU Governor Viktor Yushchenko, Minister Yuri Yekhanurov, and many others.² On the one hand, inflation had faded away for the first time. On the other, it was already evident that GDP would fall by about 10 percent in 1996. The question was how Ukraine could return to economic growth, and this remains the key economic question for Ukraine. This was the underlying theme of our conference and it is the thread that ties together the chapters of this book, which originated at that conference. We have made the selections so as to exclude papers that did not explicitly deal with Ukraine.³ The papers by Viktor Pynzenyk, Viktor Yushchenko, Georges de Ménil, and Anders Åslund were newly written in the summer of 1999, while the others have been revised and updated, for the most part substantially.⁴

We have three purposes in publishing these papers. The first purpose is to expose the main problems in the Ukrainian economy and to analyze them. The second aim is to put forward policy suggestions as to how these problems can be solved. The third goal is to present economic thinking as it has actually existed in Ukraine for some time, in order for everybody to judge for themselves that Ukraine has had a substantial and qualified public debate on economic reform and that important reform proposals have long been made. Since 1995, the problem has been less in the discussion and understanding of the economic issues than in the lack of both policy decisions and implementation.

After the present introductory section, which presents an overview, the structure of the book follows from the themes of concern. The second section deals with the overall strategy of economic reform, the third focuses on macroeconomic stabilization, the fourth on fiscal policy, the fifth on structural reforms in the energy sector, the sixth on privatization and the legal system, the seventh on social policy, and the eighth puts the Ukrainian transition into perspective. The following pages introduce the contents of each section.

Reform Strategy

Under the Kravchuk administration, various ideas of a special Ukrainian economic model arose, but these ideas were neither very original nor viable. They can be described as a mixture of muddled Gorbachevian economic thought, that is, the last stage of communist confusion, and

statist economic thinking about the need for a strong state that has survived since the 1930s. Fortunately, these ideas have become badly discredited because of economic failure, though they persist among some socialists and hard-line nationalists.

Instead, the dominant thinking among Ukrainian reformers is that the country should no longer try to be original but, at long last, do what is necessary to create a normal market economy that is integrated with the international system. The three key expressions are the standard ones: macroeconomic stabilization, deregulation, and privatization.

In June 1996 macroeconomic stabilization was finally taking hold—inflation was zero that month. Although inflation has stayed below 20 percent a year since then, concerns remain about how to maintain macroeconomic stability and how to do away with various structural problems that can undermine macroeconomic stability in the future. In particular, the proliferation of nonpayments is a matter of real concern.

In 1995 Ukraine undertook a quite far-reaching deregulation. Two notable successes were the liberalization of agricultural trade and substantial measures in energy, although foreign trade was only formally deregulated. However, new problems have continued to pop up, and it is all too obvious that the foreign trade administration favors trade regulation. The sad truth is that regulations empower bureaucrats and generate bribes. A more general problem is the very poorly functioning government administration. There are still too many government bodies; they are too centralized and coordination remains minimal. An extraordinary degree of chaos has persisted, and it seems to be peculiar to Ukraine. Beneath this administrative chaos, a large number of government officials bother enterprises and enrich themselves as they please. The key issue seems to be to get the state apparatus under control, so that it will be possible to run independent enterprises.

Chapter 2 in this book, by Minister Roman Shpek, discusses the main problems of the reforms to date and what should be done in the future. His emphasis is on the regulatory system. Shpek notes what has been accomplished and formulates priorities for the future.

Macroeconomic Stabilization

The crisis Ukraine experienced in 1993 was a classical case of hyperinflation brought about by disorganization, confusion, and corruption. If Ukrainians were sure of one thing in the end, it was that they hated

inflation. President Kuchma understood that he had been elected, in part, to keep inflation down, and that, to do so, he had to restore discipline to the budget. His October 1994 program called for eliminating controls and the subsidies that go with them, freeing the exchange rate, and reducing the deficit. The price increases of November and December of that year (prices went up 70 percent in November) were anti-inflationary price increases, the kind that make it possible to stop subsidies and bring down deficits.

Because it went to the heart of the central problem—budget deficits and control—the Kuchma stabilization program worked. Inflation was brought down from 100 percent per month in November 1993 to zero in June 1996. Stabilization, however, proved to be only half of the macroeconomic problem. In the absence of further simplification of the maze of high taxes and burdensome regulations, output remained stagnant and the economy remained vulnerable. Problems began to appear at the time of the Asian crisis, becoming acute during the Russian crisis and in its aftermath. Chapters 3 through 5 analyze these macroeconomic developments.

Georges de Ménéil provides an account of economic policy making after independence. He breaks the period into four phases: the years of “disorganization” immediately following independence; “stabilization without liberalization” from January 1994 through September 1994; “stabilization and reform” from October 1994 through November 1996; and a period of “stalemate” from December 1996 through the presidential election of October 1999. He shows how Ukraine, until the summer of 1996, was a textbook example of the relationship between inflation and growth in the early years of transition in Europe: high inflation led to negative growth; the higher the inflation, the sharper the decline. After 1996, the focus changed. The reform effort stalled. The initiative fell into the hands of vested interests. In the absence of the full liberalization of internal and external trade, output stagnated. The economy remained vulnerable and the Russian crisis and its aftermath threatened destabilization.

In the next two chapters, two forceful Ukrainian reformers present their interpretations of these developments. Viktor Yushchenko, governor of the National Bank, was the man who stopped hyperinflation almost single-handedly. At the height of inflation in 1993, he put a halt to the excessive monetary emissions of the NBU, and inflation dropped from three digits per month to one digit per month in three

months. In chapter 3, Yushchenko revisits the lessons of those early years of confusion, arguing that the conduct of monetary policy, and macroeconomic policy in general, changed permanently after 1994. The will to protect domestic production at all costs was replaced by a new focus on price stabilization and a new monetary mechanism. He emphasizes the lasting importance of this conceptual change, arguing that the new monetary policy helped mitigate the consequences of the Russian crisis in Ukraine.

Viktor Pynzenyk, the protagonist of Leonid Kuchma's attempted reforms as prime minister, was brought back to government as deputy prime minister for economic reform after Kuchma was elected president. He was the architect of the second wave of reforms, the "Program for Economic Growth," which was presented to Parliament in November 1996, and which Parliament failed to pass. In his judgment, this failure of reform opened the way to clan capitalism and left stabilization itself in jeopardy. He foresees the possibility of external default, financial crisis, and a return of inflation—a Ukrainian-style Bulgarian crisis.

Yushchenko and Pynzenyk agree on the lessons of Ukraine's hyperinflation: only deep reforms, not easy money, can produce durable output growth. Cheap credits and lax fiscal policy lead to financial crisis and falling standards of living. In Pynzenyk's view, the stabilization gains of 1994–96 may prove to be a casualty of the interruption of reform after 1996. Yushchenko is confident that noninflationary policies will be maintained.

Fiscal Policy

If initial success in reducing budget deficits depends primarily upon cutting expenditures, the sustainability of the effort as well as the promotion of growth call for fundamental tax reform. Marek Dabrowski has argued that the process of transition entails a natural progression of fiscal crises. The first and most dramatic of these results from the disintegration of the Soviet system and the loss of control of the state. It makes radical stabilization a priority of reform. The second crisis generally emerges more slowly as firms are privatized and the profits (and profit taxes) of the first inflation disappear. It uncovers a deep structural imbalance in the budgets of many post-Soviet governments. Its resolution calls for fundamental fiscal reform.

In chapter 6, Marek Dabrowski, Marcin Luczyński, and Malgorzata

Markiewicz argue that, because stabilization was delayed in Ukraine (not coming until 1994, almost three years after independence), the country entered the second fiscal crisis before emerging from the first. They contend that the way out of this crisis passes through comprehensive budgetary reform, including, notably, the partial privatization and capitalization of the pension system, the restructuring of the rest of the social security system, across-the-board tax reform, and the acceleration of privatization. In their view, this ambitious program can be carried out only by a strong Ministry of Finance, one that both charts and executes strategy, and that has recaptured the initiative in financial affairs from the Cabinet of Ministers. Logically, those changes should themselves be embedded in a general restructuring of government.

In chapter 7, Serhyi Teriokhin details some specific proposals that should be included in the agenda for comprehensive tax reform. His recommendations are grounded in his first-hand experience as chairman of one of the parliamentary subcommittees that reviews tax proposals. He describes the surrealistic character of tax policy before 1995, and advocates the rationalization of the VAT, excise taxes, payroll taxes, and property taxes.

Structural Reform—The Case of Energy

When reform began in earnest in the fall of 1994, the Ukrainian economy was in a state of disarray. Three generations of brutal Soviet mismanagement and two years of the region's worst peace-time hyperinflation had left hundreds of thousands of workers in giant, obsolete plants, crippled with recurrent shortages of parts and supplies, producing unwanted products, often at a greater cost in materials alone than the price for which they could ever be sold. It is a euphemism to say that what was needed was structural reform. Ukraine, like much of the former Soviet Union, was in a worse state than that of Western Europe after World War II. There, when the transport networks and the plants were rebuilt, the old structures could resume production. In Ukraine, only radically new economic structures could provide the bases for continued national independence and offer the hope of a modest standard of well-being.

How does an economy with such a rusted, obsolete heritage rebuild? First, it must dismantle price controls and bring inflation under control. That has been the focus of this book's previous sections. But is this

enough? Will free and stable market prices by themselves provide sufficient incentives for private agents to rebuild the economy? What should be the roles of specific sectoral policies, on the one hand, and broad-based institution building, on the other? The chapters in this and the next section begin to address these questions.

Of all the sectoral problems, the most pervasive and most important problem is in the energy sector. In 1995, Ukraine consumed USD 12 billion in energy, as much as all of France, which produced almost thirty times more GDP. Ukraine's manufacturing exports were sufficient to cover only half of its energy imports. The military-industrial complex that the Soviet government built in Ukraine had been geared to using electricity at a fraction of its industrial market price in the West. Families were similarly accustomed to wasting energy when they could get it at all. Clearly, a new economy would have to be built on radically new patterns of energy usage.

A central feature of President Kuchma's October 1994 program was to set the prices of gas, oil, and eventually electricity, at world market prices. This was an essential, necessary condition for restructuring energy usage, but it was far from the end of the story. How could it be, when the suppliers of gas and electricity are gigantic, state-owned monopolies and the oil and coal sectors are essentially run by their respective ministries? The next step was to be a series of major, institutional supply-side reforms, a topic set forth by Christian von Hirschhausen and Volkhart Vincentz in chapter 8 on this key structural problem. They describe the government's ambitious blueprints at that time—modeled on U.K. experience—for breaking up the national monopoly in electricity (and possibly gas) and replacing it with regional monopolies, free to compete in production and distribution and regulated by an independent authority. They discuss the importance of enforcing payments to stop arrears from providing a back-door means of avoiding world prices. They analyze what needs to be done in the oil and politically sensitive coal industries.

As essential as it is, truth in pricing is not enough to change the behavior of entrenched state firms. From their analysis of energy Von Hirschhausen and Vincentz draw lessons for industry in general. Structural policies are needed, but not "pick the winners" industrial policy. They advocate "horizontal" structural policies, which promote competition, improve corporate governance, and tighten financial discipline.

Unfortunately, the reforms discussed in 1994 and 1995 have not come to fruition. What is worse, the government's hold over parts of the

energy sector, notably gas, has even strengthened, and it has not been used for any public benefit.

Privatization and the Legal System

Most privatization in Ukraine was undertaken from 1996 to 1998, and it has long been the focus of nearly all of the criticism of Ukraine's economic reforms. It is difficult to obtain any exact numbers on the degree of privatization of the economy—particularly since Ukraine has a huge gray economy of informal economic activities—but a reasonable assessment is that half of the official economy was in private hands as of 1999.

The most straightforward form of privatization is the privatization of small enterprises and shops. They can be sold easily, preferably through auctions, but they tend more often to be sold cheaply to their staff. It was an oddity that surprisingly little small-scale privatization took place in Ukraine during the first three years of independence, but it took off in 1995 and was essentially completed by 1996.

The primary privatization issue has long been the privatization of large and medium-sized industrial enterprises. It was badly complicated by a large amount of legislation adopted by Parliament at various times. Internally inconsistent, this legislation seemed totally impractical because one principle had been added to another. Only in 1996, when Yuri Yekhanurov was minister of privatization, were a number of Gordian knots cut, so that, at long last, large-scale privatization could begin.

While the privatization method in Ukraine has been rather similar to the Russian voucher privatization, it has been more complicated and worse in a number of ways. Of Ukraine's two types of vouchers, only the less important one was tradable. The share of stocks in an enterprise sold for vouchers tended to be smaller than in Russia, while the managers and other employees got an even larger share of the stocks. The stock market remains nascent and poorly regulated. Shareholders' rights continue not to be taken seriously. Still, privatization may offer some possibility of change. In 1996, the average enterprise manager's tenure was ten years and it was virtually impossible to remove a passive, incompetent, or criminal manager; moreover, a great number of managers had run their companies down close to the point of standstill, but they did not give up or sell off any assets. They only demanded more money from the government. Privatization has undoubtedly unsettled many incompetent and parasitic managers.

Foreign direct investment still seems a distant possibility. The regulatory system has to be improved significantly before foreign direct investment can become sizable. Few large enterprises have been offered in open sales, and the arcane practices of Ukrainian privatization have deterred foreign investors. In 1997 alone, Poland attracted four times more foreign direct investment than Ukraine had accumulated during the entire period of its independence.

Land reform, with the introduction of private ownership of land, has been a persistent aim of the reformers, but the left-wingers in Parliament are too strong and too committed to public ownership of land to render this possible. From time to time, Parliament's attempts to block all privatization have been a major problem.

Yuri Yekhanurov, who was minister of privatization from 1994 until 1997, has written a very substantial chapter (see chapter 9) about privatization in Ukraine. He describes the different mechanisms used for privatization, compares the pace of progress before and after a presidential decree accelerating the process in July 1994, and discusses the problems he has confronted and how they have been or should be resolved. He also reflects on the social implications of privatization, its relationship to the *nomenklatura*, and the importance of maintaining broad popular support for the process.

Privatization itself does not ensure that the newly privatized businesses will function efficiently. A system of laws that are enforced and a network of market institutions are needed to ensure normal, competitive conditions. In chapter 10, Alexander Sundakov, former deputy resident representative of the International Monetary Fund, discusses the characteristics of the legal infrastructure that are most important for business. His descriptions of the shortfalls of the Ukrainian legal system are prescient: some of the difficulties foreign investors have experienced are directly traceable to the inadequacy of law enforcement and the lack of transparency of legal procedures that he describes.

Social Policy

There are two primary dilemmas in Ukrainian social policy. On the one hand, Ukraine is now a very poor country, but social expenditures, to an amazing extent, are concentrated in the wealthiest segment of the population, even more so than in Russia (Milanovic 1998). The reason for this concentration of "social" benefits on the wealthiest is that a multi-

tude of old nomenklatura privileges persist. Instead, social benefits need to be focused on priorities, notably pensions, health care, education, and a social safety net for the poorest members of the population.

The other problem with Ukraine's social expenditures is that they are persistently very large—over 20 percent of GDP. Few countries can afford such large social expenditures, and Ukraine certainly cannot. Yet, there is a strong populist opinion against any cutting back of social expenditures. In particular, the left in Parliament is up in arms whenever the scaling back of any social benefits is debated.

Nadia Malysh, an advisor to the president on social issues, discusses in chapter 11 what should be done to improve and rationalize social expenditures, as well as the politics involved. Malysh focuses on the need to make the pension system sustainable. She observes that the current pension system is financially untenable and suggests two principal options. In the short term, Malysh wants to limit the number of pensioners by raising the retirement age and reducing pensions to working pensioners. In the longer term, she favors a transition to a fully financed pension system based on personal savings accounts.

Helena Górska has written a very ambitious and telling chapter. She examines in chapter 12 all the different social expenditures and asks what these amounts are actually spent on as well as whether the state should be doing that or something different. In her detective work, Górska reveals one nomenklatura privilege after the other under labels that sound completely social. In particular, the amount spent for subsidized holidays that the Ukrainian state continued to afford to its privileged citizens is amazing. Naturally, Górska suggests that such unjustified expenditures be cut, and she assesses what effects this step would have on state finances and taxes.

Ukrainian Transition in Perspective

The last chapter in this book by Anders Åslund discusses why Ukraine was the only post-communist country that failed to achieve economic growth for a whole decade. He examines many of the explanations that are often given. He refutes the idea that the reforms have been too radical and that Russian exploitation has been the cause. There appears to be some merit to the importance of Ukraine's poor preconditions for reform, the tardy financial stabilization and privatization, and the weak state administration and disorganization. However, none of these factors seems a sufficient explanation.

Rather than looking upon Ukraine's recent history as an unfortunate accident, Åslund considers it a natural outcome of the predominance of rent seeking by the ruling elite. He indicates that the socially harmful policies have helped to maintain the incomes of the big and powerful at the cost of the population at large. He further elaborates this result by analyzing the nature of Ukraine's ruling elite and going on to present the Ukrainian economy as a model of rent seeking. While this model seems to be in a state of equilibrium, Åslund pinpoints a large number of factors that can shake this equilibrium and indeed the entire model.

Ukraine's Reform Dilemma Has Been Aggravated

Why has the road to reform in Ukraine been so long and so frustrating? There are as many explanations as there have been obstacles to reform.

If we focus on the reform attempt of fall 1996, the main reason for its failure seems to be that the large state bureaucracy was deeply addicted to corruption at virtually all levels. We had expected that the 10 percent drop in GDP in 1996 would mobilize the country's leaders to action. As it turned out, whatever pressure there may have been was insufficient to break through habits of rent seeking and to force change. The most corrupt bureaucrats continued to be the most successful, and they were not punished. The demise of the "clean hands" program was both predictable and portentous.

Corruption has gone hand in hand with inefficiency. The Ukrainian state administration suffers from extreme over-centralization and a profound dilution of responsibility. A government decision may require over twenty signatures, and, consequently, nobody is perceived as responsible for it. With about 1,000 employees, the presidential administration is far too large, as is the apparatus of the Cabinet of Ministers with some 700 people. While these bodies sit at the top level of the government, they have few useful functions. Ukraine badly needs a fundamental government reform that should involve the reduction of these two bodies and the abolition of many other useless or harmful government bodies (notably a host of unnecessary control bodies, a reduction by at least half of the number of bureaucrats, and a decentralization of decision making and responsibility). At the same time, the quality of the civil servants should be regularly monitored, and the good among them should be better remunerated.⁵

The absence of any clear, popular vision of an ideal to strive toward also contributed to the resistance to reform. After the demise of the absurd Ukrainian economic model, there was no model at all. Outsiders presumed that Ukrainians would look to Poland as an example to follow. After all, these two post-communist countries are neighbors of similar culture, size, and industrial structure. Yet, for historic reasons, Ukrainians refused to see Poland as a model. The net result was that, whereas the public in Poland has had a clear sense of where it was going—it wanted to “rejoin Europe”—the public in Ukraine has no clear sense of its objectives or any clear hope. Apart from some lingering post-Soviet confusion, Ukraine has become a country without an ideology.

An underlying reason for the absence of vision and the weakness of reform has been Ukraine’s very weak civil society. The press remains of miserable quality, a problem that has been aggravated by the government’s multiple closures, on dubious grounds, of independent-minded newspapers. Public organizations of all kinds are weak, with the exception of the coal miners’ trade unions. Few workers go on strike, even when they have not been paid their wages for half a year or more. The political parties are rudimentary, although the latest parliamentary elections at least encouraged the strengthening of parties. Most Ukrainians seem to be resigned to the view that you can expect no good from the state, and, after all, you can survive on your private agricultural plot. Much of the country has fallen into subsistence farming on these plots of two to three acres of land.

Even more than elsewhere, political discourse in Ukraine tends to be a game of blame. Parliament blames the president and the government. The president blames Parliament and the government. Prime ministers Marchuk and Lazarenko blamed Parliament and the president. Part of the problem was that it took until June 1996 to adopt a reasonable constitution with a division of powers, but reform remained blocked, even under the new constitution.

To sum up, Ukraine suffers from a weak state, the absence of a sense of direction, and a weak civil society, while it is dominated by an omnipotent ruling elite that is more interested in its own rent seeking than in the public’s welfare. To an outsider, the cost incurred by the half-hearted nature of reform and by its delays is abundantly evident. But to many Ukrainians, who seem to be suffering from reform fatigue, it rather appears that the country has had too many reform programs. We hope readers of this book will see that the prescriptions, though radical, are simple. Many of them had already been clearly formulated by the sum-

mer of 1996. Whether or not they will be implemented, we consider to be a political rather than an economic question.

Notes

1. Anders Åslund was brought in as an economic advisor to President Kuchma by George Soros in August 1994 and organized an advisory team that initially worked primarily with Minister of Economy Roman Shpek. The early Kuchma period has been analyzed in Kuzio (1997).

2. Other participants in this conference included Prime Minister Pavlo Lazarenko, former Russian acting Prime Minister Egor Gaidar, future Deputy Prime Minister of Russia Maxim Boycko, Deputy Prime Minister of Moldova Ion Hutu, and Professor Jeffrey Sachs of Harvard. Total attendance numbered about 200 people.

3. Shortly after our conference, the IMF and the World Bank gathered a group of Ukrainian reformers and foreign experts in Washington to review technical papers prepared by their staffs with a view to the EFF negotiations, which were about to begin. Those papers and the discussion were published afterward in Cornelius and Lenain (1997).

4. Two other books that have come out of international economic advisory activities in Ukraine are Dabrowski and Antczak (1996) of the Polish Center for Social and Economic Research, who worked in our group, and Siedenberg and Hoffmann (1999), which arose out of the German Economic Advisory Group to the Ukrainian Government.

5. The evolution and problems of Ukraine's political institutions have been analyzed in a recent book (Kuzio et al., 1999).

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