Introduction

Janusz Szyrmer

The post-communist transition process in Central and Eastern Europe, we hypothesize, has been shaped by the existing (pre-1990) social and institutional environments rather than by economic and technological conditions. The most successful countries, in which the transition has proceeded the fastest, are those countries that were more open, more homogeneous ethnically (free of serious internal ethnic conflicts), and more heterogeneous politically (having relatively strong groups and organizations that were able to resist communist authorities or, at least, to maintain a certain level of autonomy within the communist state). The current disappointment with transition – especially with the performance of such countries as Russia, Belarus, Moldova, Ukraine, or even the Czech Republic – may not be a result of "bad will" of political leaders in these countries or "bad foreign aid". Instead, we suggest, it is a consequence of unrealistic expectations and the lack of solid understanding of the process of transition and its underlying factors and forces. Perhaps, the former Soviet bloc countries have simply accomplished what, under the circumstances, was feasible to accomplish.

Given very difficult initial conditions, Ukraine emerges from the first decade of transition in a better shape than almost all other members of the Commonwealth of Independent States (CIS). Ukraine's GDP per capita is the highest among the CIS countries, after Russia and Kazakhstan.[1] Many important reforms have been initiated. The Ukrainian economy is growing. Economic fundamentals are

[1] One has to keep in mind that these two countries are amply endowed with natural resources and Ukraine is not.

reasonably stable. Ukraine has got, for the first time, a truly reform-minded leadership. Implementing a number of comprehensive reforms became, we hope, only matter of time.

Thus, the question becomes: "If it is that good, why is it so bad?" Our answer is that most of Ukraine's development, so far, has remained "underground". It has been more qualitative than quantitative and, therefore, is not well reflected by standard economic indicators. Development has predominantly been in the sphere of institutional infrastructure and capacity building – in learning the "rules of the game" rather than "playing the game." Those involved in academic education know well how rapid the progress of graduates from Ukrainian colleges has been, in particular in economics, finance, business management, and languages (English and also Ukrainian). The overall quality of Ukrainian statistics, policy research, understanding of market and democracy among government officials and in mass media has improved substantially.

The Harvard/CASE Ukraine Project's team has been working in Ukraine for four and a half years. We have been fortunate to participate in a unique and truly historical process of transformations. We are proud of Ukraine's accomplishments and our own contributions. We are also concerned about Ukraine's failures, but believe that the cost of these failures is necessary tuition that each country has to pay while enrolled in a worldwide school fostering market democracy. As long as there is learning from mistakes, these mistakes have value.

In this book we present diverse concepts and ideas concerning post-Soviet transition in general and Ukraine's transition in particular. Our efforts have been to analyze and evaluate current experience with transition and try to formulate some specific recommendations for Ukraine and other countries of the region.

In the introductory chapter, ***Post-Soviet Transition: Problems, Lessons, and Solutions***, we analyze different aspects of transition-related issues. The analysis leads to the formulation of some conclusions (the lessons) for the Ukrainian economy. Our focus is on knowledge, information, institutions, including informal institutions, and policies. We believe that thus far things were done with insufficient knowledge and understanding of the environment in which reforms have been introduced. Probably, if there were less doing and more thinking, better results could have been accomplished. We have witnessed a pervasive anti-intellectual approach. Concept building, longer-term programs, and in-depth policy analyses have often been denounced as "academic" and therefore not useful.[2]

The authors of the chapter ***An Analysis of Fundamental Economic Problems in Ukraine and An Agenda for a Comprehensive Reform Effort***, argue that excessive state intervention in Ukraine's economy makes it almost impossible to engage in profitable legal and productive business. As a consequence, there are strong incentives for individuals and enterprises to seek rents – to take value from others – rather than to create value. This rent-seeking environment hampers investment and growth. Fundamental reforms are necessary. Obviously, without identifying the main causalities that are behind all these problems, one may endlessly keep trying to fix the economy with no success. There is no good alternative to knowledge and information.

External manifestations of the internal ills of an economy appear as economic distortions. It is difficult – often impossible – to decide what the problem exactly is, although we can confirm, with high probability, the existence of some problem when we note a statistically significant distortion (irregularity). In order to identify these distortions, we study relationships among important economic variables. Economic theory and results of a large amount of empirical research provide us with certain benchmarks. If some countries deviate from these benchmarks and are consistent outliers, then we conclude that something wrong is probably going on with these countries. When using this approach, we have spotted large distortions in the Ukrainian economy. The chapter on ***Openness, Distortions, and Growth*** presents examples of such irregularities. Among these are unusually low level of bank credits to enterprises, unusually low foreign currency reserves, and unusually high energy intensity of Ukrainian industry.

The author of the chapter on ***Economic Transformation in the NIS and the Failure of the Washington Consensus: More Questions Than Answers*** is focused on the importance of all these factors that Douglass North (Institutions, Institutional Change and

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[2] During our four-and-a-half year activities in Ukraine, we have frequently been requested to work on specific reform issues and come up with solution proposals for some complex problems within a few days (and a few nights). Sometimes, we have been given only one day to formulate an important recommendation. In each case, we have been told that there was no time to study these problems. Time management has emerged as a main issue in policymaking. If things have to be done quickly, and be useful, one ought to know what is to be accomplished, which way to go, and where it leads. Without such solid underlying knowledge, it is hard to expect great accomplishments. Information and knowledge turn to be crucial factors in a successful transition.

Economic Performance. Cambridge University Press, 1990) defines as "informal institutions". Among these are systems of values, norms of behavior, social conventions, and self-imposed codes of conduct. While formal institutions (e.g., constitutions, laws, and regulations) have found some appreciation in the eyes of both East Europeans and Western experts, the informal institutions, for many years, were left to the so-called academics. Policy-makers dealing with practical problems did not have time or interest to pay much attention to these issues. Yet, more and more economists have become convinced that these informal factors play a decisive role in the transition process. The fact that they are the most complex and the least researched does not mean that they should be ignored and left alone as uncontrollable. While it is true that there are "more questions than answers", all these issues can be studied and should be studied. Even if we cannot change much in these informal institutions in a short period of time, we should at least know more about them and take them into account while making recommendations and policy decisions. In his introduction the author of the chapter writes:

... at the first and most important stage of reforms, a vast majority of Western advisors and politicians essentially underestimated two major aspects: institutional/behavioral issues and political economy issues. These two issues, of course, are closely connected to each other, and both of them require extensive concepts not only from economics but also from other disciplines. By taking into account these issues, one could design more appropriate strategy and tactics for reforms, as well as evaluate more realistically the results they yield.

One problem with transition reforms was their piecemeal character. Each reform has brought together a group of experts who worked away on a specific task. This task was often narrowly defined as a stand-alone issue, isolated from a broader context. Relationship between formal and informal institutions was one such problem that was not given much attention. Another fundamental issue was relationships between the microeconomic level and the macroeconomic level within the Ukrainian economy. Privatization was viewed by transition theorists as one of the three main "pillars" of transition. Despite its microeconomic nature, similarly to two other pillars – liberalization and stabilization – it had to bridge the "micro" with the "macro", especially in the fiscal sphere. It turned out to be as important, as complex, and as controversial as the two other pillars. The next chapter: ***Prospects for Entrepreneurship: Privatization and Capital Accumulation*** considers the fundamental problems with privatization policies and formulates specific recommendations. Implemented within a broad economic policy context, privatization will begin to have a real positive impact on the economy. Otherwise it will remain reduced to formal transfer of ownership title, which provides little help in building a market economy in Ukraine.

The political economy of transition remains at its initial stages of development. We know that political factors are very important, but we are not sure how to approach them while designing reform. The chapter on ***Building a Pro-Reform Coalition in Ukraine: Reducing the Bargaining Power of Bureaucracy*** is an attempt to address some of these issues. The author emphasizes the strength of post-Soviet bureaucracy, which turns out to be the number one "enemy" of reforms. A main job of bureaucrats is to distribute scarce resources according to their preferences. Control over the resource allocation provides them with high social status, political power, and income. The market is their obvious competitor. If it were allowed to take over the job of resource allocation, most post-Soviet bureaucrats would lose their jobs. Looking at vested interests of different political factions and social groups and designing right strategies for reform from this perspective is a truly challenging task. A policymaker in charge of economic reforms not only has to know what to do but also how to make it happen. During the early stages of reforms, we have seen a lot of formal technical ability in fixing the economy that was not very helpful because it lacked the necessary political support. Building an operational pro-reform coalition should become one of the most important tasks for a political leader who wants to be successful in his/her reform endeavor.

Due to their political, economic, social, and other complexities, reforms need solid, well thought-out programs. It is hard to undertake good reform measures without a long-term vision and thorough evaluation of various direct and indirect effects of each measure in the context of the entire economy. The next four chapters of the book provide an overview of several important reform programs elaborated in Ukraine during the last four years. As convincingly argued in ***Government Program: 'Reforms for Welfare'***, these official programs of the Ukrainian government have been significantly improving over time. The program formulated this year "Reforms for Welfare", despite its obvious flaws, is the most comprehensive and the most consistent of all Ukrainian official broad reform programs thus far.

The comparison of this program against a similar program formulated recently for Russia – ***The Social and Economic Policy Programs of the Russian Federation, with a Comparison to Ukraine –*** provides interesting and useful insights.

The two subsequent chapters – ***The Program to Bring Activities out of the Shadow Economy Is on the Agenda*** and ***1997 Program for Economic Growth in Ukraine*** – present two other important developments. It seems that their significance has not been fully appreciated. It is unrealistic and unreasonable to expect all reform programs to be quickly and fully (or even partially) implemented. The very fact that such programs are formulated, that a large number of government officials and experts work on them, ask relevant questions, consider alternative measures, elaborate a broader concept of reforms, stimulate the debate among economists and in mass media, etc., is in itself a very important and useful development. Even if the effects of this activity are not immediate, just the effort to identify problems, ask right questions, and conceptualize main causal relationships has great value. This contributes to the building of a critical mass, which is a necessary process for eventual successful implementation of the reforms. In particular the Pynzenyk "Economic Growth" program was a great success, despite its short-term failure.

A useful reform program must always be a mixture of solid economics knowledge, good understanding of specific problems, and last but not least <u>common sense</u>. Today, it does not take a great thinker to understand fundamental logical flaws of the Soviet system and to accept the undeniable necessity for the introduction of a system based on market economics. To paraphrase Churchill's famous statement of Churchill about democracy: it is true that the market is a very bad system, but so far nothing better has been invented. This truth was not equally obvious eighty years ago, when Ludwig von Mises (***An Anti-Socialist Prophet***) vehemently argued against any non-market arrangements: "…economic calculation can only take place by means of money prices established in the market of production goods in a society resting on private property." In any non-market system (such as Soviet-type socialism), in which economic calculation is not enabled, "…there can be no economic activity in our sense of the word." A long-term consequence of such a system is "the general decline of economic thought" (including the painful loss of the relevant informal institutions). It seems that if, an almost century ago, people listened to Mises, today no post-Soviet transition would be needed.

Post-Soviet Transition: Problems, Lessons, and Solutions

Janusz Szyrmer

Post-Soviet transition is a process of transformation moving from the Soviet system, which was dominated by monopolistic (vertical) structures, towards so-called western market democracy, based on competitive (horizontal) structures. The success of this process depends on how fast old structures and old institutions are replaced by new structures and new institutions.[1] Leaders of former Soviet bloc countries who promote this process must overcome numerous stumbling blocks. First, they have to overcome their own lack of information and experience. Second, they have to overcome a similar ignorance on the part of their fellow countrymen. Third, these leaders have to face the ignorance of foreign donors who, though lacking relevant experience, attempt to assist in this process. Fourth, while incurring the high costs of this complex and expensive transformation, they must, for obvious reasons, maintain an extensive and expensive safety net. Fifth, the transition is predominantly of an institutional nature. This means that both formal and informal institutions must change. While the former can be relatively easily transformed, if appropriate technical assistance is provided by Western countries, the latter are much more conservative and their change requires great educational efforts and a lot of time. The role of the informal institutions (perceptions, beliefs, values, etc.) does not seem to get sufficient attention and appreciation from transition leaders and therefore emerges as a major slowing factor. Finally, the change is systemic in nature. Unless complex causal relationships are well understood and the

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[1] Institutions are "humanly devised constraints that structure human interaction. They are made up of formal constraints (e.g., rules, laws, constitutions), informal constraints (e.g., norms of behavior, conventions, self-imposed codes of conduct), and their enforcement characteristics. Together they define the incentive structure of societies and specifically economies" (North, 1993).

reform sequence is thoroughly designed, most efforts may be wasted or even produce results opposite to those intended by their proponents.

This chapter presents discussion of the main transition-related problems and formulates some policy recommendations in the light of the existing experience, gained through a decade of trial-and-error policies in former Soviet bloc (FSB) countries. The chapter ends with specific comments and policy recommendations focusing on Ukraine, and a concluding section. The Appendix includes two comparative analysis tables.

1. Problems with *GOVERNMENT*

In the wake of the breakup of the Soviet state and the Soviet bloc, the process of establishing and solidifying sovereignty by both previously existing and by newly created (re-created) national states, during its early stages, has been remarkably smooth. Given the scale and the magnitude of this process, there were relatively little violence and military conflict.[2]

Abolition of the one-party system and introduction of free elections have also progressed relatively smoothly. In many FSB countries, democratic foundations have been firmly laid. Main market institutions began operating and have expanded rapidly. Yet, the whole process is still far from the end. Once sovereign states have been established and the main institutions of democracy put in place, the national governments assume a crucial role in carrying out the reforms. Their capacity to continue strengthening democratic governance, to resist pressures from powerful interests, to promote competitive markets, to protect people from transition-related excessive hardships, and to enforce law and order becomes critical. The failure of the government to perform these tasks brings about the failure of reforms and directs the whole process toward some unspecified "third-way" experiments, including some non-democratic and/or non-market (pseudo-market) variants, or perhaps some novel "neo-soviet" solutions.

In spite of (or because of) the process of de-statization and the shrinkage of the government during transition, its tasks not only do

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[2] The civil wars, which erupted in the Balkans, the Caucasus, and Central Asia, do not take away from the overall good record of post-Soviet transitions. The wars affected only a relatively small fraction of the FSB population and territory. Under any circumstances, given the complex and turbulent history of these regions and many years of political and national oppression, it would be hard to control the situation at the moment of the removal of the political and military dictatorship. An explosion was hardly avoidable with whatever level of liberalization. Yet, this liberalization was necessary to establish an effective market democracy.

not shrink but become much larger. The mission of the government in a transition economy is crucial to the whole transition process. The government faces challenges on an unprecedented scale (Levine and Szyrmer, 2000). Unfortunately, these tasks tend to outgrow the real capacity of a post-Soviet government. **What we witness in the FSB countries is much less the failure of the market than the failure of the government.** For quite a long period of time, the post-Soviet government has to do the jobs of three different governments at once, as discussed in the following sections.

Command economy government

First, until the effective privatization of the state sector is accomplished, the government needs to continue its old role as owner, supervisor, and coordinator of productive activities: this under the conditions even more difficult than ever before, and with very limited control capacities. The government remains the master of state owned enterprises, while the instruments at its disposal to perform this task are modest. In all transition economies, the power of enterprise insiders greatly increases. The use of Stalin-era brutal control measures is not possible. It is not possible to execute people for mismanagement. Neither can there be use of Brezhnev-era party-discipline pressures. Political parties are unstable, fragmented, seeking support from powerful (and often very conservative) large “socialist” enterprise directors. The government also has to continue provision of a variety of social services that used to be delivered by the socialist state: health, education, even housing and other communal services, pensions, and a variety of other social benefits. This leads to an unavoidable fiscal crisis. The government is too weak to enforce good performance upon state owned enterprises, unable to generate significant tax income from new private firms, and incapable of stopping tax leakages to the informal sector (the shadow economy). On the other hand, it has to face growing unemployment and shrinking wages. Poor performance of many state enterprises results in pressures for and eventual grants of large subsidies. Privatization of these enterprises is difficult for political and social reasons, as is any effort to shut down those which function at a loss. The government also has to continue financing a host of social activities until far-reaching reforms of the budget-supported sector allow for a significant reduction in funding. This reform involves restructuring of budget sphere spending, privatization of some such activities, or even discontinuation of those less important. The continuation of large social expenditures is obligated by the sheer number of poor, unemployed, and pensioners (whose disappointment would vote out of office any government). In Hungary and Ukraine populist inclinations of their first post-communist governments resulted in large fiscal deficits which destabilized the economies. The efforts of subsequent governments to bridge the fiscal gap resulted in low social benefits and again brought about another U-turn in voters' preferences. Similar shifts in voters' choices between populist destabilizers and belt-tightening shock therapists occurred in many other FSB countries.

The power of insiders in large industrial state owned enterprises has increased significantly. In some countries, such as Poland and former Yugoslav republics, labor unions and workers' councils maintain effective controls over most state enterprises. Workers' demands for wage increases and job security are hard to contain. Enterprise managers and the government lack the capacity to resist. Larger enterprises possess significant political powers to defy government efforts to discipline the company, not to mention their capacities to impede any restructuring and orderly privatization. The power of insiders was especially strong in Poland where large industrial enterprises, dominated by the Solidarity labor union, have challenged successive national governments (many of which have themselves been dominated by Solidarity activists). Solidarity led the movement that succeeded in removing the Communist government and in bringing about political and economic reforms.[3] To impose work discipline, cut subsidies, privatize enterprises and lay off several million workers, many of them members of the victorious Solidarity, was a dreadful task. On the other hand, most of budget sphere organizations were dominated by old post-Communist trade unions, which were wooed by all major political forces. This political constellation explains why, in Poland, reforms of the budget sector and privatization have been slow and shallow. The government has had to continue its "socialist" responsibilities.

In other countries, such as Russia and many other former Soviet republics, enterprise managers dominate. They are in the main former Communist *nomenklatura* members with significant political power supported by the money they accumulated while running state enterprises. The state administration is weak, often incompetent and corrupt. It is not able to defend its autonomy and resist powerful interests. Law and order institutions, police and the army are in disarray. The enterprises defend themselves by "emitting" a "smog" of inter-enterprise arrears, barter, hidden unemployment, etc. (Szyrmer, 2000; Besedina, 2000; Zhylayev and Orlova, 2000). The government cooperates by creating a dense web of price fixing, red tape, free trade zones, exemptions, loopholes, credit lines, subsidies, penalties for tax arrears, write-offs of non-paid taxes, and so on. The situation

[3] Especially grave conflicts occurred in the bankrupt Gdansk shipyard, which was the birthplace of the Polish Solidarity Labor Union, and in Warsaw's Ursus tractor factory, well known for its resistance to the Communist authorities before 1989.

becomes less and less transparent (Dubrovskiy, 2000). Figuring out which enterprise is profitable and which is loss-making (distinguishing between value-adding and value-subtracting activities) becomes almost impossible. In many situations, the government becomes helpless. Sometimes, in desperate attempts to extract tax and debt payments from uncontrollable enterprises, it shifts to quite nonstandard methods to enforce compliance.[4]

Market democracy government

Second, the government in a transition economy must begin new functions, those expected of a government in a market democracy. They involve design and implementation of financial, monetary, fiscal, trade, and other policies. But the subject, format, means and aims of these policies are often unknown to state leaders and their staff. To be able to perform these functions, the government's leaders must undergo intense learning – mostly through learning-by-doing and day-to-day trial and error. The new tasks include different forms of control, regulation, supervision, sponsorship, and promotion of market institutions and market activities. Many of these institutions and activities are fundamentally different from those that existed and operated in the old system. The most important of them include autonomous courts, banking, credit and equity markets, tax collection units, and foreign investment agencies. Many old standards and procedures must change – accounting methods, state statistics (both in content and technique), financial auditing, and so on.

Complexity is aggravated by the fact that this young market is still "incomplete" – fragile and unstable - most of the time suffering from a recession that is more severe than any economic crisis experienced by any modern Western democracy in peace time. Working for the government in a country where output keeps shrinking, inflation is very high, unemployment is growing, and poverty becomes pervasive would be a great challenge to even the most experienced Western political leaders and policy-makers. The weakness of the market and the painful recession have served as a rationalization for frequent idiosyncratic government interventions and "corrections". Given the lack of market experience and the power of interests, the government's involvement in the economy often hurts rather than helps transition. The economy is so non-transparent that an accurate evaluation of the government's actions is not possible. Western donors lack capacity to evaluate these interventions, and their

[4] In summer of 1998, in a desperate move, the Prime Minister of Ukraine decided to send enterprise managers to a detention camp, until they pay overdue taxes. Little money was collected. After a few days, the Prime Minister had to give up and release his hostages.

reactions tend to be inconsistent. Sometimes they praise, sometimes they "understandingly" tolerate, sometimes they condemn. Such mixed reactions emerged in the wake of the "anti-crisis measures" implemented by Russian and Ukrainian governments in the fall 1998.

The transition government

Third, the government must perform transition-related tasks. This assignment must be fulfilled in addition to the two previous government responsibilities. The government must implement, or help implement, many new institutions and assist the adjustment process of the old institutions. As most of these duties cannot be efficiently implemented by the market alone, active involvement of the government is necessary. In particular, the very institution of the market is to a large extent a public good and can hardly be "self-serviced" (especially in a relatively short period of time). The market cannot be implemented and maintained by itself, although how much state involvement is appropriate for market implementation remains debatable.

The task of restructuring and reforms of the government is an even greater challenge. This task must be performed by the national government, since in a sovereign state there is of course no super-government that could reform the actual government, which, therefore, has to self-reform, while performing all these numerous other complex duties, under the watchful eye of its electorate.[5] Yet, both the government and the electorate are not very clear or knowledgeable about their objectives. The government must break the resistance of powerful interest groups while struggling with its own ignorance. Market reforms are often done by former Communist Party officials, *Komsomol* activists, professors of Marxism-Leninism, and the like. Many of them have never been to a country with a market economy. Most of them do not know foreign languages and their access to the world mass media and Western literature is limited to a small subset of texts that were translated into Russian (or their native language, if it is not Russian). They have never studied Western economics and Western political science. While working hard for the government they do not have the time and capacity to enhance their knowledge.

The challenge is the greater as there is no solid popular support for reforms. Just as their leaders, the majority of people in the FSB

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[5] International organizations, such as the World Bank, have an important role to play in reforms (or in establishment as often is the case) of national governments and public administration. This turns out to be a daunting task. Various agencies of the government receive funds to reform themselves. Obviously the effectiveness and speed of this kind of reforms tends not to be very high.

countries never experienced democracy and the market. They learned about them from Soviet textbooks, Communist-controlled mass media, and American movies. Their assessment of these institutions is not always very favorable. Democracy and market are for many people synonyms of moral decadence, weak and corrupted governments, social and economic injustice, lawlessness and chaos. Thus, the government faces an apparently insurmountable challenge: to impose a market democracy, by democratic means, upon the people, a majority of whom rejects (or does not comprehend) this system. How are political and economic freedoms to be imposed on someone who does not want them? Some politicians try to "trick" the electorate in order to implement unpopular reforms they believe are necessary.

1.1 Lessons

Paradoxically, a successful transition requires "more government", not "less government". Yet, this must be a "different government". Economic deregulation has often been misunderstood. In fact, what is needed is more regulation rather than less regulation. In the Soviet system many activities were not regulated enough, or not regulated at all, or regulated in an inconsistent and non-transparent way. This poor regulation enabled Communist Party leaders and bureaucrats to manipulate the system to their advantage. A market economy needs a lot of regulation - clear and strong rules of the game - to reduce the discretion of governmental administration officials. A strong and competent government is needed to be able to create and enforce right rules, and to follow these rules.

Transition is not and cannot be a one-way process. A peculiar symmetry, or balance of changes, must be preserved. Thus, for example, any process of de-statization/decentralization must be accompanied by a parallel process of statization/centralization. A diminished police infiltration into personal affairs of people (decentralization) requires an improved and reinforced law and order system with strong independent and efficient courts (centralization). By the same token, the withdrawal of the state from direct production activities (decentralization) requires comprehensive and transparent regulations (centralization) that must replace the old direct controls of state bureaucracy. To reduce unavoidable negative externalities of privatization (decentralization), various regulation measures (centralization) must be devised. Less decision-making at the central level may require more state activities at a local level.[6] The local level in a highly centralized autocratic country was used mostly as a passive "information transmission belt" with little space for

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[6] "These processes can be seen as either institutional innovations, as devices intended to enhance microeconomic efficiency, or as resulting from a competitive process whereby the most efficient institution (in controlling free riders, for instance) emerges" (Dallago and Mittone, 1996).

autonomous decision-making. This two-way change – decentralization and centralization at the same time – is needed to avoid any destabilization during transition. An asymmetry in this process may damage it.[7]

2. Problems with *MARKET*

Milton Friedman once said that **economics** is a simple discipline and that its main concepts may be written on a few pages and easily understood by almost everybody. Yet, at the same time, almost everyone is confused about economics. This confusion can be seen, for example, during national elections in which many people (often the majority) would cast their votes for candidates who feed their electorates with a primitive cheap populism having little to do not only with basic economics, but often even with common sense.

The market is an economic concept *par excellence* that shares with this discipline its "Friedmanian" features. It is simple and straightforward, yet, it is widely misunderstood, confused, misused, and abused. In a broad sense, the market is a place, or an institution (institutional framework), where exchanges (transfers) between individuals and/or organizations[8] occur. Typically these are transfers of money, goods, and services. In economics we often distinguish between factor markets (labor, capital, including land and other property, and technology) and product markets (production output, or commodities and services). This factor/product dichotomy, however, is somewhat confusing, since in a circular economic system "being a factor" and "being a product" are simply two aspects of the same thing ("two sides of the same coin"). For instance, labor skills in a production process are at the same time both factor and product (workers both produce and learn on the job). As concerns labor market, we may want to distinguish between its different categories, such as bureaucrats (the *chinovniki*),

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7 For example, in both Russia and the Czech Republic, fast privatization in the early 1990s (decentralization), which was not followed by the necessary equity market regulations and effective corporate governance laws (centralization), has delayed rather than sped up transition in these countries. Likewise, the liberalization of the banking sector in Bulgaria (decentralization) without the necessary regulations (centralization) resulted in highly non-transparent and corrupted banking, which led to a deep financial and economic crisis in 1996-97. This in turn brought about a major political shift enabling changes in policy, including corrections that improved the centralization-decentralization balance.

8 Organizations are groups of individuals bound by some common purpose to achieve objectives. They include political bodies (political parties, the parliament), economic bodies (firms), social bodies (churches, cultural organizations), and educational bodies (schools). Individuals and organizations are decision-makers, whose creation, evolution over time, and activities are influenced/constrained by the institutions. At the same time these decision-makers influence how the institutions evolve (North, 1993).

managers, and workers. Very important markets that are rapidly developing worldwide are markets for liquid financial assets (currency, bonds, stocks, and various other types of securities), and market for intellectual property. Another important kind of market is the contacts market (networks). During the last decade, economists began paying more attention to institutions, which are both production factor and important product of social and economic activities. Since the market itself is an institution, there operates a huge market of markets (for example, the sale/purchase of the rights to provide telecommunication services). Finally, the concept of market can be easily extended into thoughts, ideas, reform programs, political choices (while voting), etc.

There are different **market structures**, or modes of operations: competitive, monopolistic, and various combinations of these two extremes. The competitive structure is defined by horizontal interactions among market participants. All of them face transparent rules and enjoy well defined rights. The competitors participating in a specific market have equal rights. The monopolistic structure is defined by vertical hierarchical interactions. Those located higher-up in this structure affect, or control, those below them by imposing their decisions by means of direct measures. Both kinds of market structures have built-in their own "efficiency drives".

The paradigm of the competitive market is built around the search for competitive equilibrium. The paradigm for the monopolistic structure is built around the search for perfect control. This control drive stimulates the monopolist to keep the system detached from the external world, by as much as possible, in order to insulate it from outside competition and thus to solidify the monopolistic controls. Monopolists like closed systems that are highly segmented with no direct (horizontal) contacts between the segments. In a monopolistic structure direct means of influence, such as orders and administrative decisions, dominate. Dictators and bureaucrats have little confidence in autonomous institutional mechanisms and distrust the indirect methods of influence – economic incentives, stimuli, etc.

A mixture of different market structures occurs in all countries. The essential difference is in proportions, in which these structures are mixed. FSB countries tend to possess strong monopolists and weak competitors. As we know from economics, in the case of a highly monopolistic production structure, we end up with low quantity of output, high price, and high rent gained by the monopolists. If the monopolists are control maximizers rather than profit maximizers, little of this rent is reinvested back into the economy. Instead most of the rent is used to support and expand their control capacities. Increasing profitability of enterprises does not lead to new investments and growth. Corruption and poverty are promoted, and systematically reproduced and reinforced (Fonkych, 2000).

2.1 Lessons

The word “market” is usually used in singular mode, whereas in fact it is a plural concept. During the last decade we have learned that no single kind of market can survive without the support of many other “fellow-markets”. These inter-market relationships are poorly understood. In fact, the different markets need each other. There exist inherent links between product and factor markets, equity and credit markets: even the markets of contacts and managerial experience. Weakness in one market (for example in the land market due to the lack of necessary legislation or the management market due to weak corporate governance) may stymie operations and development of all other markets.

To be stable and well performing markets should be highly diversified. Efforts to “install” some kinds of markets while neglecting other kinds are likely to fail.

Markets come with different structures. An important task of the government is to promote competitiveness while curtailing monopolistic practices. Governments that are inclined to support monopolists – for instance, by implementing various protectionist policies – enable the generation of high rents for some producers while hurting the national economy (although typically the official justification for protectionism is the support for the national economy).[9]

3. Problems with *INFORMAL INSTITUTIONS*

Transformations in the FSB countries are fundamental and unprecedented in human history. They involve not only the change of formal institutions and procedures, but also people’s perceptions of such questions as: how the economy and society should operate, what the role of the state should be, what rights and responsibilities of individuals are, etc. Without adequate changes in perceptions and values, the successful introduction of the new system does not seem possible. A critical mass of support among both the government leaders and the population at large is necessary for any change to be effectively implemented. This support in turn is only possible if there is enough understanding and acceptance among the people of this change. Yet this understanding and acceptance is

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9 For example, countries that decided to protect their car industry (Ukraine) have practically destroyed this industry and several other related activities, while countries that made allowance for foreign competition (the Czech Republic) have seen a fast development of this industry.

not likely if no successful reforms are introduced and if people do not experience their benefits. Below, I provide examples of conflicts between some “principles” of the Soviet system (which have survived as “informal institutions”) and modern market democracy.

Discipline. In the Soviet Union, economic success was a function of imposed discipline. This was the discipline that made the relationship between Communist Party leaders, government bureaucrats, and industrial producers operational. Things worked as long as the Party maintained an effective control over the government, which in turn controlled enterprise managers who controlled workers. Little could be accomplished based on entrepreneurship and individual initiative. These were associated with disorganization and chaos. The cornerstone of market operations is sovereignty of producers and consumers who freely perform different economic activities and freely enter purchase/sale transactions. A competitive market’s outcomes are not “controlled” by anybody, not predetermined by anybody, and can be predicted only in terms of their expected probabilities. Many people blame the lack of firm governmental controls for transition related ills. These views result in different actions through which the government tries to impose discipline in order to reduce the shadow economy or in order to force the payment of an overdue debt. Most of the time these actions are doomed to fail because governmental orders are not consistent with a system that lacks the rigors of central planning.

Pragmatic approach to law. In the Soviet Union the law was not well developed and implemented. Most every-day decisions were made by Party *apparatchiks* and the bureaucrats. The judiciary system was weak and ineffective. The whole system was highly idiosyncratic and lacked transparency. Courts were not autonomous and their role was limited. The law was treated loosely as a collection of general directives and applied in a pragmatic way. It was used to support political leaders and bureaucrats whatever their agenda would be. This flexible and utilitarian approach to law is not consistent with the market democracy, which success depends on the strength of the law and the effectiveness of its implementation.

Legality. In a (post-) Soviet society, free market transactions suffer from an odium of illegality, dishonesty, and cheating. Stock exchange speculators, foreign investors seeking profit, banks collecting interest, and successful local businessmen are often perceived as criminals and are blamed for current economic problems. The conditions are such that in fact it is impossible to become rich without breaking the law (Litvack, 1991).

Egalitarianism. A Soviet egalitarian concept of society prevails. By virtue of this concept, one of the main functions of the state is to prevent people from becoming rich.

Speculation. Speculation remains a bad word. Anybody, who makes money on financial transactions, without producing "real things" does not enjoy a high social status. Policymakers are more concerned about speculation (which may provide somebody with some income) than about deep price distortions due to confused policies, weak contracts, non-transparent privatization procedures, tax exemptions for some privileged enterprises, etc. The entire financial sector, which provides a variety of services to firms and individuals, is viewed as not useful, since it does not produce the real things, in contrast to the respectable "real sector" of the economy.[10]

Exploitation. The market economy is based on the concept of voluntary transactions, such as a sale/purchase. If *A* buys a good from *B*, then *A* decides that he will be better off by having this good rather than keeping the amount of money he pays for the good, while *B* decides that he will be better off by having the money paid by *A* rather than holding on to the good. If so, both *A* and *B* are better off as a result of such a transaction. As a result of a great number of such transactions people, firms, and the entire economy become better off. The concept of a "positive sum game" is fundamental to a market economy. Voluntary transactions remain at its core. In the Soviet system many transactions were not voluntary. They occurred as a result of somebody's order. Since prices were often seriously distorted, sale/purchase transactions often made somebody better off while making somebody else worse off. The perception of economic transaction as a "zero sum game" operation is pervasive in FSB countries.[11] The Ricardian concept of comparative advantage is "admitted" but not "practiced". When a foreign investor gains from an investment, then the country is believed to suffer loss. The concept that both the investor and the country may be better off is not widely accepted. A successful foreign investor is believed to be an exploiter, if not a criminal.

Money. In the Soviet Union money played a limited role – mostly as a common denominator in accounting and statistics (see Woodruff, 1999). The notion of financial capital, interest rate, opportunity cost, decreasing returns, etc., were barely known and used. Pervasive financial problems of post-Soviet transition economies, such as payment arrears, budget deficit, and barter, reflect the lack of experience with financial operations, which are the core of a market economy. Economic activities are perceived in concrete real (physical) terms rather than as financial transactions. Policy-makers keep trying to solve specific allocation problems (feed for

[10] Similarly, the Marxian distinction between "productive" and "non-productive" activities is still widely used (it survives in official state statistics in Ukraine and other FSB countries).

[11] An alternative interpretation is offered by Buchanan (1993), who finds in the Soviet culture an inclination toward a negative sum game.

livestock, coal for power stations, sugar for household consumption, tires for export, etc.) rather than analyzing financial liquidity or credit markets. As concerns investments into the economy, the main policy question remains which industries and which products should be supported and subsidized by the government (see Dubrovskiy, 1999). Little attention is paid to interest rates and accessibility of commercial credits. The lack of experience with monetary policies led many countries first to very high inflation, next to huge wage arrears and unsustainable foreign debt. The funds provided by foreign donors were often misused. Instead of being used to finance market reforms they were used to support inefficient enterprises (so-called negative value-added activities). Thus these funds did not assist the reforms but, instead, they enable the state to hold off reforms.

3.1 Lessons

It is difficult to formulate and implement modern economic policies, make right investment decisions, and enable sustainable growth and prosperity without appropriate formal market institutions. Yet, progress in introducing the formal institutions is a function of the status of informal institutions. The success of transition-related reforms is closely related to people's perceptions of the economy and market. These perceptions in turn depend on many factors, including the intensities of interactions with people and institutions of highly developed Western countries (Jacob, Ostrowski, and Teune, 1993). So far, reforms in the FSB countries have suffered from a simplistic technocratic paradigm. Western institutions have been introduced somewhat mechanically without paying much attention to their social and cultural environment. Without redesigning reforms away from formal institutions toward informal institutions, social and cultural issues, openness, and solid education of both people in the FSB countries and their Western assistants, no significant reform progress is possible.

4. Problems with economic *THEORY*

The pains and failures of the post-Soviet transition reflect a lack of conceptual foundations for this transition. A new system begins to emerge – the transition system. It looks differently in different FSB countries. Its common denominator is the renunciation of the old Soviet system and urge for change. New political leaders are reluctant to use the old failed system (which they know but reject) and, at the same time, are unable to introduce a new system (which they do not know but approve). The lack of experience with this kind of systemic change, the lack of useful transition theory, helplessness, confusion, and frustration accompany transition efforts throughout all FSB countries.

Old socialist command economy models became useless due to their lack of compatibility with a modern market economy. On the other hand, Western economics with its mainstream neoclassical models lack institutional context. Many important explanatory variables are missing. These models are not able to produce accurate descriptions and predictions for the on-going transition process. More often than not they confuse rather than help transition policy-makers (see Zhalilo, 1998).

Table A1 (see Appendix) illustrates a number of problems of transition economics in the context of the neoclassical paradigm derived from the perfect competition model.[12]

Western economic theory fails to provide adequate support to the post-Soviet transition for several reasons.

First, all mainstream economic theories suffer from a conservative inclination. While they tend to be well equipped to study particular systems, they lack tools to investigate a process of change from one system to another.

Second, as presented in Table A1, neoclassical theory is not a good match for the post-Soviet transition. For example, it is not possible to explain the pattern of growth of transition economies by means of the celebrated (Solow) neoclassical growth model or any other standard growth model without making major adjustments (see Sachs and Warner, 1996). Many FSB countries enjoy plenty of capital and a high quality labor force. They allocate a significant part of their income into investment. Despite this (or perhaps partly because of this) their economies kept shrinking.[13]

Figure 1 provides a good illustration for this relationship. Economic growth (and the location of a particular country in the diagram) depends more on the institutional/geographic features of countries, rather than on their investment efforts. Interestingly, for former Soviet Union countries (FSU), the investment-growth line is almost vertical. Their growth is not a function of investment but some other variables.[14]

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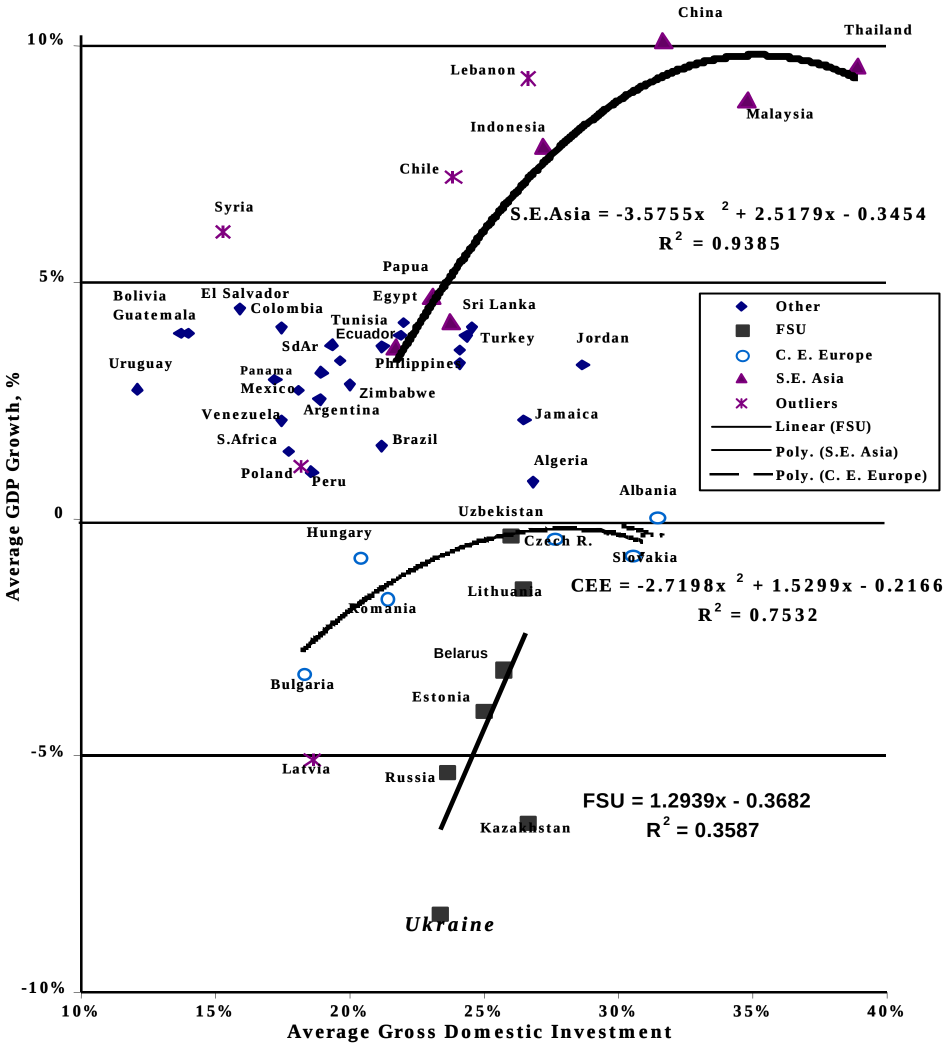
[12] "… this model does not have sufficient interpretative power for an economy as a whole, not so much because of its extreme simplification as because it ignores components of great importance in the real world" (Dallago and Mittone, 1996).

[13] A good example from a pre-transition era is a painful lesson that Poland learned in the 1970s. Its heavy investment in steel and coal industries resulted in an economic decline rather than the dynamic growth hoped for by the Polish communist leadership.

[14] There are many examples for this phenomenon at the microeconomic level. Two similar cement factories, of similar size, using similar capital and technologies, and owned by the same western company, perform differently. One is profitable while the other is a loss maker. There is evidence that the difference can be explained by institutional conditions in which the two factories operate (Pivovarsky, 1999). Another example is two agricultural farms of similar size, similar soil quality, similar assets and technologies, etc., which differ greatly in factor productivity and profitability, again due to institutional differences (Jarzynowski, 2000).

Figure 1

Average GDP Growth, Annual Percentage Change, and Average Gross Domestic Investment, Percent of GDP, Middle Income Countries*, 1996-1998



* Countries with GDP per capita $750 – 9,655 as of 1997.

Source: World Bank Development Report, 1998-99, pp. 190, 211; database of the World Bank.

Ironically, a decline in investment and increase in unemployment often help growth.[15] A "standard" well trained Western economist who lacks exposure to a post-Soviet economy is not able to produce a meaningful analysis, and his recommendations are not likely to be helpful. Without consideration of institutional variables that reflect local (systemic) constraints on economic activities, it is hard to produce useful results. Typically, such arrangements as arrears, barter, and shadow economic activities impede any standard economic analysis. Unless these transition peculiarities are explicitly included in the analysis, its results have little to do with the complex reality of transition. On the other hand, it is very difficult to account for these phenomena, since by their very definitions they are murky or simply "invisible" and "non-measurable".

Third, the transition process has an uncomfortable "novelty" status. The post-Soviet transition has appeared *deus ex machina* as an unexpected and brand new phenomenon. While, for a long time, scholars have been busy figuring out the transition process from capitalism to socialism (and communism), little work was done on the process that goes in the opposite direction. Thus, main problems of the post-Soviet transition are not only related to its dynamic nature (the "process" rather than the "state") and its particular institutional setup, but also its sudden unexpected emergence. People and local institutions lack experience with this kind of process. The role of the state in this process is not well understood and still remains *terra incognita* for political scientists and economists. The popular concept of "de-etatization" is vague and lacks solid theory. The need for simultaneity of political and economic transformations as well as the importance of (rapid) privatization is questioned by many scholars and politicians. All we know is that we do not know. Yet, in the real world and real time real decisions have to be made. Development of the transition theory has begun. It follows rather than leads economic and institutional transformations.[16]

4.1 Lessons

The 1990s witnessed spectacular (and somewhat unexpected) successes of the US economy, as well as painful failures of socialist economies (for instance, Cuba and North Korea) and post-socialist economies (such as Russia and Ukraine). It can be argued that this

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[15] In a cross country analysis for the early 1990s the unemployment rate and GDP growth are positively correlated. The higher the unemployment the more growth (the less decline). For some countries, like Russia and Ukraine, the capital investment and GDP are negatively correlated: the less investment the more growth (less decline). Data related problems are only partly responsible for these results.

[16] This tardiness of the theory is expected to last for some time. When talking about macroeconomics in the next century, Buchanan (1992) predicts: "Economists will attain broad consensus on choices among policy options *before* observed agreement on underlying analytical models of macroeconomic interactions" (p. 17).

great contrast in economic performance is, to some extent at least, an effect of the strength/weakness of economic theory that supports the institutional arrangements and policy measures implemented in these economies. Poor theory and weakness in the overall "intellectual" environment in socialist and post-socialist countries lead to poor performances of their economies.

The experience of the last decade has strengthened the conviction of a need to reformulate and extend standard Western (predominantly neoclassical) economics by incorporating into it some conceptualizations and findings from other disciplines, such as political science, legal studies, and psychology of decision-making (psychology of choice).

This new economics should move away from both socialism - this Hayekian "fatal conceit" (Hayek, 1989) - and the abstract (but elegant) world of neoclassicals. The core of this discipline should be built around interactions between human behavior and institutions. Its focus should be on change and growth (evolution in time) and its qualitative and informational aspects (Murrell, 1992). Broadly understood innovations, rather than growing volumes of labor and capital, should be viewed as a main growth factor. Innovations in cultures and institutions/organizations have been shown to be more important to growth and development than "standard" technological innovations and physical investments. Of course, the latter are absolutely necessary for growth, but they turn out to be predominantly endogenous – driven by institutional arrangements. The opposite causality (institutions as functions of technological innovations) seems to be much weaker, at least in transition economies.

The main engine of growth is human creativity and entrepreneurship (Schumpeter, 1950). In this context, more attention must be given to the role of incentives (private property) viewed from the perspective of the psychology of value.[17] Old models that promote state paternalism and people's passivity (central planning) as well as individualistic static profit maximization outside of an institutional context are not sustainable. Both the "collectivist paradigm" and the neoclassical paradigm should be replaced by a new paradigm. This new paradigm will be built around such concepts as growth and change (dynamic disequilibrium rather than a static equilibrium), institutions (a "catalytic" perspective rather than the old maximizing/optimizing perspective), and a pragmatic approach (normative approach rather the old predominantly positive and abstract approach).[18]

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[17] Evaluation is "located" in humans not in goods (Buchanan, 1992).

[18] The change in "... the perspective on politics and political process, a shift that already occurred, will force normative evaluation to incorporate comparisons among institutional alternatives that remain within the possible" (Buchanan, 1992).

As some economists have argued, this new “useful” economics should move its focus away from the concepts of efficiency/ effectiveness and the losses due to different constraints imposed by governments (and by other institutions) upon the voluntary market exchanges (tariffs, price regulations, restrictions on entry and exit of firms). Instead, it should focus on causes of, and motives for, these constraints and on the measures of their opportunity costs. Thus, the shift should occur from “choices within constraints” to “choices among constraints” (Buchanan, 1992). The new focus should be on complex structures instead of homogeneous aggregate structure-less units. Within these structures, the attention should go to the process of predominantly endogenous changes in the behavior of individuals, organizations, and institutions over time (learning) rather than instantaneous changes produced by unspecified exogenous shocks.

Further down the line, this new approach will (hopefully) provide useful support for governmental policies in the economies and societies undergoing fundamental (and painful) systemic transformations.[19]

5. Problems with *STRATEGY* (transition sequence)

A typical development path in Southern Europe, Latin America, and Eastern Asia leads from private ownership and market economy through significant economic growth, followed by a political liberalization, to a wealthy market democracy. This has been the case of Greece, Spain, Portugal, Mexico, Chile, Argentina, South Korea, Taiwan, Hong Kong, Singapore and other countries. This path – property>market>wealth>democracy – is currently followed, to some extent, also by China. Yet, it does not seem to have been an option for the FSB countries. Within the Soviet system, no partial gradual reforms were possible. As argued by many authors, the complete eradication of this system and abolishment of its powerful *nomenklatura* was necessary to enable sustainable market reforms (Balcerowicz, 1990; Ericson, 1991). Obviously such radical changes, introduced in a very short period of time, have had to be expensive; their social and economic costs had to be very high.

The Soviet bureaucracy was a system that had several fundamental institutions (“basic features”), such as: central planning, *nomenklatura*, and “centralization of organizational rights”. These institutions were supported by “derivative characteristics”, for example, administered prices, foreign trade monopoly and related to it protectionist regulations and import substitution policies, soft budget constraints for enterprises, extreme concentration and

[19] For an excellent discussion and analysis of the role of institutions and policies in post-Soviet transition see Havrylyshyn and van Rooden (2000).

monopolization of industries, producer dominated market, lack of domestic and foreign competition, etc. (Balcerowicz, 1990). All these institutions were mutually interrelated and reinforced one another. They generated in turn a plethora of structural and functional properties and activities that bound the system into one indivisible whole (Ericson, 1991). All attempts that aimed only at changing some of system's derivative characteristics, such as the soft budget constraint or lack of market competition, had to fail as long as the fundamental features of this system remained in place. By the same token, any attempt to abolish only some of the fundamental features rather than all of them were doomed to be rejected by the system. History provides many examples of failed partial reforms (such as those intended to reduce or dilute the power of some state monopolies). These were: administrative decentralization of the Soviet economy by Khruschev in the early 1960s, the abolishment of censorship and other reforms in Czechoslovakia in the late 1960s, attempts to abate central planning in different periods of time in Yugoslavia, Hungary, and Poland, and many other initiatives. Ironically, many efforts before Gorbachev's *perestroyka*, despite intentions of their initiators, failed to introduce systemic changes because they were not radical enough. By contrast, the *perestroyka* in the USSR in the 1980s, despite the apparent intentions of Gorbachev, failed not to introduce systemic changes because the reforms ended up being radical enough to undermine the fundamental features of the Soviet system. Even if Gorbachev wanted to improve – not to abolish – the Soviet system, the *perestroyka* resulted in crossing the threshold of "no-return".

The post-Soviet transition involves the following steps:

(1) **Political** liberalization – abolition of Communist Party controls and of the institution of *nomenklatura* and the establishment of a working democracy

(2) **Social** safety net – establishment of a welfare system that would guarantee a minimum level of wealth for all people; and the establishment of an income control system that would protect the nation against an extreme income inequality

(3) **Economic** reforms – macroeconomic stabilization and microeconomic liberalization/deregulation that would enable introduction of a competitive market

(4) **Institutional** transformations – enabling/promoting the activities of private businesses; privatization of many state owned enterprises; establishment of market institutions; and other institutional changes (Fisher and Gelb, 1991)

The first two steps are essentially preconditions for any economic and institutional reforms. The dictatorship of the Communist Party had to be abolished and an effective safety net had to be established in order to protect the poorest from transition related hardships. The introduction of reforms also required certain level of political and macroeconomic **stability**. Civil wars, weak and unstable governments, serious social tensions, widespread criminal activities (the mafia), as well as shortages of food and of goods necessary for normal economic activities, very high inflation and unemployment would make any major reform very difficult if at all feasible. Economic **liberalization** facilitated the introduction of a competitive market. The establishment of the institution of private ownership and other fundamental **institutional reforms** led to the creation of modern market democracy (Lipton and Sachs, 1990; Sachs, 1997).

All of these steps had to be initiated at the very beginning of the transition period. The failure in accomplishing these tasks caused great damage to reforms and even reversed the whole process. Democratization failure (as in Belarus), welfare failure (as in Albania and Moldova), liberalization failure (Ukraine), or inequality prevention failure (as in Russia) have undermined the reform process.

If the learning process is successful and the country is able to draw proper conclusions from its earlier mistakes then, after a period of failed reforms, it is able to introduce radical reforms and secure solid growth (as was the case in Bulgaria).

Leaders in transition are those countries that, while following the above formulated reform sequence (political-social-economic-institutional), managed to introduce all the reforms early in the process and provide them consistent policy support (Poland and Estonia). This sequence – democracy>welfare>market>property – appears to be a reversal of the development transition path followed by other developing countries. As discussed above, their development path began with market institutional foundations (property rights) and the implementation of a competitive market, which in turn brought about economic growth and wealth and eventually led to political liberalization (democracy). During the post-Soviet transition this development process has been re-run, but in reverse order. It starts from democracy and broad social welfare (which have appeared in many developing countries toward the end of their development process) and ends with the establishment of the market, market institutions, (voluntary) contract enforcement, and private property implementation. This development in reverse order appears to be a great challenge to these countries. In some cases it has remained beyond their capacity to manage.

In many of the FSB countries government employees – the inexperienced civil servants – earn $50 a month or less. The choice they face is to find additional sources of income – which often breeds corruption and illegal activities – or abandon government and instead seek a job in the private sector where income tends to be much higher. This makes an incompetent and corrupt government even less competent and more corrupt. Such a government is not able to, or not willing to, introduce the necessary reforms. The country is becoming poorer, the state budget is becoming smaller, the wages of budget sphere employees (including the government) shrink, the capacity to implement the necessary reforms becomes even lower than during the initial period of transition. Over time, this vicious circle brings down the economy, and reform capacity as well. It may end up with a third-world style incomplete market and reduce the process to a point equivalent to the beginning of the "standard" development sequence. This sequence, in contrast, begins with the (re-) establishment of property rights (in order to formalize the ownership of wealth accumulated by the new elite during the post-soviet privatization), through a gradual introduction of market, followed by economic growth (the Chinese-style) and eventual political liberalization (the Chilean-style). The candidates for this transition scenario include Belarus, Serbia, Albania, and former Soviet Central Asian republics. There is some danger that, in the wake of economic hardships during the 1990s, Russia and Ukraine may end up following a similar scenario.

5.1 Lessons

The relationship between democracy and market remains a controversial issue. There is a whole array of authors who claim that these two attributes are mutually consistent. There are many, however, who argue that the two are contradictory.[20] Lessons from the most recent experience of the FSB countries seem to support both views: <u>market and democracy are mutually consistent because they are mutually contradictory</u>. Democratic mechanisms correct the market's extremist inclinations and keep income inequality within an acceptable range (Thurow, 1996).

Market mechanisms protect societies from *uravnilovka*-related efficiency losses by helping with efficient allocation of resources and, thus, promoting economic growth and prosperity.

6. Problems with *POLICY*

Most of the so-called emerging market economies, including the FSB countries, follow policy standards spread by modern market missionaries of the International Monetary Fund and the World

[20] For a comprehensive discussion of this issue see Przeworski and Limongi (1993).

Bank, assisted by many other international assistance organizations. Transition policies are defined by a set of standard measures, called sometimes the "Washington Consensus" (Williamson, 1994). These are prescribed for early stages of economic reforms by a group of economists clustered around Washington-based international financial organizations.

Table 1 lists the main policy standards included in the Washington Consensus and presents results of an attempt to evaluate their implementation in selected FSB countries (as of September 1998). The scores were produced by judgments of eight transition policy experts as a result of an HIID research project. A 10-grade scale was used, with 10 being the highest performance score and 0 being the lowest performance score. The scores are averages of values assigned by the experts. Obviously they have been arbitrary and should be approached with a due caution.

Table 1

Evaluation of the Implementation of Reform Measures Prescribed by the Washington Consensus for Selected FSB Countries

	POLICY MEASURES	BUL	EST	POL	RUS	UKR
1	**Fiscal discipline**	6	8	8	3	4
2	**Redirection of public expenditure priorities towards health, education, and infrastructure**	5	7	7	5	3
3	**Tax reform, including the broadening of the tax base and cutting marginal tax rates**	6	8	7	4	2
4	**Unified exchange rates**	10	10	10	10	10
5	**Competitive exchange rates**	7	9	8	9	6
6	**Secure property rights**	5	8	7	3	2
7	**Deregulation**	6	8	6	6	4
8	**Trade liberalization**	7	8	6	5	3
9	**Privatization**	5	7	6	7	3
10	**Elimination of barriers to direct foreign investment**	5	8	8	4	2
11	**Financial liberalization**	5	9	8	6	4
	Total	67	90	81	62	43

Source: HIID database

At one end there are Estonia and Poland, believed to follow the Washington Consensus policy measures more than most of the other FSB countries. Reforms in these two countries move faster and economic growth has been stronger than elsewhere. They collect, respectively, 90 and 81 points (out of 110). The remaining Baltic and

Central European countries closely follow these two transition leaders. At the other end is Ukraine whose policies deviate substantially from the Consensus standards. Ukraine performs relatively well as concerns monetary and exchange rate policies. Its weakest spots are fiscal policy, property rights,[21] trade liberalization, and privatization. Ukraine collects only 43 points, much less than the other four FSB countries analyzed.

One problem is by how much a particular country follows the Consensus' recommendations. A different problem is whether these recommendations are right. There are many economists who challenge these recommendations (Stiglitz, 1998; Burki and Perry, 1998) and those who challenge the challengers (Dabrowski, Gomulka, and Rostowski, 2000).[22] A more extensive discussion of problems with the Consensus remains beyond the scope of this chapter.

While the Consensus seems to satisfy the requirements of modern Western economics (and those of common sense), its main shortcomings are not what it covers but rather what it ignores. Issues related to information,[23] education, informal institutions, contract enforcement, etc., which are at the core of transition, are not explicitly addressed by the Consensus.

6.1 Lessons

Transition policies prescribed by Western economists have been helpful in formulating specific measures put in place by FSB countries. The main problem with these measures is their technocratic character. They failed to account for complex social and institutional environment in which they have been introduced. More often than not nominal "visible" policies and activities have differed significantly from true policies and processes actually in place. As a result, a reform illusion has been created, explicitly or implicitly supported by Western aid providers, who tended to look at things at their official face value. Not enough attention has been paid to information, contract enforcement, and various fundamental distortions that cripple otherwise valid policy measures.[24]

The whole transition-period policy, actively supported by Western advisors, has been highly segmented, broken down to specific measures and lacking a broader systemic and conceptual approach. Perhaps the main problem was not the Consensus-supported policy measures themselves but interactions between these measures and a broader context in which these measures have been implemented.

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[21] In Ukraine, property rights are not well protected by the government. Frequent failures to pay wages on time and fulfill other financial liabilities violate property rights and contract obligations.

[22] See also "Economic Transformation in the NIS" in this volume.

[23] See Gregory (2000).

[24] See "Openness, Distortions, and Growth" in this volume.

7. Problems with *SYSTEMIC CONSISTENCY*

Lack of consistency in post-Soviet reforms can be shown to be a factor responsible for many failures of economic and social policies. The FSB countries failed to formulate an operational “economic constitution” that would ground fundamental principles on which the reform should be based and to consistently observe these principles. Many legislative initiatives and policy measures have been mutually contradictory - sticking to the “old rules of the game” while introducing “new rules of the game”. It is difficult to satisfy two mutually contradictory sets of rules at the same time. Table A2 (see Appendix) is an attempt to identify the main differences between the new system and the old system: the competitive market structure versus the monopolistic structure. Of course there are many problems with the kind of classification as displayed in Table A2. In the real world there are no perfectly competitive or perfectly monopolistic markets (systems). Therefore, the generalizations and simplifications used in Table A2 are only partly true. Monopolistic structures are pervasive inside individual organizations (bureaucratic organizations, companies, etc.). In a Soviet-type system, to a significant degree, entire countries and even blocs of countries operate according to a rigid monopolistic pattern (operate as one company). Competitive structures are typical for Western democracies.

The table provides a “flat” enumeration of characteristics with no efforts to structure these characteristics into certain categories. Obviously, some of these characteristics are “fundamental”, others are “marginal” or “derivative” (see Balcerowicz, 1990).

7.1 Lessons

The main message presented in Table A2 is a systemic consistency of various features of competitive and monopolistic structures, each of which has its own internal logic. Efforts to overcome the features of the monopolistic model cannot be successful unless a truly fundamental systemic change occurs.

8. Problems with *FOREIGN AID*

Donor-imposed conditionality for foreign aid has not been effective for many reasons.[25]

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25 Joseph Stiglitz rejects conditionality altogether. He argues that conditionality is flawed and may even undermine democracy in countries receiving loans. “Was imposing conditionality an effective way of changing policies? There is increasing evidence that it was not. Good policies cannot be bought. [Some researchers found out that] ... imposing conditionality outside times of macro-crisis may actually reduce borrowing governments’ incentives to comply with IMF programs by inducing resentment and make international investors doubt their genuine commitment to reform.” The Financial Times, November 29, 1999.

First political criteria tend to dominate economic policy interests.[26] Conditionality has often played the role of a fig leaf for non-economic objectives. As a result, donors' credibility has been affected. Governments of beneficiary countries learned not to treat this conditionality seriously.

Second, a large fraction of aid has been allocated to countries with poor policies. It has been demonstrated that financial aid for these countries is not effective.[27]

Third, the intangible nature of many conditions combined with low transparency of institutions[28] and poor statistics in aid recipient countries enabled hiding many facts in a shadow and made it impossible to verify the outcomes. The effective monitoring of conditions formulated by the donors has not been possible.

Fourth, fungibility of aid enabled the government to use the funding for its own ends.[29] Little attention was paid to conditions attached to aid by donors.

Fifth, the conditionality was often formulated in such a way that it was never possible to meet all conditions but it was always possible to meet some conditions. Hence, it could be easily manipulated by both the donors and the aid recipients.[30]

Sixth, conditions often encroached on state sovereignty and involved significant micro-management by donors. This has had a negative effect on their implementation.

Seventh, more often than not negotiations between the donors and the recipient country's officials have been conducted behind a closed door. Therefore they lacked support from many politicians

[26] Direction of foreign aid is dictated by political and strategic considerations, much more than by economic needs and policy performance of the recipients. While foreign aid flows respond more to political variables, FDI are more sensitive to economic incentives, particularly good policies and protection of property rights in the receiving countries (Alesina and Dollar, 1998).

[27] Conditional lending is worthwhile where reforms have serious domestic support (Dollar et al, 1998).

[28] See Dubrovskiy (2000), and "Economic Transformation in the NIS and Failure of the Washington Consensus: More Questions than Answers" in this volume.

[29] Since foreign aid is highly fungible, donor's influence of the recipient's policy is weak (Svensson, 1999). Almost all projects are fungible. There is no direct relationship between the composition of project aid and the composition of the recipient's budget. Donors are more or less financing whatever the government chooses to do (Dollar et al, 1998). "It is argued either that lending to governments per se strengthens them and is undesirable or that the availability of IFI [mostly IMF and the World Bank] support has permitted governments to pursue inappropriate policies longer than they otherwise would have" (Krueger, 1998).

[30] Aid has a positive impact on growth in more democratic countries with an institutional check on the governmental power. In less democratic countries it will be used to satisfy the government's own nonproductive goals (Svensson, 1999).

not participating in these negotiations. The officials were often perceived by the public as corrupted and incompetent. The population at large felt suspicious about the whole procedure.[31] The outcome of this clandestine procedure was an increase in the indebtedness of the state without visible improvements of the economy.

Eighth, an important factor was the lack of efforts to provide solid well documented explanation and justification for the items included in the conditionality agreed upon during these meetings and lack of major public relations efforts to explain this conditionality to the public. This conditionality "technology" generated confusion and created great political obstacles to implement the required measures.

8.1 Lessons

Improvement in knowledge should be given the highest priority. To modify a popular bumper sticker about the cost of education, once common in the US, "**If you think knowledge is expensive, try ignorance.**" During the last decade, in Ukraine and other FSB countries, one can find plenty of evidence how expensive ignorance can be. Without in-depth social and economic research many reform measures will keep failing or be less successful. The payoff for analytical work has been shown to be very high.[32] Many previous mistakes of both donors and FSB governments could have been avoided, if more serious research were undertaken and, even more important, the decision-makers were willing to pay attention to the results of this research. The existing data and research capacity of donors and FSB governments are very modest. Relying almost exclusively on politicians' perceptions, intuitions, and beliefs is not a recommended way of proceeding with reforms.

Our recommendation for the donors is to consider limiting aid conditionality to the requirement for a minimum transparency of policies and the provision of reliable (verifiable) information/data. Making significant information available to the public would create by itself a mechanism for solving many problems related to shadow activities, over-commitment and misuse of public funds, corruption, etc.[33] Donors should explain why the information is crucial for reforms, market operations, and funding capacities. If a minimum of substantial information is not available, no bank or international organization should agree to provide funds. Reliable information enables good policies, good investment, reduces investment risks,

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31 "Critics say that the [World] Bank and the Fund [IMF] ... collude in dealing with developing countries" (Krueger, 1998).

32 Many authors argue that economic research is underinvested. Expenditures on solid research before any aid project is launched are highly cost effective (Deininger, Squire, and Basu, 1998).

33 See Paskhaver (1998) and Fonkych (2000).

reduces investment costs (interest rates), reduces transaction costs, enables growth, etc. Information enables efficient decisions of consumers and producers, exporters and importers.

9. Problems with *EDUCATION*

Education becomes an important task and a major challenge to governments in the FSB countries. In fact this is knowledge (or lack of it) that turns out to be a very significant barrier to reforms and growth. In the former Soviet bloc countries, several generations were educated under a system that lacked democratic and market institutions. Problems with Soviet education were both on the supply side and demand side. The entire educational system was "supply side driven". It was designed by the Communist authorities and did not reflect the needs of a modern developed economy. On the other hand, under the Soviet rule, there was not much demand for the skills needed by a market economy; especially not theoretical economics, economic policy, management, banking, finance, insurance, and real estate.

A serious challenge for the government during transition is to support the shift toward market-oriented education, at a time when budget financial resources are greatly restricted and a large proportion of the population suffers from a decline in income and cannot afford to pay for education from its own earnings.

As shown in Tables 2, 3, and 4, changes in education are related to the success with post-Soviet reforms. Countries that are considered to be most successful with these reforms tend to experience much greater increases in enrollment of students in the institutions of higher education (Poland, Hungary, and Estonia), while in countries considered to be less successful with reforms (Ukraine, Russia, and Belarus) this enrolment has not increased. The development of labor market has created a situation in which people's investments in human capital (education) began to be profitable.[34]

Another very significant change is the shift in the structure of subjects being studied. The proportion of students enrolled into engineering and natural sciences has declined while the proportion of students enrolled into law, economics, business, etc., has increased. Most countries with highest proportions of social science students and lowest proportions of natural science/engineering students are again those considered to be the most successful in transition (countries such as Slovenia, Poland, and Estonia).

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[34] Results from an analysis for the Czech Republic during the first years of transition demonstrated a systematic increase of positive correlation between education and wages (Vecernik, 1995).

Table 2

Students Enrolled in Institutions of Higher Education in FSB Countries, During 1990s

Country	Years	Students, Thousands		Change %	Students per 100,000 population
	$Year_0$-$Year_1$	$Year_0$	$Year_1$		$Year_1$
Belarus	90/91-96/97	189	180	-5	1,750
Bulgaria	90/91-96/97	188	263	40	3,103
Croatia	90/91-96/97	72	86	19	1,905
The Czech R.	90/91-96/97	118	192	63	2,008
Estonia	90/91-97/98	26	44	68	2,956
Hungary	90/91-96/97	102	195	91	1,926
Latvia	90/91-97/98	46	56	22	1,756
Lithuania	90/91-97/98	89	84	-6	2,244
Poland	90/91-97/98	394	1,092	177	3,532
Romania	90/91-97/98	193	412	113	1,817
Russia	90/91-95/96	2,825	2,655	-6	1,790
Slovakia	92/93-97/98	66	102	55	1,903
Slovenia	90/91-97/98	34	51	52	2,755
Ukraine	90/91-97/98	881	1110	26	2,215

Sources: International Statistics Yearbook, 2000, Warsaw: Main Statistical Office, pp. 160-164; Statistics Yearbook of Belarus, 1998, Minsk: Ministry of Statistics of Belarus, pp. 177-179; Russian Statistics Yearbook, 1996, Moscow: State Statistics Committee of Russia, pp. 179-180; Ukrainian Statistics Yearbook, 1999, Kyiv: State Statistics Committee of Ukraine, p. 432.

Table 3

Students Studying Social Sciences (Law, Economics, Business, etc.) as Percent of All Students Enrolled in Institutions of Higher Education in the FSB Countries, During 1990s

Country	$Year_0$-$Year_1$	$Year_0$	$Year_1$	Change ($Year_1$ minus $Year_0$)
Belarus	90/91-96/97	9.0	10.0	1.0
Bulgaria	90/91-97/98	17.6	28.8	11.2
Croatia	92/93-96/97	27.6	32.3	4.7
The Czech R.	92/93-97/98	19.6	26.1	6.5
Estonia	92/93-97/98	24.9	36.0	11.1
Hungary	90/91-95/96	17.6	25.8	8.2
Latvia	92/93-97/98	23.5	30.2	6.7
Lithuania	96/97		24.8	
Poland	90/91-98/99	24.6	41.5	16.9
Romania	89/90-97/98	10.8	40.4	29.6
Russia	90/91-95/96	7.1	8.2	1.1
Slovakia	92/93-97/98	17.8	22.5	4.7
Slovenia	91/92-97/98	34.8	43.3	8.5
Ukraine	Data not available			

Sources: see Table 2.

Table 4

Students Studying Mathematics and Natural Sciences (Engineering, Medicine, etc.) as Percent of All Students Enrolled in Institutions of Higher Education in the FSB Countries, During 1990s

Country	$Year_0$-$Year_1$	$Year_0$	$Year_1$	Change ($Year_1$ minus $Year_0$)
Belarus	90/91-96/97	75.8	73.2	-2.6
Bulgaria	90/91-96/97	54.0	32.4	-21.6
Croatia	92/93-96/97	51.7	44.8	-6.9
The Czech R.	92/93-97/98	52.1	43.8	-8.3
Estonia	92/93-97/98	46.3	39.2	-7.1
Hungary	90/91-95/96	38.7	39.2	0.5
Latvia	92/93-97/98	51.8	32.7	-19.1
Lithuania	96/97		46.6	46.6
Poland	90/91-98/99	41.6	28.4	-13.2
Romania	89/90-97/98	84.6	45.8	-38.8
Russia	90/91-95/96	76.8	75.3	-1.5
Slovakia	92/93-97/98	55.4	51.6	-3.8
Slovenia	91/92-97/98	43.9	35.4	-8.5
Ukraine	Data not available			

Sources: see Table 2.

The very significant shifts in the number of students and disciplines studied may be used as good indicators for the depth of systemic changes in these countries during the 1990s.

Despite great efforts, the FSB countries are not able to provide high quality education in the disciplines that were underdeveloped under the Communist rule. Here the importance of Western involvement is especially significant.

As presented in Table 5, two decades ago the number of students from FSB countries in the USA was very low. In 1980/81 only 1,700 students from these countries attended US institutions of higher education. This was a small fraction of all foreign students in the USA. By 1995/96 this number grew more than ten times and continues growing.

The number of persons studying in the US (Table 6) varied greatly among the FSB countries. It is interesting to note that countries that had a relatively high number of students (in proportion to their population) in the early 1990s, such as Poland, Hungary, and the Baltics, have been more successful in reforming their economies than other FSB countries. Yet, Bulgaria, despite a high number of students was less successful though the situation seems to be improving now.

Table 5

Foreign Students Enrolled in Institutions of Higher Education in the USA, by Region.

Region	Academic year				Academic year			
	80/81	85/86	90/91	95/96	80/81	85/86	90/91	95/96
	Foreign students, thousand				Foreign students, percent			
Canada	14.3	15.4	18.4	23.0	4.60	4.48	4.50	5.07
Latin America	49.8	45.5	47.6	47.3	16.01	13.23	11.68	10.41
Western Europe	23.7	32.5	44.9	49.3	7.61	9.47	11.01	10.87
Eastern Europe	1.7	1.8	4.8	18.0	0.54	0.51	1.17	3.97
Middle East	84.7	52.7	33.4	30.6	27.23	15.34	8.20	6.74
Africa	38.2	34.2	23.8	20.8	12.27	9.95	5.84	4.59
South&East Asia	94.0	156.8	229.8	259.9	30.23	45.62	56.40	57.27
Other	4.7	4.8	4.9	4.9	1.51	1.41	1.20	1.07
Total	311.1	343.8	407.5	453.8	100.00	100.00	100.00	100.00

Sources: Open Doors 1996-1997: Report on International Educational Exchange (1997, Todd M. Devis, ed. New York: Institute for International Education) and the editions preceding from 1993/94, 1994/95, 1995/96).

Table 6

Eastern European Students Enrolled in Institutions of Higher Education in the USA, by Country, 1993/94 and 1995/96

Country	1993/94	1995/96	Increase
	Number	Number	# of times
Russia	1,582	5,589	3.53
Poland	1,424	1,743	1.22
Bulgaria	1,195	1,588	1.33
Romania	875	1,456	1.66
Hungary	867	908	1.05
Ukraine	313	1,215	3.88
Croatia	273	525	1.92
Latvia	114	194	1.70
Czech Rep.	108	735	6.81
Lithuania	108	252	2.33
Estonia	106	168	1.58
Other	565	3,659	6.48
TOTAL	7,530	18,032	2.39

Sources: See Table 5.

9.1 Lessons

Education, reforms, and economic growth are very closely interrelated. A powerful feedback seems to operate. Good education helps reforms and growth, while reforms and growth help improve education. The numbers provided in the tables above seem to support this claim. Countries that were slow with educational reforms could not be very successful with institutional and economic reforms. Provision of the appropriate education is difficult for many reasons, one being the very low salaries of academic personnel.

Education is an area where Western aid can be the most helpful. The proportion of Western aid spent on education remains at a level that seems too low given the overall level of funding FSB countries receive from the West. Support for higher education at Western schools is one of the most useful forms of Western assistance to post-Soviet countries.

It can be argued that the large number of graduates from US colleges was an important economic growth factor in Asia and Latin America during the 1990s. One can hope that a significant number of graduates from Western schools will come back to Ukraine and in a few years, the effect of this educational shift will begin to have an impact on economic policymaking and business.

10. Transition in Ukraine

Ukraine is currently a mixture of old Soviet (highly monopolistic) system and new Western (predominantly competitive) system. This mixture is not very efficient. It is highly unstable and lacks capacity for sustainable growth. The main problem is mutual incompatibility of old and new institutions that co-habit and hinder each other. Inconsistent policies remind one more of Brownian motions than well designed strategies.[35]

Monetary policy

Forward step. There are unquestionably many accomplishments in the transition process. A respectable Ukrainian currency, the hryvnia, was successfully introduced and made internally convertible. Since last January the hryvnia has been floating and has remained impressively stable. A devastating hyperinflation of the early 1990s was terminated. Currently the level of inflation is reasonably low (20-30 percent annually). Monopolies in commercial

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[35] This discussion reflects the situation in the Ukrainian economy as of the mid-2000. During the second half of 2000 significant improvements in economic policies and positive trends in the performance of the economy have occurred that are not included in this analysis.

banking have been abolished by creation of a large number of banks. The banking system has been strengthened. Many new financial institutions have been established.

Backward step. Efforts to “support” the hryvnia by means of unrealistic official exchange rate corridors have been practiced until January 2000, when they were abandoned; yet various semi-official and unofficial pressures on the banks to support the hryvnia continue. A variety of “anti-speculation measures” are used. Since the market proves to be stronger than exchange rate supporters, Ukraine lives through periods of relative stability sandwiched between periods of crises, during which the hryvnia “suddenly” suffers significant losses in its value.

Dramatic increases in the money base are followed by great efforts to inhibit inflation. These efforts include various kinds of direct and indirect price controls, including phone calls from local authorities requesting producers and traders not to increase prices, etc. This strategy creates significant price distortions, affects profitability of firms that are not allowed to use prices determined by the market, and discourages investment. It seems that a good monetary policy, consistent with the support for competitive markets and sustainable growth, would consist of:

- floating hryvnia (to send right signals to producers and consumers)
- stable hryvnia, supported by its solid market value (to build its international respect and reputation)
- inexpensive hryvnia (to promote exports and discourage imports)
- low barriers to trade (to help income generation of firms involved in international trade, increase participation of Ukraine in the global economy, develop contacts between Ukrainian and foreign businesses, and speed up general opening up and modernization of the Ukrainian economy)
- tight money supply (to keep inflation low)
- domestic prices determined by the market (to avoid price distortions and to support competition, profitability, efficiency and growth)

What Ukraine has been doing was exactly the opposite. The exchange rate tended to be overvalued and actively micro-managed by the central bank. Its rate has often defied the wishes of the market. This peculiar stabilization policy has made the hryvnia highly unstable. Barriers to trade have been growing (to “protect” the national producer). In fact these barriers have significantly weakened competition, supported backwardness, hindered international trade, and were financed by the Ukrainian consumer, who was forced to buy products of lower quality at high prices (Szyrmer et al., 2000). Monetary policy was rather soft while price policy was quite rigid.[36]

Budget policy

Forward step. Significant improvements in the budget process were introduced. It became better structured and more transparent. Expenses on state bureaucracy and direct subsidies to enterprises have been trimmed.

Backward step. The Ukrainian budget, as confirmed by the Budget Law, despite almost a decade of experience, remains unrealistic.[37] The cost of this lack of realism is very significant.

- The lack of fiscal realism greatly contributes to the lack of contract enforcement, causes numerous violations of laws (especially violations of property rights), increases non-transparency, and stimulates corruption.
- Budget unfeasibility shifts the effective controls over spending from the parliament to political leaders who are in charge of budget management.
- Unrealistic fiscal income expectations justify extraordinary efforts on the part of tax authorities. These authorities enjoy special powers. This results in a situation in which the taxpayer has only responsibilities but almost no rights, while tax authorities have plenty of rights and effectively are not accountable before anybody (as long as they fulfill their patriotic duty of filling state coffers with tax money). Short-run successes of these authorities result in long-run failures. Tax collection procedures and imposition of penalties are left to the discretion of tax inspectors. As a result, tax arrears are growing (the tax authorities may decide who is allowed not to pay and how much the penalty would be). More than half of companies are loss-making. People are afraid to set up firms, to invest, to produce, and to export. The shadow sector is expanding (Mandybura, 1998). Budget income is declining.
- Unrealistic fiscal income needs justify the efforts to fulfill the deficit target by promoting paying taxes in kind and other non-monetary settlements with the budget (Khoroshkovskiy,

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[36] For an excellent discussion of monetary policy, price policy and related issues see Pynzenyk (1998, 2000).

[37] The situation is expected to improve in 2000, when for the first time the budget is likely to be fulfilled in nominal terms (though in real terms it will remain below the level determined by the 2000 Budget Law).

2000, Szyrmer, 2000). These are non-transparent and shift controls to parties involved in these settlements (authorities, budget sphere organizations, and commercial enterprises).

- Unrealistic fiscal income needs lead to printing money. Again, weak money supports non-monetary operations. Inflation imposes a tax on the poorest whose income is mostly in local currency. Inflation provides additional income and controls to rich officials whose income and savings are predominantly in hard currency.
- Unrealistic fiscal income needs justify foreign and domestic loans, which help solve current problems. These are expensive and reduce budget capacity in the future. They promote corruption (access of government officials to hard currency, non-transparent debt management, etc.), lead to demonetization, financial crises (these in turn justify increased controls via a variety of extraordinary anti-crisis control measures).

Agriculture

Forward step. Many important reforms have been introduced. Privatization has been sped up by a bold Presidential Decree of December 1999.

Backward step. Agriculture is a good example of how to destroy a sector by bureaucratic price controls and micro-management. The tendency was to keep agricultural prices at a low level by means of many measures, such as direct price controls; support for local monopolists who provide agriculture with inputs; support for local monopsonists who purchase its outputs; maintaining export tariffs on certain agricultural products; frequent restrictions on shipping agriculture output from one region to another; etc. Thus the same government that makes agriculture unprofitable by slashing its prices supports this sector with huge subsidies. This tax-and-spend strategy helps increase bureaucratic controls but undermines the capacity of agriculture to produce and to generate profits (Szyrmer and Reiner, 1997; Leonard, 2000).

10.1 Lessons

In Ukraine the mixture of “old” and “new” is solidly entrenched. Unless some radical reform measures are introduced this mixture may survive for a long time. It is not an efficient structure. It includes features of a competitive system:

- the country is open; state monopoly over foreign trade was abolished
- the hryvnia is convertible

- rights of individuals are protected by a democratic constitution
- NGOs are expanding
- private ownership is officially protected
- the parliament officially controls state budget
- official state price controls are removed from a large number of commodities
- a large number of small private firms have emerged

Yet, many of these institutions are still fragile. Moreover, in many cases they tend to be paper creatures not supported by real world entities. They are often more official than real. Openness of Ukraine is hampered by tariff barriers, and numerous impediments at the border. Private property protection is weak. The budget is mismanaged. Prices are subject to various unofficial (shadow) controls. Half of the economy is demonetized (barter, arrears, and nonpayments) and for this half deregulated prices are not of primary importance anyway. There continue to exist significant obstacles to set up new businesses. Under the existing tax system their fast development is rarely possible. Budget constraints remain relatively soft. Total indebtedness of enterprises exceeds annual GDP. Contract enforcement is weak. Corruption is pervasive. Etc.

The State is not in a healthy condition. Given systematically growing indebtedness, incapacity of credit and equity markets, weak banking, declining investments into the economy (currently about 10 percent of GDP), progressing decapitalization of industry, an urban and communal infrastructure that is decaying, and gradual destruction of human capital, comprehensive and deep reforms are necessary to stop the current processes.

Probably, the most fundamental reform would be a redefinition of the role of the government in Ukraine. The following list enumerates the main changes necessary for successful reforms and sustainable growth:

- the focus of authorities should be shifted from micro-management of the economy to establishing competitive mechanisms
- the government should not protect the monopolists (Daewoo, Khlib Ukrainy, etc.) but prevent their monopolistic practices
- the use of indirect policy measures should replace current direct orders and hidden controls
- shadow price controls should be stopped

- a realistic budget and repayments of all governmental liabilities is a must
- abolition of non-monetary transactions should be implemented
- support for an efficient strong banking system is needed (currently it is systematically abused by the authorities; it is forced to give credits, to operate as an agent of state tax administration, not protected by law against bad loans)
- strong capital market must be developed
- friendly borders promoting trade, tourism, and investment must be established

A new competitive horizontal structure must be implemented and actively supported. The state should transform itself from a main law abuser (nonpayments of wages and pensions, violations of the budget law, infringements on individual freedoms, etc.) to the principal law protector.

Conclusion

Post-Soviet transition does not occur in a void. It proceeds in the context of a complex reality. The main mistake of past reform policies was their simplistic and superficial character. The measures tended to be short-term, treated as stand-alone activities, extracted from the intricate social, political, and institutional context. There was too much of a pragmatic, intuitive common-sense approach not supported by deeper systemic analyses. There are many examples of apparent policy successes that ended up as great failures, such as superficial monetary stabilization; cuts in budget deficit that were enabled by arrears and resulted in a highly non-transparent public finance; poorly designed mass privatization; etc.

There is an urgent need to make a comprehensive evaluation of past reform policies and draw conclusions from both accomplishments and failures. Several reform priorities must be reconsidered. Only good policies can make international financial assistance useful and effective.[38] Aid priorities should be shifted from money to ideas: data/information, research, education, and policy analysis and advice.

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38 Financial aid works only in a good policy environment. In poor policy environment ideas are more important than money (Dollar et al, 1998).

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APPENDIX

Table A1

Neoclassical Economic Theory Versus Post-Soviet Transition

Neoclassical economic theory	Post-soviet transition economies
EQUILIBRIUM: The focus is on stability, equilibrium, and static efficiency.	A transition economy remains far from equilibrium and is highly unstable.
ENVIRONMENT: The behavior of the system is a function of predominantly economic (endogenous) variables.	In a far-from-equilibrium economic system with an "incomplete market", the effects of non-economic variables (the environment) are very strong. Explanation, prediction, and control of this system must take into account many social, legal, political, and other variables to a much greater degree than in the case of a mature market economy.
RATIONALITY and CONSISTENCY: Actors are assumed to be utility/profit maximizers, be rational and consistent in their decision-making.	A typical feature of transition is pervasive confusion. Analysts, policymakers, investors, producers, and consumers operate in a non-transparent, unstable and highly unpredictable economy. In the FSB countries the understanding of market is low. Assumptions about knowledge, rationality, and consistency can hardly be applied.
PERFECT COMPETITION: Perfect competition involves a large number of small producers and consumers. Prices are determined by free market forces. Other assumptions include: zero profits, free entry and exit, and perfect information.	In a post-Soviet economy, the initial number of enterprises is small. In many industries the concentration of production is very high. Prices on a number of important goods (such as energy) often remain regulated. Some producers, especially those operating in the so-called shadow economy, generate huge profits, while a large number of official enterprises operate at a loss. Exit from the market is made difficult by strict labor laws and the absence of effective bankruptcy procedures. Market entry is hampered by the shortage in start-up capital, low availability of bank credits, high taxes, restrictive regulations, corruption, criminal activities, etc. Transparency of the whole economy is very low due to the lack of reliable data, idiosyncratic laws, discrete policies, shadow economy operations, etc. Informational asymmetries are at the core of the transition economy.

TRANSACTIONS and INSTITUTIONS: Standard models assume zero transaction costs, and an implicit availability of appropriate market institutions (such as stock exchanges and financial intermediaries).	Many transactions happen outside regular markets. Nonpayments and payment arrears occur frequently. Barter is pervasive. Due to the absence of efficient market institutions, low financial liquidity, frequent bureaucratic harassment, and high criminalization of the economy, transaction costs tend to be very high. They would often include expensive credits, bribes, and shadow "taxes" collected by the *mafia*.
OWNERSHIP: A transparent and secure ownership is implicit. All contracts are enforced "automatically".	Ownership is not secure. Private property rights and sale-purchase contracts are poorly enforced. State and communal ownership remains high. Frequently dispersed ownership (as a result of mass privatizations) and weak corporate governance limits the rights of owners to control and manage their property.
TIME: The main paradigm is built around a comparative statics analysis. Adjustments to exogenous shocks occur instantaneously. No need for learning occurs (by virtue of the assumption of perfect information).	Transition process requires a dynamic approach. The economy is "misaligned". The time dimension of intense structural and functional adjustments is of crucial importance. These adjustments involve an intense learning process that takes a lot of time.
FLEXIBILITY/LIQUIDITY: The neoclassical economy is "monetized". Its factor mobility is perfect (or very high). Financial liquidity enables the allocation of factors to their best uses (where their marginal productivity is the highest).	The "demonetization" of the transition economy is often very high due to high inflation, and/or high costs (low availability) of credits. The market is often highly segmented and inflexible. The financial liquidity of firms is very low. Debt, arrears, barter are pervasive.
GOVERNMENT: The market operates through horizontal relationships among actors. The role of the government, policies, and any other vertical relationships remain outside the core of the neoclassic theory.	At the beginning of post-Soviet transition the government and vertical relationships are strong while horizontal relationships are weak and underdeveloped. The transition process involves strengthening the horizontal links and redefining the vertical links. Since many of the market institutions are public goods, the role of the government in a transition economy is significant. Transition failures are often related to failures of the government in reforming and restructuring the economy.

EXTERNALITIES: Public goods and external effects of the market economy are not well handled by the market. In evaluating externalities and "full" social costs and benefits economics needs more support from other disciplines.	Due to an institutional weakness, the transition economy is less equipped to deal with negative externalities than a Western mature market economy. Rapidly growing income inequality, inadequate health care, and criminalization are examples of such externalities that threaten the very feasibility of transition process.
FOREIGN SECTOR: A typical economics textbook begins with models of a closed (market economy) which subsequently are extended by the inclusion of foreign trade.	Transition involves intense learning in which a crucial role is played by the foreign sector (foreign assistance, trade, international capital, and movements of people). This sector, rather than internal relationships, becomes a main factor of institutional reforms and growth.

Table A2

Comparative Analysis: Competitive Structure Versus Monopolistic Structure

Characteristics	Competitive structure	Monopolistic structure
Openness	High	Low (a closed and highly segmented system)
Dominant relationships	Horizontal	Vertical
Political and economic rights	Equality	Hierarchy
Efficiency mechanism	Perfect (competitive) equilibrium	Perfect (hierarchical) control
Means of operation	Indirect means (signals and stimuli)	Direct means (orders)
"Rules of the game"	Uniform/general/stable	Idiosyncratic/individualized/unstable
Lawfulness	High	Low
Collection of information	Predominantly indirect methods (the use of "proxy" indicators) and random sampling	Direct, detailed, and complete data
Contact networks	Formal/anonymous	Informal/personalized
Dominant rights	Individuals	Collectives
System transparency	High	Low
Predictability	High	Low
Political regime	Democracy	Autocracy

Civil society	Well developed/formalized	Weak/informal
Number and size of NGOs	Large number of diverse NGOs	Powerful monopolistic organizations (one political party, one trade union organization, one youth organization, etc.) and/or a large number of small and weak organizations
Property rights	Strong/transparent	Weak/non-transparent
Private ownership	Dominant	Limited
Budget constraint	Hard	Soft
Contract enforcement	Strong	Weak
Efficiency drive	Maximum profit/utility	Maximum control
Government's priorities	Long-run: focus on public goods and perfecting the equilibrating mechanism (checks and balances)	Short-run: micro-management of the economy and society
Government involvement into the economy	Fighting monopolists, protection of competition	Picking and protecting monopolists
Measures used by governments	Predominantly indirect policy measures	Predominantly direct administrative measures
Economic structures	Well connected, balanced by financial flows	Highly segmented, relationships expressed in physical units of a large number of products
Perception of capital and investment	Financial stocks and flows allocated by a competitive market	Physical units allocated by administrative decisions
Dominant transactions	Monetary	Nonmonetary
Banking and other financial institutions	Important and well developed	Unimportant and weak
Price formation by economic actors	Price taking	Price setting
Economic growth	Demand driven	Supply driven (command economy)
Main constraint	Low supply	Low demand
Barriers for economic actors to entry and exit	Low	High
Size of firms	Diversified	Dominance of large companies

An Analysis of Fundamental Economic Problems in Ukraine and an Agenda for a Comprehensive Reform Effort

David Snelbecker
Edward Novoseletsky

1. Introduction

After 70 years of socialism and ten years of aimless "transition," Ukraine's economy seems stuck in continual stagnation. The impediments that prevent the economy from developing are deep and fundamental, implying that only a comprehensive change in basic economic conditions would allow Ukraine to move to a path of sustainable economic growth. Ukraine stands at a crossroads and must choose which path to follow from here. On the one hand, there is the path of comprehensive reforms that has been chosen by most Central European countries, involving several years of difficult change, followed by dramatic improvements in living standards for most of the population. Even Russia this year seems to have started along this path of reform, under the coordination of the Economic Program elaborated by German Gref and his colleagues.[1] On the other hand, there is the path of continued stagnation and backsliding, which has been followed by Belarus and Uzbekistan. This latter path, of course, leads nowhere, resulting in continued economic malaise and a growing gap in living standards compared to those of developing neighbors.

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[1] See "The Social and Economic Policy Programs of the Russian Federation, with a Comparison to Ukraine" in this volume.

In this chapter, we examine what the fundamental problems of the economy of Ukraine are and we make conceptual recommendations for what kinds of reforms would be necessary in order for Ukraine to truly turn the corner, onto a path of sustainable market-oriented development.

2. Analysis of economic problems

Fundamental impediments to economic growth

There are two fundamental problems of the economy of Ukraine: one that we might determine to be on the "supply" side, and the other on the "demand" side.

On the supply side, the economy of Ukraine, like any economy, can be seen as being comprised of two types of economic activity:

- Those that produce goods and services (the "producers"), adding value to society - in Ukraine this is done generally by "new" market-oriented enterprises
- Those that seek to take value from others rather than producing it themselves (the "rent seekers") – in Ukraine this is done generally by "old" socialistic enterprises and by bureaucracy

The first fundamental problem of the Ukrainian economy, on the supply side, is that there are too many constraints on producers (through, for instance, excessive taxation and regulation), and it is too easy to take value from others (through subsidies to enterprises cloaked in barter and arrears, and government regulatory bureaucracy that preys on value-creating enterprises). As a consequence, there is less and less production in the economy and more and more rent seeking. Rather than increasing in size every year through value-adding production, the economy of Ukraine is slowly self-destructing, consuming its own capital stock in order to survive in the short-term.

The second fundamental problem of the economy, on the demand side, is that there are insufficient sources of demand for Ukrainian goods and services. Ukrainian households, enterprises and government are poor, so they have few financial resources with which to buy Ukrainian goods and services. As well, foreign enterprises and households, although many are quite wealthy, have little access to goods and services from Ukraine's market. Although increasing the financial resources of domestic consumers can only be a gradual process, opening the economy of Ukraine to foreign demand can be achieved rapidly, with the adoption of sound economic policy.

As a result of these two problems, Ukraine, arguably, is no longer a transitional economy, but rather has completed a transition process into a new type of economy. Unfortunately, it is not the market economy for which they had hoped. The current type of economy can be called **oligarchic socialism**, to contrast it with centrally planned socialism. (By using the word “socialist,” we just mean to indicate some similarities between current economic conditions and those that existed during the Soviet period. Arguably, even the economy of the Soviet period differed substantially from any true definition of socialism.) Oligarchic socialism, or what others have called a virtual economy, is quite unlike a true market economy, even unlike the emerging market economies of Central Europe. Rather, it is perhaps most similar to Central European economies 25 years ago, under what was called reform socialism, or "goulash socialism." Although there are considerable differences between Ukraine today and Central Europe 25 years ago, the two types of economies are similar in that they mixed elements of traditional Soviet socialism and the market, leading to various imbalances and an absence of growth.

Current economic conditions that have developed in Ukraine, and also in Russia, with their peculiar characteristics of arrears, barter and shadow economy, seem potentially quite permanent. Without a radical change in course, despite prior hopes and expectations, these conditions may not be merely a transitional phase in the development of a true market economy but rather a quite permanent condition along a low-level equilibrium path. Table 1 compares characteristics of Ukraine’s economy with the Soviet period and a true market economy.

Current conditions differ from the Soviet period most fundamentally in that decision-making is not concentrated at the center. Decisions regarding allocation of resources are decentralized, made by enterprise managers or sectoral or local bureaucrats. The breakdown in centralized control, which is related to the end of iron-fist totalitarianism, has also allowed the development of a shadow economy where none would have been tolerated under the past system. (This shadow economy consists primarily of small businesses operating mostly along market principles.)

Current conditions are similar to the Soviet period in that budget constraints are soft, many prices are distorted and do not signal relative scarcity, enterprises maximize production and employment rather than profits, and goods and services are “sold” without using money as the means of exchange. These characteristics apply to most old state enterprises and to the budget sphere, but not to some new enterprises that often operate in the shadow economy and are more market-oriented.

In seeking to explain why Central European countries have developed into emerging market economies while Ukraine, Russia and the other large post-Soviet countries have transformed into some kind of a post-socialist hybrid economy, we suggest the following hypothesis. In the Central European countries, new, market-oriented enterprises (mostly small businesses or other enterprises with effective private ownership) became particularly widespread and strong at the early stages of reform. At the same time, the economies were open to international trade and contact with the rest of the world. The new enterprises and foreign companies dominated the old socialist enterprises when it came to setting the overall economic environment. With the relative strength and prevalence of new enterprises, and openness to the outside world, a market environment prevailed. In this environment, enterprises maximize the profits subject to hard budget constraints and pressure from competition and owners, prices give accurate signals of relative scarcity, and money is used as the medium of exchange. Even old socialist enterprises were subjected to this market environment and slowly reformed to meet new conditions. The prevalence of new enterprises and openness of the economies were due both to initial starting conditions and to positive economic policies that were adopted by reformist governments (e.g., deregulation, adoption of market-oriented commercial codes, and general openness).

However, in the large post-Soviet countries, there were far fewer new enterprises, and there was far less openness to the West. Old socialist enterprises dominated, perpetuating the socialist environment of loose budget constraints, poor corporate governance, distorted prices limited competition and barter. A market environment was not created. Instead, even potentially healthy enterprises were corrupted and held back by the prevailing socialist environment. Even potentially profitable enterprises cannot find customers with money and have trouble allocating resources efficiently in the face of distorted prices. Because of tougher starting conditions (fewer new enterprises and less openness to the outside world) and failure to adopt reform policies, these countries have remained stuck on a low-level equilibrium path, having abandoned Soviet socialism but not yet achieving market conditions.

Table 1

Types of Economic Systems

Soviet system	Ukraine today	Market
Soft budget constraints in budget and enterprise sectors	Soft budget constraints in budget and enterprise sectors	Hard budget constraints in budget and enterprise sectors
Promised state programs exceed available resources	Promised state programs exceed available resources	Promised state programs within available resources
Distorted prices, set arbitrarily by the center, do not signal relative scarcity	Distorted prices, set arbitrarily by enterprise managers or bureaucrats, do not signal relative scarcity	Prices, set freely by market mechanism, signal relative scarcity
Enterprises, with weak ownership by the state, maximize production and employment	Enterprises, with weak ownership by the state or dispersed private owners, maximize production and employment	Enterprises, with strong private ownership, maximize profits
Allocation of resources is centralized, directed by the government based on political objectives, unconnected to flows of money	Allocation of resources is decentralized, directed by enterprise managers or bureaucrats based on political or rent-seeking objectives, unconnected to flows of money (payment in barter for goods and services; and arrears)	Allocation of resources is decentralized, directed by enterprise managers, based on profit-maximizing objectives, connected to flows of money (payment in money for goods and services)
Price distortions and soft budget constraints manifest themselves in shortages	Price distortions and soft budget constraints manifest themselves in hyperinflation when monetary policy is loose and in arrears and barter when monetary policy is tight	No price distortions; hard budget constraints
Totalitarianism does not allow much economic activity outside the state sector	Liberalized political climate allows shadow economy—small enterprises and evasion at large enterprises	General economic liberty

Pseudo-stabilization and the lack of liberalization

Many observers point to alleged macro-stabilization (i.e., low inflation and a steady exchange rate) as a chief success of the reform process in Ukraine since the hyperinflation of the early 1990s. Indeed, prices and the exchange rate have been quite stable in recent years.

Figure 1

Annual Inflation Rate, %, 1996-1998

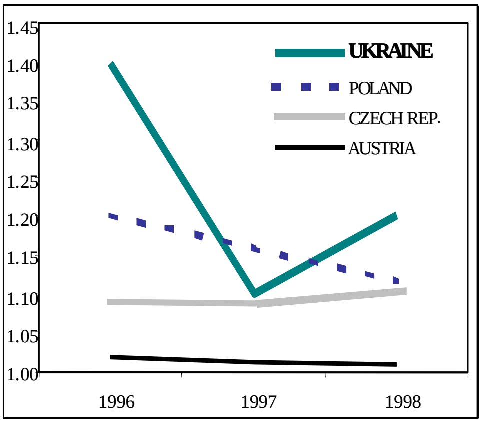
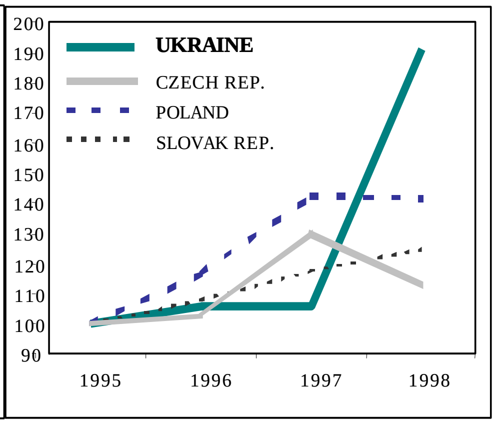


Figure 2

Exchange Rate, Index per USD, 1995=100, 1995-1998



Source: State Statistics Committee of Ukraine.

Under the Soviet regime, prices and exchange rates were also stable. However, it was a false stability, achieved at the cost of shortages of goods and low living standards, and maintained through artificial controls over prices and exchange rates. Similarly, in Ukraine today, the stability is false in that it has been achieved through spending down National Bank foreign reserves, implementing official and hidden controls on trade, and establishing various price controls and soft budget constraints that allow non-market prices.

One can compare the three stages of the Ukrainian economy over the last decade: the Soviet shortage economy, the hyperinflationary economy and the barter/arrears economy. In the Soviet economy, prices were controlled officially, and shortages represented an implicit tax on consumers. In the hyperinflationary economy, prices were non-market prices in as much as constant changes in the overall price level created considerable noise in relative prices, and printing money represented an implicit tax on consumers. In the barter/arrears economy, prices again are non-market prices. An enterprise might agree to a price for a good and then either not pay it (arrears) or pay in kind with another good (barter). In both cases, the prices are not market prices since they do not represent the monetary price customers that are actually willing to pay. Barter and arrears also represent a hidden tax on the population, since people are promised one wage but, because they are either not paid, or are paid in kind with goods whose market price is lower than the nominal price, they receive a wage lower than what was promised. Although many prices in the economy, particularly at the consumer level, are legitimate market prices, actually paid in money, the presence of so much non-market pricing in Ukraine's economy today causes substantial distortions and a lack of transparency in the allocation of society's resources.

The shortage economy, the hyperinflationary economy and the barter/arrears economy are all characterized by a lack of market prices and hidden taxes on the population. In this sense, the current so-called stabilization of the economy constitutes no significant progress from the hyperinflation and shortage economies it replaced.

All three periods involved either high inflation or repressed inflation. In the Soviet period, repressed inflation could be defined conceptually as the inflation level that would have resulted if prices were freed. In the current barter/arrears period, repressed inflation could be defined as the inflation level that would result if enough money were printed to cover the difference between market and nominal prices of bartered goods and services *plus* the nominal prices of outstanding overdue arrears.

It seems, therefore, that the current so-called stabilization of the economy is overvalued in importance by the government and western observers. Stabilization is supposed to be one tool to help achieve economic growth, but it is not supposed to be an end in itself. In the current case, it is worth examining whether the stabilization and the instruments used to achieve it are in fact not harming the economy. The original formulation of the tasks of economic transition, set forth in the early 1990s, was, in order: liberalization, stabilization, privatization and institutionalization. While one might argue about the proper sequencing, it seems that liberalization should come first; and the extent to which stabilization in Ukraine is being maintained through deliberalization of the economy suggests that fundamental economic policies must be rethought.

Issues of political economy also must be considered. The current pseudo-stabilization and deliberalization have created rent-seeking "intermediate winners," who benefit from rents from various controls on financial markets and who have an interest in blocking true liberalization.

Capital and investment

Although hard to measure, the size of the capital stock in Ukraine seems to be declining, and levels of domestic and direct foreign investment are quite low.

Figure 3

Gross Domestic Investment, % of GDP, Ukraine, 1992-1997

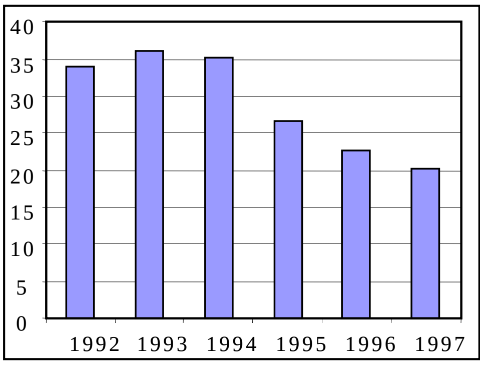
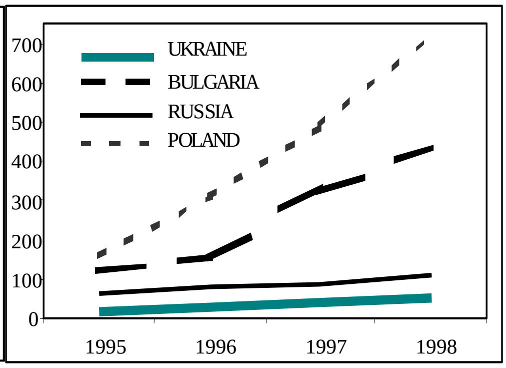


Figure 4

FDI per Capita, USD, Selected Countries, 1995-1998



Source: State Statistics Committee of Ukraine

World capital travels rather freely across borders and would be sent into the economy of Ukraine if conditions were appropriate. Substantial capital exists in Ukraine is, unfortunately, mostly sent abroad at the first chance owners get. The problem of increasing capital in the economy, therefore, is not in identifying potential sources of capital. It also makes little sense to try to identify capital "needs." No economy ever has "enough" capital. All societies always "need" more capital than they have so that they can grow and raise living standards for their people. Attention therefore should be focused on creating proper economic conditions so that both foreign and Ukrainian owners of capital choose to invest their capital in Ukraine. The more capital, the better. Solving this problem brings us back to the general question of adopting sound economic policy.

Entrepreneurship and government stimulation of economic activity

In thinking about how to understand Ukraine's economic problems, it is important to keep in mind where the driving force of economic activity comes from. Namely, individuals seek to maximize their wellbeing; therefore, they work. Those who are particularly gifted with business skills open and manage enterprises. The government does not need to stimulate this desire in individuals. It is there naturally. The task of government therefore is not to determine which sectors of the economy are of highest priority, nor is the task to somehow stimulate people and enterprises to work. Rather, its function must be to remove various barriers and to create conditions under which individuals and enterprises can work. Such an understanding leads to a reversal of the government's role in society, from "initiator" and "central planner" during the Soviet period, to "enabler" during the market period.

Achievements in economic policy since Independence

Since Independence, a number of achievements have been made with reforms of economic policy. The following list presents some of the important achievements.

- Tax payment in kind has been greatly reduced, decreasing the level of hidden subsidies to economy
- Administrative reforms have rationalized economic policy decision-making within the Cabinet of Ministers
- The Chernobyl Fund tax was eliminated, and payroll taxes have been reduced by over ten percent
- Certain zero-rating categories for the VAT have been eliminated
- The tax system has moved more toward accrual method, away from cash method
- The regulatory burden on enterprises has been somewhat eased, with reductions in licensing and inspection, and simplified business registration procedures
- A number of administrative foreign exchange controls have been lifted
- The economy and society have been opened somewhat to the global market, creating opportunities for Ukrainians to travel abroad and to benefit from world commerce
- The state budget has become more transparent, making it easier for experts and citizens to see how public funds are spent
- Much of society's property has been turned over to private hands, where it can be managed more effectively
- The banking system has developed so that it is closer to world standards

These changes reflect the positive results of hard work by the Government and the Parliament in designing and building the political support for difficult economic reforms. Nevertheless, they are insufficient to form a critical mass of positive economic conditions so that the economy can finally embark on a path of sustained economic growth. For such a fundamental turnaround, a comprehensive reform effort is needed.

3. An agenda for economic reform

Introduction

Prospects for Ukraine are not hopeless. Ukraine's potential for development is indeed great. Given its highly educated workforce, its internal ethnic harmony, and its proximity to European markets, Ukraine actually has the potential for dramatic, sustained economic growth, perhaps as high as 10 percent per year for an extended period of time. That which has prevented Ukraine from realizing its potential over the last eight years is inadequate economic policy. If Ukraine is to be successful in fundamentally changing its economic policy, its economic prospects will change just as fundamentally.

Late 2000 through 2001, is an important period for Ukraine. Most of the Central European countries have clearly made the transition from socialism to market economies, and now Russia has adopted a strongly pro-market program, meaning that Ukraine risks falling far behind its neighbors if it is unable to make big steps forward in the near future.

A prescription for policy measures should rest on four pillars, which are designed to address the supply problem (which makes value-adding production too difficult and rent seeking too easy) and the demand problem (which involves opening the economy to foreign demand):

- pressure to reform old enterprises (through the strengthening of private ownership in the long-run and the punishment of value-subtracting activities by the tax system in the short-run – hardening of budget constraints)
- support to new enterprises (through tax relief for value-adding, job-creating enterprises, and through deregulation)
- restructuring of the budget sector to greatly reduce expenditure commitments
- comprehensive opening of the economy to the outside world in order to "import" a market environment (including a monetary and exchange policy compatible with growth and integration into the world economy)

In order to succeed in getting the economy to jump from a low-level socialist equilibrium path to a higher-level market equilibrium path, reforms must be comprehensive and far-reaching. The following four sections provide specific proposals that could comprise a comprehensive reform program. They are meant to orient discussion and contribute to debate. They should not be regarded as a finished program.

The supply problem: Encouraging value-adding production and discouraging rent seeking

Reforming old enterprises: Hardening budget constraints on enterprises and the state sector to prevent transfer of resources from productive enterprises to non-productive enterprises.

Old, state owned, socialist enterprises should be reformed by changing the environment in which they operate, mostly with measures aimed at hardening budget constraints. In the long run, a standard array of policies is needed: improvement of bankruptcy procedures and institutions, determination of a small number of specific enterprises for first bankruptcy actions, continued privatization, strengthening of corporate governance mechanisms, improvement and enactment of contract and other commercial law, etc. These measures, which one might call first-best solutions, seem to have been difficult to implement quickly. Therefore, we recommend another set of measures, which one might call second-best solutions that can be implemented quickly if there is political will and that would put substantial pressure on old enterprises to reform. The goal of such measures should be to harden budget constraints and discourage barter, value-subtracting production and other socialistic economic activity. They are:

- Applying VAT on an accrual basis with provisions to prevent excessive credits in barter and value-subtracting production (i.e., assess VAT liability on an accrual basis on sales, but only allow VAT input credits when inputs are paid for with money)
- Eliminating VAT zero-ratings, especially on energy and imports, particularly for budget sphere
- Permitting no tax or energy payments in kind or in promissory notes
- Reforming budget sector expenditures commitment procedures to increase authority, accountability and transparency in order to prevent accrual of arrears
- Facilitating restructuring of old enterprises by allocating sufficient funds for severance pay to laid-off workers. (Severance pay could be provided to laid-off workers from bankrupt enterprises, financed as a special program funded by the World Bank.)

Supporting new enterprises: Reducing tax rates on productive, job-creating enterprises (in conjunction with elimination of tax exemptions so that revenues to state budget remain roughly constant).

New enterprises should be supported by a substantial reduction in tax rates (particularly those for value- and job-creating enterprises) and extensive deregulation. (By "job-creating," we mean only productive jobs in wage-paying enterprises that add value. Many such enterprises are likely to be small businesses and labor-intensive firms.) The government should:

- Raise non-taxable minimum income to around UAH 200, above which a flat personal income tax rate could apply
- Eliminate most earmarked taxes (Roads Fund, Innovation Fund, etc.)
- Reduce VAT rate to around 15 percent and/or reduce or eliminate profit tax
- Eliminate payroll taxes for social insurance and unemployment (transferring these programs to general budget), and reduce ceiling on wages subject to pension contribution to around UAH 500

Setting a cap on income for Pension Fund contributions means that the state pension system would focus on providing income for lower- and middle-income retirees, while wealthier individuals would be expected to maintain supplemental voluntary pension savings accounts.

Supporting new enterprises: Reducing regulatory burden on economy and increasing regulation of bureaucracy.

Deregulation should focus on eliminating the incentives bureaucrats have for harassing businesses by eliminating their potential financial gains. Again, the government should:

- Require that all regulatory-related fees, fines and other payments be paid through the banking sector, not in cash, and be applied to central budget, rather than to organs collecting the payment
- Reduce the number of bureaucrats in the tax administration and other agencies who have authority for controlling economic activity
- Enact centralized licensing and supervision of regulators to limit the number of people with the right to inspect enterprises
- Allow enterprises to seek various forms of certification and licensing from any appropriate office in the country rather than only from the local rayon, office, creating competition of licensers

Radically restructuring the budget sphere

A legacy of socialism is that the government promises expenditures on programs far in excess of what available resources will allow, contributing to a high tax burden that stifles enterprises. The budget sphere has swollen so far beyond its means that it is essentially bankrupt. Comprehensive restructuring is essential. The substantial tax cuts recommended earlier would require commensurately deep cuts in expenditures. It is necessary to:

- Define expenditure priorities in areas such as social protection, education and health, choosing carefully within these categories (for instance, by increasing spending at the local level for schools and hospitals but decreasing state-level health and education expenditure)
- Eliminate remaining expenditure items, providing various direct and indirect subsidies to the national economy
- Determine an overall expenditure level that is reasonable at the outset, set spending limits for each broad area and make commitments for hiring staff and other expenditures within these limits
- Allocate severance pay to those who are laid-off
- Develop regulations and rules for strengthening the budget process and assigning personal responsibility to managers for ensuring that expenditure commitments do not exceed allowable levels
- Develop professional civil service based on competition for positions, determined by objective criteria

It is essential for the government itself to abide by contracts, commitments and other promises, ensuring discipline and hard budget constraints. Addressing these problems throughout the society must start with the government sector.

The demand problem: promoting an open economy: integrating Ukraine into the world economy to increase demand for Ukrainian goods and increase investment

In order to "import" a market environment, policies should be adopted to open the economy as much as possible to a freer flow of goods, services, currency and people. Although from a legislative perspective Ukraine’s economy is in many ways relatively open, many barriers exist informally, for instance, those due to corruption in the customs services. Therefore, promoting openness of the economy to a large extent means not only legislative changes but also administrative reforms to reduce informal barriers. Some recommended changes and reforms include:

- Eliminating tariffs and non-tariff barriers on export
- Setting uniformly low import tariffs

- Eliminating visa requirements for EU members and North Americans to encourage business and tourist visits, consistent with world standards. (Ukraine, along with Russia, is among the only countries in the world that require visas for Americans. Most countries set their visa policy according to the principle of being as open as possible to any countries from which they seek investment and trade, as long as there is no substantial threat of immigration. Most countries in the world do not set visa policy based on a principle of reciprocity because doing so is not in their own self interest.)
- Accepting certification standards of the EU, Poland, Hungary and Czech Republic
- Reducing administrative foreign exchange controls
- Reforming the customs service by introducing a system of pre-inspection with licensed companies abroad (following examples of other reforming countries)
- Encouraging foreign banks to open fully functioning branches in Ukraine

Some suggest that openness has two sides and that, if excessive or wrongly implemented, it can magnify risks and even obstruct economic growth. However, in the particular case of Ukraine, the risks and obstacles for growth coming from excessive bureaucracy and rent seeking seem much more substantial than risks from openness. Openness, as well as other points of liberalization, increases competition, reduces the power of bureaucracy and diminishes rents.

Prioritization and sequencing of reforms

Although many reforms may be important, successful implementation of a reform program that will improve living standards hinges on choosing those reforms from long lists of possible measures that are most essential to creating a critical mass of change in current conditions and that can be implemented quickly. Other measures could be implemented as a second wave of reforms. In this document, we focus mostly on those measures that should be implemented immediately. Others, particularly those that would make institutional changes in ownership structures, for example, can only be accomplished more gradually. Reforms should be divided into two phases: 1) a comprehensive set of measures that could be enacted by law and decree, all together, as a “big bang” reform in late 2000 or early 2001; and 2) general restructuring and development measures that should be implemented gradually and continuously over the course of 2001, including privatization, pension reform, sectoral reform and development of market institutions.

Table 2
Sequencing of Phases

"Big bang" package of reforms, late 2000 or early 2001	**General restructuring and development, continuous over 2001**
1.a.1. Harden budget constraints with tax and utility policies	1.a.2. Restructure social programs funded by wage taxes
1.b.1. Reduce tax burden 1.b.2. Reduce regulatory burden	1.b.3. Harden budget constraints through enterprise restructuring 1.b.4. Offer social protection for displaced workers
1.c.1. Reduce expenditures in 2001 budget 1.c.2. Reform expenditure commitment procedures	1.c.3. Restructure long-term budget-sphere
2.1. Liberalize international flow of people and goods 2.2. Liberalize exchange policy	2.3. Reform customs service

Factors determining success of implementation of an economic program

In order for an economic program to be implemented successfully, several conditions must be met.

First, particularly in a case such as Ukraine, where the country is caught on a low-level equilibrium path, it is important that the proposed economic measures, when taken as a whole, constitute a critical mass of change that is sufficient for fundamentally altering economic conditions. In the program proposed in this document, the three broad breakthroughs that are set as principal objectives are: 1) increasing opportunities for value-creating economic activity (through large tax-rate reductions on value addition and labor, and deregulation); 2) decreasing opportunities for rent seeking (through hardening budget constraints on enterprises and government due to changes in tax, utility and budget expenditure policy); and 3) opening the economy internationally to tap foreign demand. If these three objectives are achieved, it is hoped that the balance will tip in the economy so that, at the margin, it will be easier to engage in value-creation and harder to engage in rent seeking. As a result, the economy should finally begin to grow rather than continuing to contract.

Second, the proposed measures must be politically feasible. This does not mean that the program must be easy politically, for Ukraine's economy is in a dire state, and anything less than implementation of difficult comprehensive reforms will not achieve a marked change in fundamental conditions. However, the proposed program must be designed so that there are sufficient political winners who might support the program in the face of opposition from those who stand to be hurt by certain measures. In the program proposed in this document, the key winners would be value and job-creating enterprises, which would benefit from substantial cuts in tax rates in the VAT and on labor. Hopefully, their support for the program would be sufficient to counter all the rent seekers who would lose when tax exemptions, loopholes and subsidies were eliminated. The political logic of the program is that hardening of budget constraints represents a big stick, which society might be willing to accept in exchange for a big carrot – tax rate cuts.

Note that in the proposed economic program, steep tax cuts are a central component for two reasons: 1) they would improve the capacity of labor intensive, value-creating enterprises to operate; and 2) they would provide the most important political incentive to support the program.

Third, the numbers of the program must add up. Revenues plus deficit financing must equal expenditures. (Not only must *actual* expenditures and income match, but *planned* expenditures also must be kept in line so that arrears do not accrue.) Any balance-of-payments gap must be filled. And national bank foreign reserves must not be depleted. Toward achieving this goal, steep expenditure cuts and elimination of tax loopholes are recommended to offset tax rate cuts.

Fourth, the process of designing and implementing an economic reform program must be within the institutional capability of government and parliament policymaking structures. This requires careful sequencing and prioritization so that not too many measures are taken on at once, as well as attention to the reform policymaking process. Individuals need training and education to increase their qualifications; governmental structures need re-organization so that decision-making processes are more rational; and civic society must be developed so that there is more demand for reforms from society. These last issues are discussed more in Section Four, below.

Fifth, it must be possible to describe the program with a few conceptual ideas that are clearly articulated to the people and parliament and that have a logical sequencing.

Last, the program must establish the credibility of the government. Measures must be promised and then quickly implemented in full, in order to create a solid reputation for the government. This requires transparency of government actions and promises of measures that can be verified publicly.

4. The economic reform policymaking process

Political and institutional impediments

Large post-Soviet countries are in a Catch-22 situation (i.e., a closed circle). In order for economic reforms to succeed politically, there must be interest groups that support those reforms. However, it is hard to imagine how these interest groups for reform (small-business associations, corporate shareholders, etc.) will emerge before economic reforms are implemented. In contrast, not only did Central European countries at the outset of the reform process have sufficient new enterprises to create a predominantly market economic environment, they also had sufficient pro-market interest groups to create a predominantly pro-market political environment.

In Ukraine and other large post-Soviet countries, there are few small businesses, few true private shareholders, few large value-adding enterprises other than those based on natural resources, and there are also few influential academics educated in market economics. That is to say, there are few clear political allies to fight for reforms. (Although there are perhaps many more of these groups in Ukraine today than during the Soviet period, their numbers are still quite low compared to Central European countries.) Lined up against reforms, however, are a number of influential groups, including managers and shady figures drawing illicit rents from value-subtracting state owned enterprises. In addition to those in the enterprises, there are bureaucrats at all levels of government who have a rent-seeking interest in maintaining the current regime of excessive regulation and taxation. These enterprise managers, bureaucrats and other rent seekers, all of whom might be called the oligarchs of the economy, use their considerable political power to block reforms. The political power of the oligarchs in the large post-Soviet countries relative to that in Central Europe (or, conversely, the relative absence of the political power of pro-reform constituencies) has been a key factor in the slow pace of reforms in these countries.

There are also institutional impediments. Despite a generally high level of education in the population, economics skills are insufficient. Many people in government lack sufficient education in modern market economics beyond short-term training courses, and there are almost no recipients of bachelor's, master's or Ph.D. degrees in modern market economics. This constraint severely limits the ability of the government to design and implement sound economic reform policy. Furthermore, policymaking structures of Ukraine's nascent government, even nine years after independence, are still faced with the significant tasks of reorganizing and rationalizing policymaking processes. Claims to jurisdiction over economic policymaking are made by the Vice Prime Minister for Economic Reform of the Cabinet of Ministers, the Ministry of Economy, the Ministry of Finance, several offices of the President's Administration, and, to some degree, the National Bank and the Parliament. Through such collective responsibility for economic policymaking, everyone is in charge, and yet no one is in charge. It is often unclear who has ultimate responsibility for leading an economic reform effort, nor does anyone accept blame for not doing so. Economic policy lacks internal consistency. As a result, policy statements of the government often reflect a mish-mash of competing, unreconciled contradictory proposals. Without improvements in these areas, it will be hard to design and implement a successful reform program.

Improving economic policy requires a focus on individuals, structure and the process of designing economic reform program.

Individuals

Ukraine needs more individuals who have education in modern economics, in the policymaking process, preferably at the Ph.D. level, but at least at the master's level. Many believe that Latin America developed so rapidly in the 1980s because ministries of finance in many of those countries were not able to acquire talented staff until the 1970s and early 1980s. Most of these staff people had received Ph.D.'s in economics in the United States. This created a critical mass of trained professionals who understood economic problems, were capable of doing necessary quantitative analysis and shared common paradigms and concepts for designing economic policy. Such communities of economic professionals were able to create effective, coherent economic reform programs for their countries.[2] Similarly, Ukraine needs to develop its economic specialists. To the extent possible, Ukrainians with mathematical and English-language skills should be sent abroad for master's and Ph.D. education, and all attempts possible should be made to attract Ukrainians with such education into public service. Western financial assistance should be sought to support such training. Most countries of the former Soviet Union, including Russia and many Central Asian countries, fund programs from their general budgets to send young people to the West for training. Ukraine, too, should consider such a program as an important investment in future economic policy. For the time being, Ukraine can rely on short-term training programs for government staff and assistance from foreign experts to improve economic policymaking capacity, but more serious thought must be given to acquiring the necessary expertise so as to ensure long term success.

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[2] See “Post-Soviet Transition: Problems, Lessons, and Solutions” in this volume.

It is important to influence public policy discourse with modern economic paradigms, concepts and theories. Ukraine must reach the point where there is a critical mass of people in the policymaking community who understand modern economics and think like modern economists and policy advisers. As long as so many people in the policymaking community think along Soviet lines, it will be difficult to generate market-oriented economic policy, as myriad anti-market ideas will constantly be proposed from this non-market-oriented community, in turn subverting compromising the coherence and consistency of economic policy proposed by true reformers. Building consensus and a shared understanding of economic problems, and the policies needed to resolve them would more successfully promote coherent pro-reform policy than administrative attempts at direct coordination. Long-term education in the West, short-term training programs, continual dissemination of Western economic materials, and interaction with Western policy advisers would contribute to addressing these issues.

Structures

Economic policymaking structures need to be organized and rationalized. Primary responsibility for developing economic policy should be given to one ministry, under the leadership of one individual. Consideration should be given to uniting the ministries of Economy and Finance into one ministry and uniting the positions of Minister of Finance, Minister of Economy and Vice Prime Minister for Economic Reforms into one position. Note that in Poland, the positions of Vice Prime Minister and Minister of Finance have often been given to the same person (i.e., Leszek Balcerowicz). This one person and one agency should have responsibility and be held accountable for implementing sound economic policy. No other body of government, or even the president, should put forth economic policy before it has been approved by this agency, to ensure consistency with the government's overall economic program. Such a structure would avoid the current problem in which conflicting economic policies emanate from fragmented, poorly coordinated areas of government.

Process of designing a reform initiative

On the organizational issues of how to design and implement an economic reform program, much can be learned from the government's late 1996, early 1997 attempt to create such a program, both in terms of what to do and what not to do. At that time, under the leadership of the Vice Prime Minister, a large working group was formed to create a package of economic reforms. Subgroups were created for main policy areas: tax, budget, monetary policy, banking, deregulation, privatization and social policy. In each group were government officials, non-governmental

Ukrainian experts and foreign experts. Each group wrote an analysis of problems and a proposed concept for how problems should be solved, after which, specific policy recommendations and draft legal text were written. The proposed package of reforms ultimately failed for several reasons: 1) members of the Parliament and many parts of government were not sufficiently included in the process, so they could not actively participate in shaping the program and therefore they would not support it; 2) top-level political support for the program was inadequate; and 3) legal texts and supporting analyses were inadequately prepared, with insufficient attention being given to building a general understanding of the issues and political support for the proposals. In order for such a large reform effort to succeed in the future, each of these issues would need to address appropriately.

Creating demand for reforms

As a general rule, reforms happen not because foreign advisers recommend them, but because domestic political constituencies demand them. The implications of this political maxim are, firstly, that reformers should design economic programs that promote the development of pro-reform constituencies; and secondly, that in order to succeed, economic programs should provide benefits to sufficient political constituencies, so that there are more winners than losers.

Administrative restrictions on the foreign exchange market have had a strong negative impact on international trade and the financial sector - which are exactly the new, market-oriented enterprises that are the natural allies of reforms. In addition to harming value-adding production, these administrative measures have reduced the political support for future reforms by weakening pro-reform constituencies.

Current policy also works against the second point, given the incremental approach of reforms in Ukraine. The nature of the incremental measures proposed in current programs, such as proposed tax changes, means that certain interests will lose out if the policies are adopted; but there will be few significant winners from such minor changes. World experience with tax reform shows reforms are most successful only when the tax base is significantly widened at the same time that tax rates are significantly reduced – that is, when many privileges are eliminated at the same time that rates are dramatically lowered. In such cases, almost all entrepreneurs and workers are winners and provide political support for the changes. Insignificant decreases in rates will not gain substantial political support, only political opposition from those who lose benefits.

The fact that reforms must not only be top-down, but also bottom-up, suggests that more attention should be devoted to building understanding for and support of the reform program among the population during the reform process.

Transparency and the marketplace of ideas

Promoting transparency is essential for developing a marketplace of ideas in which informed policymakers and citizens can examine the actions of government and outcomes from various policies in order to improve economic policy. This requires increasing the quality and accessibility of statistics, and developing institutions for policy analysis both inside and outside government.

5. Conclusion

Although the tasks outlined here seem daunting, they are certainly possible. Ukraine is a country of highly educated people, without significant ethnic or political conflict, positioned at the edge of Europe's integrated markets. With serious effort at overhauling economic policy, significant sustained growth and improvement of living standards in Ukraine are clearly within reach.

Openness, Distortions, and Growth

Janusz Szyrmer

For the last twenty years, we have witnessed a worldwide gradual convergence of national economies and fast growth. The speed and intensity of contacts among people have increased greatly as a result of the rapid development of communication and travel. Societies and economies have become more open and more interconnected. Those countries that actively promote contacts with the rest of the world tend to grow faster than those countries that opt for isolation and protection. The fast economic growth in East Asia, Latin America, and more recently in Central Europe and in some African countries was related to policies of openness and active participation in international life. Promotion of trade,[1] tourism and other foreign exchange facilitated growth and faster convergence of national economies with more developed Western nations.

The growth of East Asia was driven by human capital advances and trade. Thousands of young Chinese and Koreans were sent to the US and Western Europe to study economics, public policy, and business.[2] Large injections of foreign funds, combined with vigorous imports of western advanced technology and marketing, made East Asian products competitive and stimulated exports and further investment and growth. Foreign travel and tourism have also played an important role in this process.

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[1] Not only exports but also imports should be promoted. Imports stimulate exports, foreign investment, and international contacts.

[2] See the section on education in “Post-Soviet Transition: Problems, Lessons, and Solutions” in this volume.

The success of Polish transition was made possible by social and economic openness and standard market reforms (stabilization, liberalization, and institutions). Poland welcomed international organizations, foreign investors and visitors, Western economics, policy advisors from the highly developed countries, and well tested market institutions. Among other things, Poland unilaterally cancelled visa requirements for US citizens (and for several other nationalities), in spite of the fact that Poles still need American visas to travel to the US. Another important element of the Polish openness policy at the early stage of transition was a cheap, systematically depreciated currency. This policy stimulated frequent visits of Germans, Americans, and other foreigners. It has helped trade and promoted foreign investment. Currently, about 80 million foreigners visit Poland annually. Many of them arrive just for shopping. This over-the-border trade has augmented Polish exports by $3-8 billion annually. This trade has enabled more imports, investment and jobs, higher wages, more tax revenue for the government, more income for the people, more consumption and growth. Between 1993 and 1999, Polish official foreign reserves increased seven times (from $4 billion to $28 billion) and they stand at approximately $26-27 billion; exports almost doubled (from $14 billion to $27 billion); foreign direct investment stock grew 19 times (from $2 billion to $39 billion).

Opening up of the Czech Republic was consistent with the liberal economic policies of this country. The Czech Republic has reduced formalities at the border to a bare minimum. Czech trade has grown significantly. The government welcomed tourists and encouraged Czech residents to travel abroad. The policy of "friendly borders" was reinforced by the very needs of life. Every year the border of the Czech Republic is crossed more than 350-400 million times by people arriving to and leaving the country. Without friendly borders, the Czechs would have had to turn into a nation of entry and exit visa producers, border controllers and custom inspectors to handle such a crowd; there would not have been enough people to take care of the tourists and there would be no income from this industry. Tourism turned into a major source of hard currency. The revenue from tourism has helped the Czech Republic to significantly develop its service sector (which was gravely underdeveloped before 1990), build its foreign reserves, maintain a stable currency and defend the country against the threats of financial crisis due to a still weak and vulnerable banking system.

The openness helps growth and facilitates learning and reforms. Less developed countries are learning from more developed countries about market institutions and about doing business. The existing system in developed market economies is a product of a long evolution. Its current shape is not an accident but the result of a long process of learning-by-doing, through trial and error. Therefore those countries that are willing to adopt this system are able to take advantage of the existing experience. They gradually move toward Western economy practices and standards of technology. By making their economies more efficient, they experience fast economic growth. Those countries that decide to experiment with their own policies, which are different from those dictated by the international experience, tend to reinforce the existing differences and widen the gap between themselves and the rest of the world. Their economies are unable to achieve sustained growth. Sooner or later they may have to join the crowd and to implement standard policies but the delay in this implementation may bring about crises and problems with growth.

Globalization and convergence are two processes that have dominated international economics for the last ten years. We have been witnessing a global trend toward similar economic activities, similar consumption patterns, similar institutions, and similar policies in many countries worldwide. Some developing national economies seem to be getting closer to what John Von Neumann called "turnpike growth," a steady state growth along a pre-defined path at an optimal speed that reflects the existing economic structure.[3] Those countries that for some reason deviate from certain "optimal" proportions would tend to grow at slower rates and experience different kinds of instabilities. These optimal proportions are defined by international experience by means of a majority rule: a large number of growing economies display similar levels of and relations between major economic indicators. These "best practice" proportions gradually emerge from millions of institutional and policy experiments which in many countries are run on a continual basis.

In economics, distortions are defined as deviations from best solutions, i.e., from efficient solutions. Given certain criteria (such as social utility or profit maximization), no better alternatives to these solutions exist. An optimal structure is an efficient structure, or equilibrium structure. A distorted structure is unstable and inefficient. It remains "out of balance" because its relationships (its proportions) are not right and ultimately this results in bad economic performance. For example, consider an economic structure with an oversized steel and machine industry and undersized services, including undersized banking and marketing. This economy produces a lot of steel and machinery but is unable to sell its products because its sales capacity is not sufficient. A large part of steel output remains unsold. The industry

[3] "*John von Neumann and Modern Economics*," ed. by Mohammed Dore, Sukhamoy Chakravarty, and Richard Goodwin, Oxford: Clarendon Press, 1989.

does not have enough income to pay its workers and input suppliers. Bank credits are not easily available. The result of such a distorted economic structure is not hard to predict – output declines, wage arrears and inter-industry arrears increase, tax income diminishes, and an economic recession occurs. A distorted economic structure corrupts the whole economy and hinders growth.

A comparative structural analysis can help in spotting and measuring distortions, although in certain cases hard evidence may never be found. In some cases structural distortions are evident. In many cases, however, they are less obvious. Nevertheless, given the body of international experience, one can argue that a country likely has structural distortions if it appears consistently to be an outlier in terms of certain structural indicators. This happens when a country begins to stand out, to deviate significantly from an average computed for the majority of similar countries. Often this suspicion of distortions can be supported by performance analysis. If the outlier country happens to misperform then the distortion hypothesis is confirmed.

Without a well operating market the economy tends to be permanently misaligned. An economy without transparent and strong property rights, which lacks contract enforcement capacity, which is, at the same time, undertaxed and overtaxed as well as underregulated and overregulated, cannot be efficient because the result is paralyzed production factors and corrupt economic activities. The country ends up being micro-managed by government bureaucrats who make everyday economic decisions, despite the fact that they lack the necessary information (and often motivation) and, therefore, they are unable to create a well-balanced economy. Structural distortions are unavoidable. In turn distorted prices do not reflect marginal scarcities and send wrong signals to producers and consumers. Investment funds are not directed to most efficient producers. There is always too much of something and not enough of something else.

Soviet economy was a relatively closed and highly distorted economy. It was run by a huge bureaucracy and suffered from pervasive structural distortions in prices, industrial output, knowledge and education (human capital), investment (physical capital), and trade (“anti-import” policies). Gradually an accumulation of distortions disabled the capacity for economic growth.

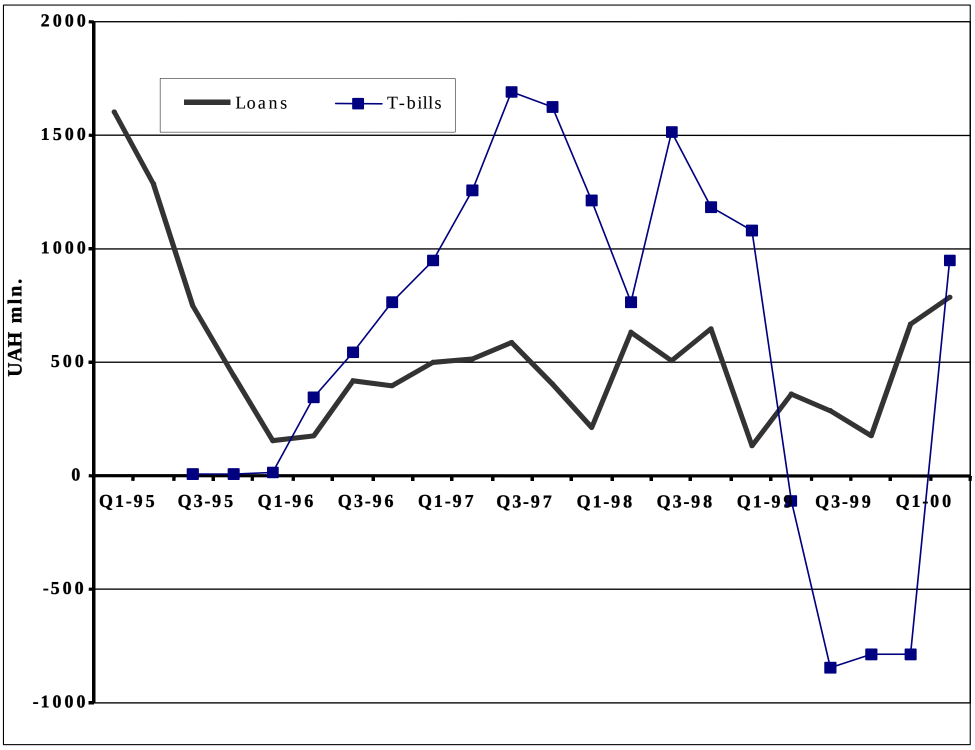
A major task of the transition period is to remove, or at least reduce, some of major distortions, and enable the economy to grow. The recent experience of other transition economies suggests that this task is very difficult to implement the necessary reforms without opening up toward other countries that are more experienced in market economics and transition. A large scale import of knowledge, institutions, and technology is necessary. Experimenting with untested "original" ideas and pseudo-reforms is expensive and likely to result in more distortions and less growth.

Examples of structural distortions in the Ukrainian Economy

A market economy cannot work without money. In Ukraine the banking system remains weak. Credit market is underdeveloped. In Harvard/CASE database one could not find a large country with a lower volume of bank credit than Ukraine. As shown on Figure 1, even the changes in state domestic debt (T-bill operations) do not have much effect on the commercial credit market. In 1996-98, financing the fiscal deficit by means of T-bills was blamed for crowding out investments into the economy. In 1999 the T-bill market practically discontinued, yet the credits remained at a very low level. This level is a grave distortion, which hampers economic development. Its cause is not budget deficit but something else.

Figure 1

Use of Credit Funds: Commercial Loans, UAH million, 3-Quarter Average, and T-bill Investments, UAH million, 3-Quarter Average, Q1-1995 - Q2-2000

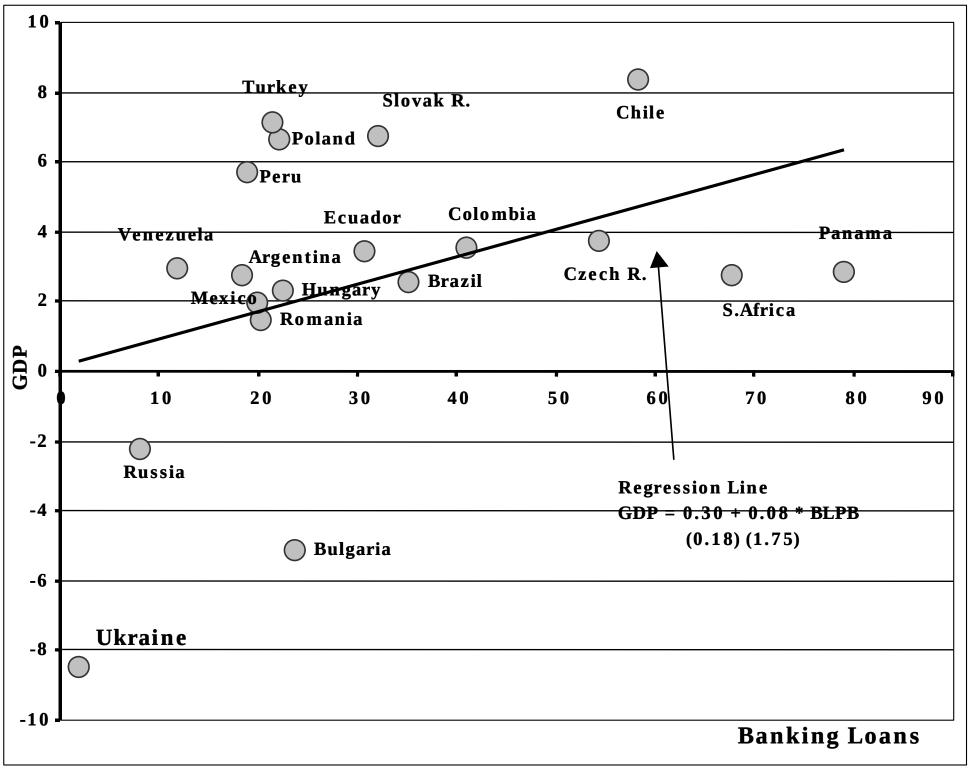


Source: HIID database.

Figure 2 shows the relationship between bank credits and GDP growth. For this diagram data from *Emerging Markets Quarterly Outlook*, Chase Securities, Inc., International Fixed Income Research, September 18, 1998 was used. The data for all the countries covered by this report was included. Ukraine's position, in comparison with other countries, was not good. The diagram shows that in the years between 1995-1997 Ukraine had the lowest average GDP growth and the lowest average bank credits (expressed as percentage of GDP) provided to enterprises. What the figure does not show is that among these developing countries Ukraine has the lowest GDP/capita, in terms of both exchange rates and purchasing power parity. Also, it does not show that a large part of bank credits in Ukraine was not provided through normal credit market but was allocated through government decisions “to help the enterprises in need” and through different kinds of (non-market) linkages between firms and banks.

Figure 2

GDP, Percentage Change, and Banking Loans to Private Borrowers (BLPB), Percent of GDP, Annual Average, 1995-1997

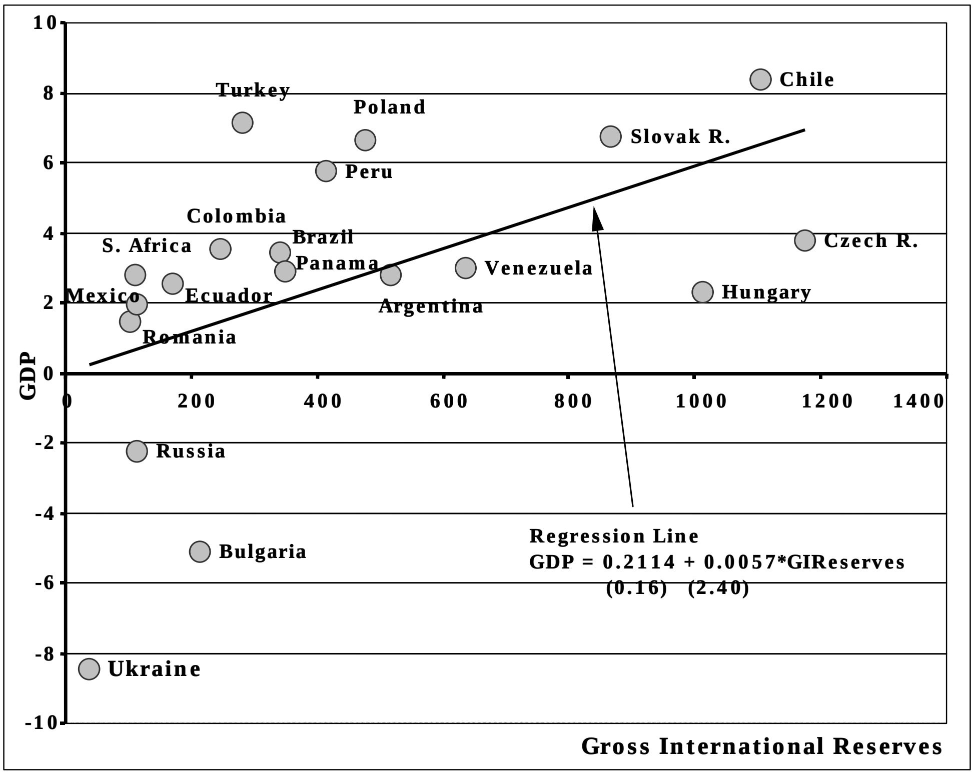


Source: "Emerging Markets Quarterly Outlook" – Chase Securities Inc., Sept. 18, 1998

Figure 3 shows the relationship between the growth of international reserves and GDP change (for all countries covered by *Emerging Markets Quarterly Outlook*, 1998). Again, Ukraine appears as the country with the lowest growth in its reserves (which are an important factor for macroeconomic stability) and the greatest decline of GDP (negative macroeconomic growth). In this case, fiscal deficit is an obvious cause of the low reserve level, which undermines stability of the Ukrainian economy. Higher deficit means larger debt and lower reserves. Lower reserves mean less stability, higher investment risks, and a more expensive debt. The high cost of debt means more debt and fewer reserves, and so the cycle is perpetuated.

Figure 3

GDP, Percentage Change, and Gross International Reserves, USD per Capita, Annual Average, 1995-1997

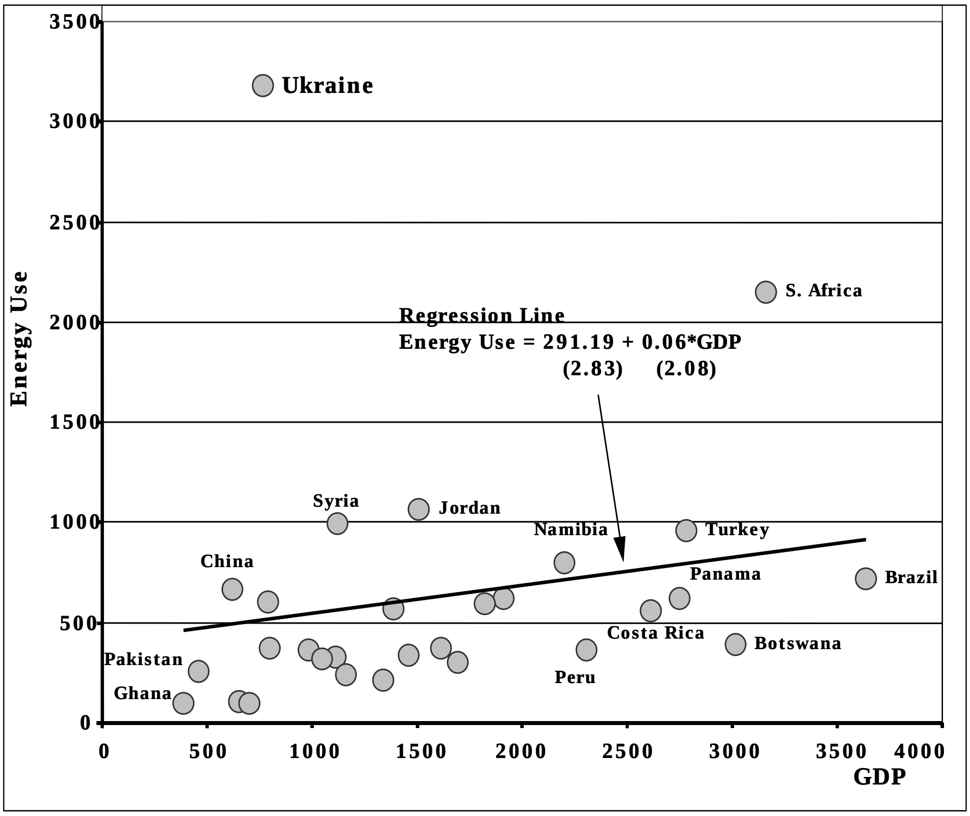


Source: HIID database.

Another diagram (Figure 4) presents the use of energy among countries with a GDP level similar to that of Ukraine. A very high use of energy in Ukraine reflects distortions in economic structure (too much energy intensive heavy industry), distortions in technology (the use of energy wasteful technology), and distortions in foreign trade and price structure (relative prices of energy in Ukraine are too low; several tax exemptions apply). This energy mismanagement hinders growth.

Figure 4

Energy, Use per Capita, kg of Oil Equivalent, and GDP per Capita, USD, 1995

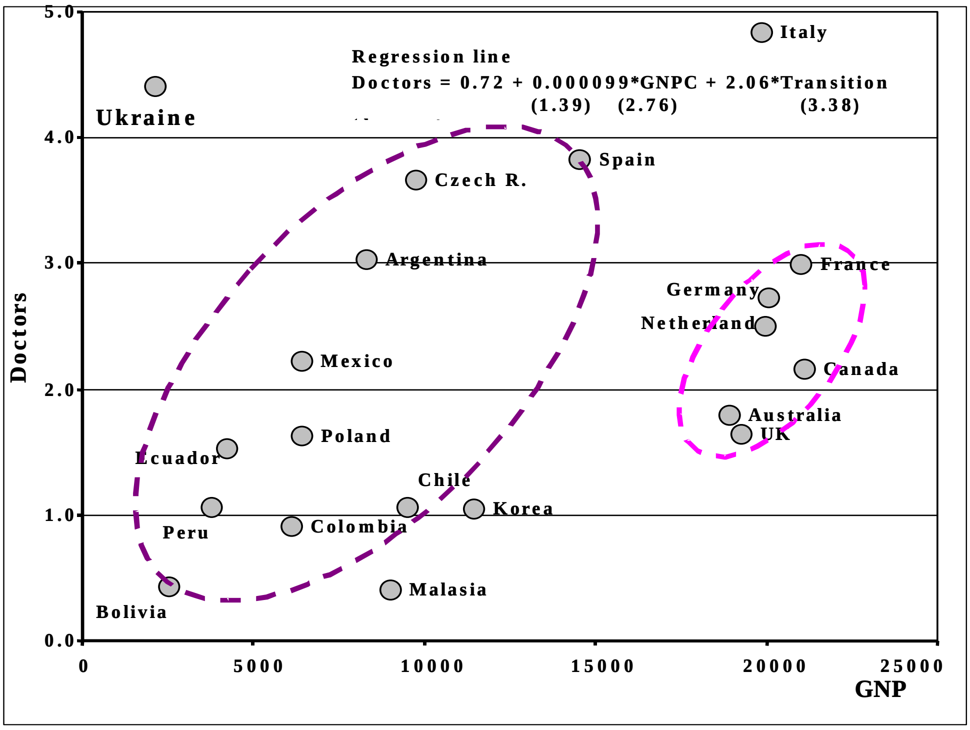


Source: World Development Report – World Bank, 1997

Another comparative study is concerned with occupational skill structure in different countries. Figure 5 shows the number of medical doctors (per 1000 people) in a group of countries. This number is higher for Ukraine than for any other country included in this study, except Italy. It is 10 times higher than in Bolivia, 3-4 times higher than in Chile, South Korea, and Poland; and twice as high as in Mexico, Canada, and Germany. These figures illustrate significant distortions in the human capital. There are too many physicians, engineers and scientists. There are not enough highly qualified public servants, policymakers and policy analysts, bankers, managers with market experience and marketing experts, and other occupational skill categories necessary for financial sectors and services. These distortions were inherited from the Soviet Union. Yet, following independence many of them have not improved. While output, budget revenue, and health care expenditures declined greatly, the number of doctors remains high. State budget can not afford to pay doctors decent salaries or to provide equipment, instruments, medicines, etc. necessary for their work. The result is low level of medical services and a high mortality rate, degradation of the medical profession, wage arrears, shadow economy, and corruption. This is a high price for the sluggishness of institutional reforms and bad policies.

Figure 5

Medical Doctors, per 1000 Population, 1997, and GNP, Expressed in Purchasing Power Parity, 1997[4]



Source: World Development Report - World Bank, 1997

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[4] Contains countries that satisfy the following requirements: population - between 10 million and 100 million, urbanization - between 50 percent and 90 percent, mineral + oil export less than 50 percent of total export.

Economic Transformation in the NIS and Failure of the Washington Consensus: More Questions than Answers[1]

Vladimir Dubrovskiy

1. Introduction

Transformation in the global historical context of modernization

How can we explain the limited success of attempts to foster economic reforms in the NIS (New Independent States – former Soviet countries, except the three Baltic States), as well as Balkan countries? My hypothesis is that, at the first and most important stage of reforms, a vast majority of Western advisors and politicians essentially underestimated two major aspects: institutional/behavioral issues and political economy issues. These two issues, of course, are closely connected, and both of them require extensive concepts not only from economics but also from other disciplines. By taking into account these issues, one could design a more appropriate strategy and tactics for reforms, as well as evaluate more realistically the results they yield. It should be mentioned that many recently discovered or

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[1]This chapter is the result of numerous fruitful discussions and research conducted over the last three years within the study "Microeconomic Foundations for Macroeconomic Policy", as part of the Harvard/CASE Ukraine Project in Kyiv. In particular, I wish to express thanks to Alexander Paskhaver, President of the Center for Economic Development; Tamara Shigaeva, Ph.D. in Economics; Vladimir Zolotaryov, political scientist and politician; William Graves; and Alexander Pivovarsky, post-graduate student at Harvard University. Many thanks to David Snelbecker for attentive editing and Arkady Toritsyn for useful comments. Special thanks go to Prof. Janusz Szyrmer, Head of the Harvard/CASE Ukraine Project, who not only established HIID's presence in Ukraine, but also made the most significant contribution through his ideas. The author accepts full responsibility for the content and elucidation of these ideas. The first version of this work was published in Russian as Dubrovskiy (2000).

re-discovered truths and revelations along these lines have been self-evident to many "insiders" for several years, even despite the shortage of literature on these issues. But scholars from the NIS had neither enough knowledge, nor enough authority, to develop and implement their ideas, or even to put them within a standard academic framework. Moreover, they often followed Western advisors along misleading tracks.

But why were these oversights not corrected? Why were political and institutional economics mostly ignored? The mainstream neoclassical macroeconomic approach has several shortcomings. It assumes that (i) market players always behave in a rational, wealth maximizing, manner, and (ii) institutions operate perfectly. These two factors together create an "invisible hand", a self-regulating mechanism that maximizes efficiency at the micro level, forces adjustment in market behavior, and, finally, makes the reaction of agents predictable (although not fully automatic). Consequently, well designed macroeconomic policy should be a necessary and sufficient condition for growth. Paradoxically, this approach is similar to the Soviet economic school, which was inclined to regard the economy as a perfectly managed system, where economic policy, as far as this term is applicable to the planned economy, automatically leads to the establishment of pre-set targets. Thus, both approaches converged in their obstinate reluctance to take into consideration microeconomic, institutional, political, and behavioral factors.

This similarity in Western and Soviet thinking was just the reflection of adaptability in the real world. The "Washington Consensus" about economic policy, which was imposed by International Financial Institutions (IFIs) was regarded as necessary and sufficient to convert the former Soviet bloc countries into market economies. While this really happened to some of them, the post-Soviet economic systems have found a way to co-exist with macroeconomic stabilization while preserving unchanged some traditional institutions which were incompatible with the market. At the same time they actively and effectively resisted attempts of implementation of fundamental institutional changes.[2]

Another aspect of the reform process that has largely been neglected is the political feasibility of "good policies," meaning those that are well designed from a purely economic perspective. Economists who had appealed for "political will" in order to realize policy change have come to understand the institutional weakness and limitations of their perspective. Here it is necessary to consider that policies must be implemented by a government that is often captured by "intermediate winners" (Hellman, 1998), that is, those individuals

[2] For instance, Ukraine has successfully met almost all of the 41 benchmarks of the IMF "stand-by" program by 1997. Just a handful of them were not met, and "deregulation of business activity" was among them.

who are least of all interested in change. The latter are able to considerably distort any kind of proposed policies, so one should always bear in mind the necessity for sufficient political support. Many observers such as politicians and journalists, both in the West and inside the NIS, explain this failure in one word: corruption. As we will see, this seems to be an oversimplification because this approach does not allow us to effectively understand policy implications, and it may be misleading. Rather than looking at corruption *per se*, causes of corruption in transition economies should be addressed.

The inability to realize economic growth in Russia and Ukraine through monetary stabilization methods that worked in Central Europe has brought greater attention to the institutional aspects of reforms. Better late than never, it has become generally accepted that in transitional economies, especially the post-Soviet type, macroeconomic restrictions are not as a rule the critical element constraining economic growth. Reversing economic decline and bringing about sustainable growth depend primarily on microeconomic and institutional factors (see, for instance, Guriev and Ickes, 2000). Consequently, "one of the key aspects of reforms is related to institutional building... Market reforms are effective if they are able to create the necessary institutions for the functioning of a market economy" (Campos and Coricelli, 2000).[3] Accordingly, the Washington Consensus formula was (rightly) amended by institutional reforms (the so-called post-Washington consensus). So, institutions should be regarded as the main object of reforms. However, few experts could claim to know the quickest and most feasible way to establish them. The nature of major impediments to institutional development is not just economic, but also sociological, psychological, anthropological, political, and even technological.

Until recently, scholars and policy analysts had focused their attention mostly on the issue of the speed of reforms. The discussion between adherents of "shock therapy" (Sachs and Lipton, 1990; Balcerowicz, 1995) and "gradualists" (for instance, Stiglitz, 1999) could be viewed as a main battle among the experts in transition. In general, the gradualists paid more attention to the role of market institutions and political factors, and fairly pointed out that their development always takes time. However, there are few possibilities to create appropriate and effective market institutions without the implementation of sound, comprehensive, and quite radical reforms due to the strong systemic inertia (Snelbecker and Novoseletsky, 1999). So, the hard question is how to break this vicious circle. Although both sides give a lot of evidence to support their views, such as initial performance and

[3] The outcomes of McKinsey (1999) consultants who concluded that Russian enterprises could increase labor productivity three-fold at the expense of updating "institutional capital" could serve as an indirect evidence for that conclusion.

indicators that characterize institutional development (like scores in world indices of corruption, etc.), the dilemma of how to break the cycle remains. In my opinion, the main oversight here is the assumption that institutional factors, as well as economic policy, are exogenous. Rather, I would suggest that they are determined by sociological and cultural circumstances that, in turn, partly depend on economic performance and dynamics.

So, the very first question to be answered is, which of the factors that determine economic performance in transition are "the most exogenous"? I do not claim to know the answer, but I believe that it can best be found if we regard the transition from central planning to a market economy in a broader perspective, that is, as an element of an overall "modernization" of society as a whole. In this context, I use this term to mean the process of moving from a "traditional society" (that is, one based on extensive and pervasive taboos, a collectivist view of the world, xenophobia, and predetermined places for individuals) to some sort of "modern society" (that is, one based on rational regulations, pluralism, tolerance, and formal relations between emancipated individuals, who enter into based on open associations according to their own economic or other personal preferences). Modernization destroys traditional societies by breaking existing (conservative) ties and promoting emancipation of individuals, including accumulation of wealth and increased significance of individual preferences in consumer demand (Eisenstadt, 1966). According to this point of view, the events and phenomena that are currently taking place in the NIS become more understandable if their origin is traced not to the end of the 1980s, but rather to the middle of the last century or even the 18th century when the modernization of this region began.

In Part 2, the link between modernization and evolution from rent[4] seeking to profit seeking is examined. As a result, the current processes observed in the NIS are put into the broader context of economic history, as well as human history. In Part 3 the pre-transitional stage of the transformation process is described within the framework of an "economy of (informal) favors", or "administrative market", with which late-Soviet social and economic relations are analyzed. In Part 4, human rational motivation is investigated. Specific institutional environments in several important cases are considered. The observed behavior of people is analyzed to explain why in Soviet and transition systems economic actors diverge significantly from the narrow meaning of *homo economicus*[5]. The stability and evolution of these systems is

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[4] There are several similar definitions of rent income. For the purposes of this chapter, I will use the definition of rent as any income resulting from wealth redistribution rather than wealth generation.

[5] Here and afterward I mean the assumption that the individual is motivated exclusively to material wealth's maximization.

considered. As demonstrated in Part 5, the path of this evolution unavoidably goes through the phase of pervasive, systemic corruption and the capture of the state by groups of vested interests ("state capture", as it is called in EBRD, 1999). These phenomena are inherent to transitional society and cannot be changed without addressing fundamental issues. The very nature of corruption here is different from that of the mature market economy. Finally, Part 6 is devoted to the lessons from the Washington Consensus' failure to cope with the problems of the NIS in light of the analytical framework developed here.

Most of the concepts described are intuitive hypotheses rather than theories, in the sense that they still lack comprehensive empirical proof. Yet, if they are true, there are still a number of issues to be clarified in order to apply this framework for economic and social policy design in transition. Accordingly, the paper is concluded not only with direct policy implications, but also with a set of questions and tasks for further research. Some of these tasks are already in process, and I hope to report the first results in the near future.

2. Power and wealth: creation or redistribution?

Modernization (in the above mentioned meaning) can be viewed from the economic perspective as a transition from rent seeking to profit seeking. The very nature of traditional society is to ban any entrepreneurial activities, and, respectively, not to allow economic profit generating. In the "perfectly traditional" world, the rent is the only means for accumulating wealth beyond minimal personal income like one that could be generated by self-employment in primitive agriculture. At the same time, some sources of rent, such as inherited power or monopoly, are sanctified by tradition. Of course, the very same tradition, in turn, strictly limits the tangible amounts of these rents, but it alters neither the nature of wealth, nor the public's perception of it. Not surprisingly, powerful strata try, first of all, to remove these obstacles to the accumulation of wealth. That could be the reason why the first stages of modernization everywhere in the world are characterized by a sharp increase in the visible flows of rent. This is also the reason why rent seekers and their advocates like so much the concept of "primitive capital accumulation".

These rent seekers break the barriers to wealth accumulation, and in doing so they partly remove main obstacles to profit seeking activities. Thus, nevertheless one could observe increasing rents, the share of rents actually becomes lower than it was under a purely traditional society - they just become more transparent. As time goes by, rising visible rents increase the demand for the establishment of limitations, which ultimately comes from the public control of civil society. The increased control by the public serves to reduce rents while allowing for profitable activities. Although this final stage (namely mature capitalism) has been studied in depth, the intermediate phases that precede it deserve more attention from researchers, especially given the accumulating experiences in other countries.

This approach could be applied to explain the observable differences between European transitional economy countries in the historical context. The process of modernization fosters a well known sense of psychological discomfort in people who have a more traditional paternalist way of thinking. Taken together with the sharp increase in visible rents, this creates severe political tension. Under the right circumstances, communist or traditionalist political movements can even assume control, as was the case in Russia in 1917, Germany in 1933, or Iran in 1979. But from the perspective of economic behavior, these and other similar revolutions did not set up systems of rent seeking, but rather transformed the existing ones without touching their essence. It is a noteworthy fact that there has not been a single successful communist or fascist coup attempt in countries where profit seeking is prevalent.

Thus, the fundamental reason behind the successful 1989 revolution in Central Europe, and their subsequent economic progress, as well as the fact that in these countries there were no successful communist coups is just the same. This was simply because they had already moved forward on the path to modernization,[6] and in the economic dimension, from rent seeking to profit seeking. This fact is supported by the case of the Baltic countries, which, in spite of a different political origin, are developing in a fashion similar to that of Central Europe,[7] far more quickly than other former Soviet states. On the opposite end of the spectrum are the Balkans, an area that is composed of countries that were never part of the USSR, but that lagged behind the countries of Central Europe in their degree of modernization prior to World War II, and according to their factor conditions, more closely resemble Russia and Ukraine in their current institutional and economic development (EBRD, 1999).

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[6] V. A. Skuratovsky drew my attention to this fact.

[7] Other important factors include: (a) relatively shorter period of living under the communist system - in all these countries there are people who used to be owners of property and industry, who represent the previous elite, and who, pass on certain traditions and forms of conduct; (b) residual small business, and a lower degree of collectivization of agriculture, especially a large private sector in Poland; (c) greater openness of the society for making international contacts (see: “Openness, Distortions, and Growth” in this volume); and d) less severe “purges” and absence of *golodomor* (famine) unlike in Ukraine, for example. These and other factors affect the degree of modernization.

3. "The economy of favors" as a pre-transitional system of pseudo-market relations

In the NIS we witness a very interesting mid-phase of modernization. I will use the framework of an economy of favors, developed by Soviet dissident Lev Timofeev in the early 1970s, to analyze it. Actually, some well known scholars have invented related concepts independently (see, for instance, Kornai, 1990), but in my opinion, Timofeev's framework remains very attractive due to its explicitness and internal coherence. Being initially developed for the purpose of explaining the Soviet society and economy, it could be easily generalized since the Soviet planned economy was just a particular case of a rent seeking system, having much in common with a medieval feudal system.

The following is a brief summary of the core concept of the Timofeev system. Informal power in the traditional or, rather, semi-traditional society could be viewed as analogous to capital by the degree to which it allows its owner to generate various favors, that could be considered to be analogous to the goods in the regular market economy. By bartering these favors with other players their owner may consume them (hence gaining an administrative rent),[8] or invest, for instance through granting the favors to some influential person. The fundamental difference in a political market is precisely this: the favors are always personal, there is always a specific person who gains the favor, and he/she is positioned either above or the same level as the granter.[9] So, the deeds that are aimed at increasing the common wealth matter only as far as they benefit the "top". Fundamentally, both capital and goods in this system are based on personal relations, and in this way it is essentially the same basis as in traditional society. However, in contrast to the traditional society, this system is partly open to some kind of competition and, to some extent, to growth: the owner may enhance the capital if he/she is thrifty and makes wise investments, or deplete it by excessive consumption and wrong investments. Such economy can be viewed as a sort of market[10] although with low efficiency caused by high transaction costs and non-transparency.

Naturally, all participants of this game are motivated to maximize the value of their wealth, which is comprised of capital and goods. To maximize the value of goods (favors), they need property rights and other formal institutions to be as unclear as possible, and

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[8] That is, a rent the person can gain due to the administrative control he/she has.

[9] A favor could be also targeted to a person at a lower level, if this person is considered to become useful in the future.

[10] Using Marxist terminology it is possible to describe the dialectics of "wealth accumulation" within this kind of economic relations as "power>favors>power+".

formal laws (if they exist) must be ineffective, inconsistent and "counter-natural" in order to keep all players beyond the boundaries of any formal regulative framework. This makes all the players susceptible to discretionary power of various individuals (Paskhaver, 1999). To maximize the value of the capital, participants need institutions that are currently in force to be kept informal and nontransparent (Zolotaryov, 1999), which provides them with power over outsiders, who lack the knowledge about intricate rules of this game. Thus, the wealth maximizing strategy of individuals encourages non-transparency.[11]

By what means are these power and favors implemented? Within the early feudal system, military force, and, respectively, military service played a key role, but the Soviet Union pretended to be a lawful state. Within this kind of lawful system, *compromat* (a dossier of discrediting materials) and, correspondingly, the possibility for criminal prosecution based on these materials were the main weapons. Any person was governable to the extend that he/she violated the laws, but these laws were, as I have already mentioned, designed in a manner that nobody could perform any substantial activity, especially economic, and still remain fully within the boundaries of legality. This tradition is flourishing in the NIS.

What is most important from the economics perspective?

- Favors are a part of the mechanism for "sharing the pie", a game with a zero or negative sum, so this system is essentially rent-oriented. Rents act as a form of conversion of power into material benefits to the extent that these benefits are necessary for the participants.
- The players are encouraged to reduce transparency, thus doing substantial harm to the economy. Many examples of this activity are given by scholars.[12]
- As long as personal power over people is the most valuable and capitalizable good in this system, it is rational for players to hamper modernization and any kind of openness by as much as they can.

Importantly, within the pure economy of favors, power could be relatively easily converted into material wealth, but not vice versa. In addition, while gaining rents, players must break the (formal) law, thus weakening their positions. Furthermore, if the player seeks to gain an amount of rent that is considered to be excessive according to informal rules, he/she loses capital. So, money is not the most

[11] Szyrmer was among the first who have identified this issue in Ukraine.
[12] See "Ludwig von Mises: an Anti-Socialist Prophet" in this volume.

liquid good for many purposes, unlike in a standard market economy. Therefore, the actors are interested in the habitual in-kind barter with favors rather than in monetary and other material transactions. This situation tends to change over time, as will be described below.

4. Motivation and economic behavior of enterprises in the Soviet and post-Soviet economies

What has motivated individuals and enterprises in the Soviet and post-Soviet type economies of favors? What are the attitudes towards risk taking, investment, ownership, and bankruptcy? The mainstream economic approach often fails to explain these issues. I put forth the hypothesis that the approach that essentially relies on the concept of *homo economicus*[13] is one of the main reasons behind this failure. For instance, Boyko, Shleifer and Vishny (1995), assumed directors of Russian enterprises to be able to change their economic behavior completely, if put under pressure of right economic incentives. Such a simplification deserves criticism for various reasons. But what approach should be used instead? I will try to provide some suggestions concerning the possible solution of this problem, and describe in brief the outcomes.

People's motivation is studied not only by economics, but also by psychology, sociology, and the marketing science. All of them concur in the basic thesis that the individuals are motivated to maximize personal utility, which means the satisfying their needs by some particular means, like a consumption of specific goods. As stressed in the marketing science, these means are a function of both universal internal human needs (systematized by Abraham Maslow and his followers), and various aspects related to people's cultures and other environmental factors.[14] For example, few Europeans would decide to satisfy their need of food with dog's meat, whereas in some Asian countries this meat is considered to be delicious. In this context, individuals maximize their wealth not only as a stock of goods but also as a utility by itself in its role to satisfy certain specific nonmaterial needs. This role strongly depends on the institutional factors (the culture), thus differ substantially among different societies as described in the Table 1.

[13] Here and afterward I mean the assumption that the individual is motivated exclusively to material wealth's maximization.
[14] See, for instance, the well known Kotler's (1984) textbook for details.

Table 1

Motivation in Various Economic Systems

Means of satisfaction / **Needs (By Maslow)**	**Developed society/ market economy**	**Medieval society**	**Late Soviet and post-Soviet society – economy of favors**
Primary (nutrition, water, housing, new information)	Material	Material	Material
Security	Material	Informal connections Wealth is a source of potential danger for its owner	Informal connections Wealth is a source of potential threat for its owner who could be prosecuted as far as the wealth is not earned within the official hierarchy
Social (love, friendship)	Non-economic	Non-economic	Non-economic
Self-affirmation	Material Wealth is a source of independence that is presumed to be earned honestly	Advancement in the hierarchy of the “nobility” Independence is in principle unattainable and undesirable. Wealth is associated with fraud, and is not respectable[15]	Advancement in the hierarchy of *nomenklatura* Independence is in principle not retainable and considered to be undesirable. Wealth is associated with money-grubbing and criminal activity, and is not respectable
Self- realization	Material The easiest way to have influence over people and achieve both a sort of immortality and fulfillment of other personal goals is to create one’s own business	Virtually unlimited power over people This implies a corresponding subordination to a “superior”	Opportunities are restricted The position of the highest authorities in the hierarchy is determined by non-transparent criteria and non-formalized rules that in principle do not allow for the transcendent values. The power over people is regulated by other people

[15] This is the position and will of the majority of the society. Certainly, among interest groups or classes values can vary considerably, but in such a case this group is itself regarded as marginal. In reality, and this is very significant, throughout the Middle Ages, and, similarly, during the Soviet period, public respect for wealth was constantly on the rise.

It goes without saying that self-affirmation and especially self-realization are deeply individual. In any society there are important categories of people who satisfy these needs in different ways; for example, for a top-class scientist, the highest award is the Nobel Prize. The winner will hardly exchange it for a sum of money that exceeds tenfold the amount of cash that comes with the Nobel Prize. And the vast majority of people look just at their children as the way to immortalize their personal values. So, even under a mature institutional system, economic behavior of an ordinary person should deviate quite substantially from the simple wealth maximization. But this simplifications fits the market economies due to effective self-selection that drives just those individuals who tend to realize their aspirations specifically by augmenting their personal material wealth in positions as owners and top managers of firms. Under different conditions, e.g., in Soviet society, the selection of candidates for the leading positions, including the directorship in enterprises, was made according to a different set of criteria determined by the economy of favors. For this reason, their behavior often could hardly be explained or justified by simple economic interests in a market economy.

Let us take the well known phenomenon of risk aversion in investment behavior as an example. Obviously, people differ substantially in their aversion to risk and individual perception of its significance, and this attitude is not subject to rapid changes. Although entrepreneurial activities such as investment are, in general, more risky, but also more promising, than work by contract, some highly entrepreneurial people strongly prefer this to the former. Naturally, this means that this category of people should be less risk averse than the average. On the contrary, people who tend to hate risk more than average tend to become bureaucrats, since this profession requires much caution. So, it is not too surprising that on the whole “red directors”, appointed in the communist times as bureaucrats, are not entrepreneurial and avoid active investments, as was observed by Johnson, McMillan and Woodruff (2000). Of course, bad investment climate also plays a role, but (i) *de novo* enterprises emerge in the same climate, and (ii) if climate is really so bad, directors could lobby to improve this policy and, no doubt, win, given their power. Why does this not happen? There are several hypotheses that come from our analysis.

The first possible reason is described above; since they cannot adapt to a system of free entrepreneurship, they are not really interested in becoming investors.

The second reason is widely described in mass media stories and embodied in common wisdom: “In the NIS, investments, but not investors are appreciated”. Directors or enterprise owners create obstacles for competitive investment because they are afraid of losing their power, even in exchange for tangible material prosperity. In other words, opposition to outside investments appears to be more important for directors than the opportunity for protection of their own property rights by the law. This could be explained in two ways. 1) They prefer real power to wealth (see previous section). This may be, in turn, because, as players of the economy of favors, they had to violate formal law so many times that only this power could protect them from criminal prosecution. Or, 2) indeed, they already have converged some of their power into wealth by gaining some under-the-table rents.

The third reason is that it is only under a capitalist system that augmenting wealth through re-investment of revenue is an easier and safer method than redistribution of wealth through theft, corruption, or rent seeking. The latter can exist as long as the expected benefits of it for the participants are greater than in the productive activities, so as long as the basic institutions of the market are not established well enough, productive investments make little if any sense. Rather, it is rational to invest income into bribing of politicians or government officials, hiring thugs, etc., in order to take a slice of the others' (or public) pie. This seems to be in line with the traditions of communist paternalism, where it was sometimes preferable to solve internal problems of an enterprise "at the top", for instance, to get new equipment, instead of fixing the existing one.

So, not surprisingly, the management inherited from Soviet times has turned out to be unable to play by the fair market rules for psychological reasons. Thus, in order for the reforms to succeed, most of these managers should have been replaced (see Winiecki, 1996). Did this happen, and, if not, why? Within the framework of the economy of favors, informal ties are very important - to such a degree that even owners of formal rights are not always able to replace the director of an enterprise without his consent, and directors often reject an offer of a "golden parachute" offered by new owners. Paternalism remains a sacred cow, so bankruptcy is highly politicized. Given the minor cadre shifts in the NIS, as compared to Central Europe (Shleifer, 1997), informal ties between directors and politicians or bureaucrats inherited from the *nomenklatura* effectively obstruct the bankruptcy process, as described by Lambert-Mogiliansky, Sonin and Zhuravskaya (2000). Anecdotal evidence from mass media and survey-based research (Pryor and Blackman, 1998; Frydman, Hessel, and Rapaczynski, 1998) suggest that after ten years of reforms in the NIS, in contrast to Central European countries, few managers were replaced. However, some changes did occur, and this issue deserves further research.

Summarizing this part, we may conclude that, as noted by Gaddy and Ickes (1998), the directors of Russian enterprises behave quite rationally within the existing framework, but this is just one side of a coin, and, perhaps, not the most interesting one. The major question is not only who established these rules that are so well fitted to the purpose of rent gaining. Rather, how could the public have allowed a "virtual economy" to become reality? The answer to this question is found in the work of Hellman (1998): rent seekers that had the necessary connections to the upper echelons of the *nomenklatura* prior to liberalization and privatization[16] remained "winners" at the stage of partial reforms. They take advantage of the weakness of democratic institutions and the strength of informal control levers, and successfully block and corrupt any attempts to drive the reforms to logical and successful conclusion. Certainly, such behavior can be described as being economically rational, but it is hardly the methodology as well as the results that reforms were meant to achieve.

5. Corruption and "capture of the state"

These topics have drawn much attention during the past few years, partially due to many corruption scandals. One can observe quite substantial progress in the understanding of these issues made recently in the works of the group of scholars at the World Bank Institute.[17] But here I will skip an extensive discussion of their substantial contributions and just will describe briefly the essence of the hypothesis of the origin and roots of corruption in transition society, from the perspective described in previous sections of this chapter.

It would be unfair to say that the factor of corruption was not considered at the beginning of the reform process. In the writings of Boyko, Shleifer, and Vishny (1995), a detailed analysis was devoted to this very topic. This analysis allowed observers to conclude that, following the privatization of enterprises, owners could reach an agreement with state officials in order to minimize obstacles to the efficient allocation of resources. Thus, according to the Coase theorem, efficient distribution of property rights would be achieved through efficient contracts on the sharing of profit between officials and entrepreneurs. In other words, scholars concluded that corruption can in fact help decrease destructive political interference in efficient business activity. An overall increase in the "corruption burden" due to the segmentation of the bureaucracy

[16] This process is described in detail by Aslund (1999) in his rather important but somewhat politicized work.

[17] Hellman, Jones, and Kaufmann (2000) and a set of related works published by the World Bank.

and lack of precise rules of the game was considered as the main problem. But this theory has not given the proper weight to the systemic nature of corruption in this framework of relations.

To analyze this phenomenon, one should address the question: in what way and why does the economy of favors evolve over time? As mentioned above, modernization is a threat to this economy, because it tends to decrease the strength of controls over the people. But this process seems inevitable and essentially irreversible. Therefore, the capability of traditional leaders to benefit from their power tends to decrease over time, and needs to be substituted with something else. *Nomenklatura* members become emancipated from the remnants of traditional society themselves, in particular revealing growing desire for personal consumption, and, moreover, a sort of hunger for the personalized consumer choice. This could hardly be achieved by the system of favors (for instance, by centralized distribution of scarce goods that allows for very limited diversity of products); whereas with enough money one could easily buy whatever he/she wants on the free consumer market abroad. Finally, rapid shifts in lifestyle that are produced by technological change entail the demand for the establishment of “eternal” or “constant” values - first and foremost, the value of true full ownership. Bureaucrats of the administrative-command system desire to convert their status capital – power – into economic (financial and material) capital. For these reasons, material wealth becomes more and more attractive for them and, respectively, formalizing and universalizing the favors by means of their monetization have become the first stage in the transformation of the economy of favors into a market economy (Zolotaryov, 1999).[18] This process leads to an increase in the visible amounts of rents in the first stage of transition that was described above.

From this perspective, the initial economics approach to corruption in transition suffers from at least two flaws of the early studies in transition economies that were mentioned in the Introduction.

Firstly, it tends to ignore the political economy aspect of the problem, because it is based on the assumption that the bureaucracy operates within a certain externally predefined legislative framework. Nonetheless, in an absence of effective public control, nothing prevents the bureaucracy from introducing inconsistent and non-transparent legislation in line with the rules of the economy of favors, i.e., designed especially for the purpose of rent seeking.

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[18] In the same Marxist dialectics framework (see the footnote 8), it should be described as “power>money>power+”.

Secondly, corrupt practices can and do allow business to circumvent inefficient decisions imposed by the authorities, such as certain heavy tax obligations, but this hypothesis implicitly assumes most enterprises to behave according to some market economy standards – e.g., to be profit-oriented, and, in general, efficient. But while the majority of CEOs in enterprises are inefficient and/or rent-oriented (both are characteristic of the post-Soviet society), nothing prevents corrupt officials and politicians from reaching agreements with directors (owners) of value-subtracting enterprises on the sharing of rent at the expense of the rest of economy, as in the case described by Lambert-Mogiliansky, Sonin, and Zhuravskaya (2000). This way, some types of enterprises and industries can survive for a while, regardless of their performance, if they can be used as a “rent pump”, as described by Dubrovskiy (2000).

So, the source of corruption lies deeper inside, in the political immaturity of society, which does not allow for a transition from an economy of favors directly to a profit seeking, incentive-based economy. Instead, an “economy of losses” (Paskhaver, 1999), or “wild capitalism” becomes the intermediary stage by default. This conclusion looks quite pessimistic, but seems to be the reality that people face in many countries. The main outcome is that it makes little if any sense to encourage anti-corruption campaigns until very substantial institutional changes take place. At present, these campaigns only serve as a tool for redistribution of power and related rents. Rephrasing an old Soviet joke, “in the battle with corruption, the latter wins”.

6. The failure of the Washington Consensus

The transition from central planning to the **competitive** market was primarily formulated on the basis of privatization in combination with a prescribed macro environment for enterprise development, allowing for profit making activity and punishing rent seeking, while ensuring transparency and providing true market value for goods and services. The means for reaching this target, the famous (or infamous) triad “liberalization>stabilization>privatization”, seemed theoretically well grounded. All together, these policies were to lead to the elimination of major sources of rents for enterprises and the enabling of profit making. Liberalization would eliminate large price arbitrage opportunities and, with stabilization, create basic conditions for the emergence of competitive market enterprises. The final deficit reduction necessary for stabilization would require reductions in subsidies. Privatization would eliminate rent sources related to private utilization of state property. This sequencing of actions was important not only for technical reasons, but also because of its effects on rents. Major sources of rent were to be eliminated prior to privatization in order to facilitate development of profit-oriented owners, who would play according to the rules of a fair market.

Nevertheless, these measures were still not sufficient for creating conditions for an effective market economy, and one can confidently conclude that these policy measures produced results that today indicate the readiness of society for greater competition and further modernization. Why did this happen? And why was the order of actions (or periods) reversed in many cases that led to maintaining and even strengthening of sources of rents?

The policy measures within the triad were closely interrelated to each other, but the order of actions contained at least one grave flaw. Particularly, liberalization and stabilization require that economic players, first of all enterprises, behave in a certain "market" way, for instance by cutting costs in response to the fall of the market price. But, as was shown earlier, these players were not quick in changing behaviors. Furthermore, they appeared to be powerful enough to block or pervert undesirable (from their perspective) reforms, and society was not ready to shift to a system of depersonalized relations, hence to replace them.

Architects of reforms considered privatization as the remedy for this problem. The right to private property is itself the key market institution behind profit maximization, profit seeking, and any sort of market-oriented behavior. In retrospect, therefore, there was little chance to achieve market-oriented behavior (and, correspondingly, the expected response to macroeconomic stabilization) in an economy where, during Soviet times, the very idea of private property had been eliminated. Mass voucher privatization was devised as a way to break this vicious circle, by placing shares of enterprises directly into the hands of the population at large and making owners out of them. Experts held that, in line with the Coase theorem, the admitted ineffectiveness of this method of "primary market" privatization would be compensated for by the emergence of a secondary market, which would concentrate management in the hands of efficient owners. This assumption was actually the cornerstone of the entire approach to reforms, since without this mechanism the crucial task of changing the economic behavior of enterprises cannot be achieved.

However, in keeping with the above mentioned process of the post-Soviet evolution of economy of favors, former *nomenklatura* members used privatization to transform their political power into property rights. The populist appeal of handing over the "people's" property into the hands of the people in return for public acceptance of privatization was thought to be an effective way for preventing citizen protest and unrest, while social equality was left by the wayside. Of course, the new owners originated from the *nomenklatura* and did not intend to open the system; thus, the secondary property market remains rudimentary even despite the formal existence of reasonable legislation. This was achieved mostly (but not exclusively) by the lack of transparency, actively supported by these “intermediate winners” (Szyrmer, 1999), so the effective and widespread mechanisms of efficient allocation of property still remain a dream.

Many researchers name the voucher privatization itself, or some aspects of its implementation, as the main cause of this failure. However, the experience of both Russia and Ukraine shows, in line with our explanation, that the government was in fact never free to choose the form of privatization; it was under constant pressure from the manufacturing and agricultural sector lobbies (Aslund, 1999). This meant that the method of privatization, in particular the rules governing competition in sell-offs, insider privileges, and special opportunities for enterprise administration (appointed managers), were not and are not exogenous factors. Rather, they are results of indicators of the performance of market and civil institutions in society.

Of course, even such dubious privatization has played some positive role because: (a) it has allowed market institutions, though quite imperfect, at least to start, (b) it allowed at least some really efficient owners and managers to operate (Szyrmer, Dubrovskiy, and Shygayeva, 1999a, 1999b); and (c) it has created some public demand for reforms backed by money and power. The latter is especially important given that corruptive motives in the NIS still seem to be much stronger than civil controls. Nonetheless, within a distorted institutional environment, the owners’ demand for reform does not go too far toward a true market, and often takes the opposite direction, as was described above. This is one of the main reasons for problems with the Washington Consensus in the NIS. Furthermore, the Washington Consensus policies did not address the root of the problem on a fundamental level, which lie in the informal institutions.

7. Conclusion

Thus, what are the lessons to be learned from Ukraine’s transition experience to date, in terms of the conceptual framework described above?

- There is no way to impose “good” legislation from outside, unless the country is occupied by military troops. Therefore, one must always bear in mind that only those laws that are backed by some powerful interest group(s) within the country could be adopted and enforced.

- Formal institutions do not matter so much. The system always can find an "informal" way around them.
- The informal institutions cannot be established by force. Thus, only indirect methods can be effective.

These lessons raise the following questions:

- How can we foster society's overall modernization, rather than just technocratic economic reforms?
- How can we break the well known vicious circle of rent seeking, which is defined as an institutional environment that allows for misallocation of resources in favor of the vested interests, political pressure of which obstructs institutional changes?
- How can we increase transparency, which is one of the most important parts of the market institutional environment?
- How can we find and encourage the interest groups that battle rent seeking in the rent seeking environment?

Two broad areas merit further research. One of the most important tasks of economic policy involves the establishment, strengthening, and participation of interest groups conveying support for transition process. But within the rent seeking environment, currently there is no faction or group strong enough to effectively fight rent seeking. Respectively, one of the key issues for designing an economic and institutional policy is studying the balance of power between different interest groups and their characteristics. The results of these studies indicate that focus should be placed on strengthening those interest groups that are essentially market-oriented and quite far from the sources of rents, e.g., small and medium enterprises, or those that are connected with relatively short-lived sources of rent and, according to their business culture, are more inclined towards, and capable of, efficient production when sources for rent seeking become exhausted.[19] Such groups could include importers of final products and the banking sector. These groups are created in many respects "from scratch". That is, their success is based on entrepreneurial initiative. If access to these markets is unrestricted, competition quickly leads to the vanishing of monopoly rents, and a new business culture promotes efficient activities. Another question is the degree of readiness of the society for particular reforms, and key tactical steps that could be accepted and implemented easily. Government actions should focus on ideas whose time has come.

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[19] See "Building a Pro-Reform Coalition in Ukraine: Reducing the Bargaining Power of Bureaucracy" in this volume.

The second area for further work regards economic indicators. In Ukraine, due to the non-market nature of the economy, key indicators, such as growth or decline of GDP, fail to describe the economy. The level of prices determines their value, which, in turn, is dependent on the lack of competition, state intervention, etc. In a Soviet-type economy, prices in the market sense were non-existent. Although this may sound paradoxical, economic policymakers should not consider indicators such as growth in GDP as their principal task; otherwise, it becomes tempting to reach this goal by manipulating statistical data (Szyrmer, 1999), or reducing competition. Perhaps, most importantly, the achievement of short-term economic growth that is not based on economic efficiency derived from macroeconomic methods (fiscal and/or monetary expansion) threatens to hamper the transition process, causes unstable levels of growth, and can create additional sources of rent. Unfortunately, corresponding indicators for research purposes are neither developed nor well recognized (Campos and Coricelli, 2000; Aron, 2000; Dubrovskiy and Szyrmer, 2000).

One should still keep in mind that the task of facilitating the transition is difficult, especially because there is no critical mass of competent, knowledgeable individuals in Ukraine who understand and can operate within a competitive market system. On the contrary, the logic of the zero sum game is widespread.[20] And people are suspicious of outsiders, so even very good and sincere advice coming from abroad is often regarded with skepticism (Szyrmer, 1997). Therefore, experts interested in the successful advancement of economic reforms need to provide strong convincing evidence in support of proposed solutions.

So, we conclude by suggesting a set of issues to be investigated in further research:

- To measure proportions between sectors of the economy that are profit seeking or rent seeking, with respective revenue estimates
- To measure the degree of motivation among directors and government bureaucrats in reaching agreements on rent distribution by assigning enterprise privileges a la “soft budget constraint”

[20] See “Post-Soviet Transition: Problems, Lessons, and Solutions”, Section 3, in this volume.

- To identify the effect of privatization on economic behavior, motivations and psychological attitudes of management and employees
- To identify the size, degree of influence, and composition of domestic and international interest groups seeking transparency and openness
- To determine the main characteristics of “value subtracting” businesses and estimate their share in the economy
- To identify and evaluate changes that are occurring in the national economic structure and subsequent behavioral changes in enterprise management
- To reveal the impact of macroeconomic policy measures on the institutional progress

Other deeper questions that should be researched are as follows:

- To what extent are people prepared to abide by the standards of a “mature” society, that is, to work conscientiously and pay for non-public goods in exchange for effective legal and social guarantees and increased welfare? Or, will the nation continue to follow the Soviet principle “they pretend to pay us, we pretend to work”? Which strata are leading and which are lagging behind in the various aspects of this modernization?
- What categories of the population are more open to accept various informal market institutions (like inviolability of private property)? What inclination towards entrepreneurship (measured with a group of indices) is found in various social strata?
- How “progressive” or ”regressive” (in line with the above-described criteria) is the elite in relation to the rest of the population?
- What is the actual basis and means by which to form a modern elite cadre at various levels of authority in both the public and private sectors?
- What are people the most tired of: constant change, social and economic injustice, or arbitrary government action?

By addressing these questions, we will assist the policies and the process of transition in Ukraine.

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Prospects for Entrepreneurship: Privatization and Capital Accumulation[1]

Alexander Paskhaver

1. Privatization as a political process

In 1998, the completion of privatization as a political process in Ukraine marked the end of a period in which privatization functioned as a driving force for market reforms.

Privatization is, in fact, the sole dynamic block of these reforms implemented on a microeconomic level. It was to create a corporate sector, develop the market infrastructure, produce a stratum of small owners and a system of non-bank financial intermediaries, and achieve partial liquidation of the state monopoly in the enterprise and financial sectors. Accordingly, public expectations (and fears) of market reform focused on the privatization process.

Privatization did not live up to these expectations. It failed to stimulate the establishment of truly competitive markets for products, capital and labor. It also failed to engender fundamental behavioral changes in both owners and high-level managers, and it never became a driving force behind the restructuring of the national economy. In short, privatization failed to prevent the worsening of the economic situation in Ukraine. However, focusing on the flaws of privatization and the barriers to its implementation diverts one's attention from the primary causes of Ukraine's economic crisis.

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[1] This chapter was written within the project "Microeconomic Foundations for Macroeconomic Policy" of the Harvard/CASE Ukraine Project in Kyiv.

Ukraine's approach to privatization was formulated in three basic privatization laws in 1992. This approach was determined mainly by political motives. The authors of Ukraine's privatization legislation considered the following social and political factors:

- The conservative nature of the Ukrainian people and the overwhelming dominance of socialist ideals, combined with traditional peasant and petty-bourgeois attitudes
- The dominance of the former communist bureaucracy in the new power structures (given the conservative nature of the constituents, it was easy to envision a low likelihood of a drastic change of personnel among the Ukrainian political elite)
- Weak political and economic impacts of new private capital
- The dominance of the managers of large state enterprises (the collectivist Gorbachev reforms in the area of enterprise management actually entitled these directors to property rights without corresponding responsibilities; with regard to enterprise activity, similar legislation came into effect in 1999)

Under such circumstances it would be unrealistic, and even dangerous, to expect any development of private capital or market infrastructure before undertaking privatization via cash sales and securities markets. Given this, the first goal of privatization was the rapid development of a large number of non-state owned enterprises. Their size and growth rate were the main criteria for success. Though privatization did lead to a decrease in the role of the government as the owner of enterprises, the number of non-state owners never reached expected levels.

The following three principal features of the Ukrainian economy led to the situation in Ukraine as described above:

1. Citizens were permitted to participate in privatization, and were given free privatization pseudo-money of limited circulation.
2. Enterprise employees, and later management, obtained significant privatization privileges in purchasing the shares of their enterprises. In small- and medium-sized enterprises, these privileges were sufficient to gain controlling ownership shares.
3. Employees of small enterprises were given the option of buyout for a nominal price, or (even more cheaply) via a lease with a buyout option.

Other competitive methods of privatization were outlined early on in the legislative process. Among them were auctions of large blocks of shares, consolidation of share packages through financial intermediaries, and the sale of these packages on the stock exchanges. Although the number of competitive methods of privatization and influence of financial intermediaries continued to increase, the overall effect of privatization led to the dissipation of property among relatively dispersed small owners, and to the dominance of insiders in the ownership structure in the majority of privatized enterprises.

These consequences were predictable from the beginning of the privatization process. ***They were the price of politicization, socialization and a fast rate of privatization in a country with little private capital.*** The goal of creating a stratum of efficient owners still awaits to be implemented during the post-privatization period.

2. The role of new capital in privatization

Initially, privatization was envisioned as an element of a market reform, accompanied by a parallel rapid development of new private capital. The idea was that this capital would attract efficient owners, establish new management, and expand the funds for technical reconstruction and development; and that it would also turn formal privatization into a fundamental economic transformation. It was planned that a consolidation of industry and a formation of a stratum of efficient owners would occur in the secondary market of securities, and in real estate.

It would be incorrect to claim that strategic plans for interaction between privatized enterprises and new private capital failed entirely. Real privatization was implemented after 1995. The process of consolidation of property rights (consolidation of share packages) was rather significant for an inchoate market economy. In 1997 major differences in the performance of state and collective (non-state) enterprises were noticed. A comparison of performance of the two sectors showed that, under comparable volume indicators, labor and capital in non-state enterprises were more productive than those in state owned enterprises. In addition, non-state enterprises were also more profitable.

However, the small scale of the positive change did not significantly affect the generally negative economic dynamics. The fundamental post-privatization transformation is only about to begin. Yet, there occur a number of unfavorable phenomena and tendencies that may hamper the development of positive trends in the post privatization processes, in particular:

- Transformation of the most dynamic small-sized capital into medium- and large-sized capital through economic growth is not taking place.
- In most cases, large (and medium) capital has been a product of monopolistic shadow transactions with the government. This capital has not achieved, and in fact could not achieve, progress in any of the three important areas: (1) enterprise management, (2) new capital investment and innovations, and (3) legal market competition. This capital has not expanded and could not grow until its owners gain experience in the three areas.
- Managers of privatized enterprises are the most active in consolidation of the property rights at their enterprises. Yet, typically, they possess neither the skills in management, nor the capital necessary for restructuring. There is also lack of trust on the part of both potential investors and domestic financial intermediaries.
- Despite a pervasive investment hunger, there occurs an ironic tendency of crowding out foreign partners from joint ventures.

3. "Stabilization" of the crisis

The above mentioned flaws in the process of private capital development in Ukraine could be attributed to the peculiarities of the development of the economy from 1991 through 1998 under perpetual crisis conditions, and to the Government's role in this process.

The collapse of the Soviet Union instantly changed the scale and structure of demand by the Government that was formerly the principal consumer. It also stimulated a shocking increase in energy prices and the collapse of traditional markets. Opening Ukraine's economy to foreign manufactures was inevitable. Most of the production in Ukraine (with the exception of natural resources processing) was inefficient.

A market economy would have responded to inefficiency by reallocation of capital and labor between and within industrial branches, bankruptcies, production restructuring and innovations. By contrast, Ukrainian enterprises, both state owned and privatized, responded by creating a new type of economy. This economy is based on barter, mutual cancellation of debts, concealment of profits, and non-payment to input suppliers and employees. These methods of reduction of cost and price have resulted in a pervasive non-profitability, though it is difficult to distinguish true non-profitability from alleged non-profitability. Analysis of the performance of the whole economy brings one to the conclusion that the actual non-profitability of state owned enterprises is considerable. Restructuring and pursuit of new markets characterize only a few areas of activities, whereas the overall economy is generally suffering from the above mentioned problems.

Despite these anti-market behaviors, the crisis has stabilized. An influential social stratum that significantly benefits from this new economy has emerged. This stratum effectively creates and supports the organizational and legal prerequisites necessary for such an economy to function.

4. Privatization of government powers

The members of the state administration have benefited from controlling the management of the loss-making economy and enterprise decapitalization. They have seized government powers of regulation and control including taxes, exchange of land, sanitation controls, price regulation, and state guarantees. They use the current enterprise management system for their own benefit. Violence, or the threat of it, provides criminal elements with similar powers.

The bureaucratic and criminal powers effectively control the performance of enterprises. However, the returns on these powers are not reflected in market asset prices. Lack of capitalization of bureaucracy powers, along with the high risks associated with their controls, are considerable determinants of the following behavioral patterns in production activities and capital investment:

- Bureaucrats are uninterested in increasing the market value of enterprise fixed capital since this increase does not contribute to their personal wealth and impedes the illegal redistribution of property.
- They obstruct the increase of official profitability of capital, since the legalization of profit hinders its illegal appropriation.
- They discourage official consolidation of capital by independent entrepreneurs and resist increases in stock liquidity, since this would develop a transparent stock market.

Loss-making production and non-transparent ways of capital investment are not the only measures working in the interest of the bureaucracy; although, they happen to satisfy these interests best.

Other measures include a gainful use of state owned enterprise capital by insiders and state officials as well as the seizure of state assets by the officials involved in privatization. At the same time, part of enterprise capital is simply lost during this process.

Many high-level enterprise managers favor this type of economy. Managers of state owned enterprises actually constitute a part of the bureaucracy and are active in illegal capture of enterprise earnings. Managers of privatized insider owned enterprises are inclined to act in a similar fashion by taking advantage of their control powers, social passivity of workers, and the weakness of corporate governance legislation.

Recently, it has become evident that the pressure groups of advocates for loss-making businesses have suffered from severe internal conflicts. These conflicts deserve thorough attention, as they have special significance for the Ukrainian economy. Also evident are the unity of interests based on illegal misappropriation of rights (“assets”) and the high risks that accompany them. Ironically, very high entrepreneurial risks make current consumption and investment into consumer durables more attractive than investment into the economy (even in the case of legal owners of privatized enterprises).

5. Bureaucracy as a subject of economic power

In terms of conflicts of interest, the transitional post-communist period might be defined as a process of redistribution of economic power from the Soviet government to private capital. According to this definition, the period of 1991 through 1998 can be split into two stages.

From 1991 through 1995, the old state administration lost its leverage on the economy while the new one was in its nascence. The creation of a shadow economy, unprecedented in its rate of growth and scale, was the response. In spite of all the negative ramifications of the shadow economy, from 1992 to 1994 it proved to be a means for the nation’s self-preservation and for maintaining a certain social economic equilibrium.

Complex laws establishing the guidelines for private entrepreneurial activity were passed in Ukraine in 1991. The low level of official government controls made it possible for private capital to actively expand in such a way that each entrepreneur was simultaneously developing the legal and shadow components of his business. Small-capital private entrepreneurs looked for their niches in the undeveloped markets of consumer goods and services. Medium- and large-capital entrepreneurs benefited from the inequitable exchange between the state sector and the private sector. From 1991 to 1993, this scheme was even partially legal. Thousands of small firms were either established as subsidiaries of the big state enterprises or were created in cooperation with high-level managers. These small firms, together with large monopolistic trade and finance firms, served as channels to seize both the current profits and state property. As a result of legislative changes in 1993, this scheme had to move entirely to the shadow while becoming more refined (and more sophisticated). Even today, it remains the principal method for private capital accumulation in Ukraine.

Once the legal framework is improved and the market infrastructure is developed, many small firms are expected to grow and develop into large enterprises. So far, the new state administration has failed to fully implement these measures, to some extent because it does not operate as a civil service, but rather as an authority in which the economic power is concentrated. ***Reformers underestimated the state administration potential for protecting bureaucratic interests.*** As a result, Ukrainian economic development continues to be distorted, since it is geared to support interests of the bureaucracy and other social groups associated with it. These distortions are significant in (1) the organizational structure of the government, (2) the management of the state owned enterprise sector, (3) the private capital structure, and (4) the microeconomic reforms.

Organizational structure of the government

There has been a significant increase in the number of governmental organizational units related to regulation (registration, licensing, certification, and control) of individuals and corporate activities. Especially, the level of “bribe-intensive” bureaucratic activities is growing. This process is taking place under the guise of the liberal ideology of deregulation. At the same time, “non-bribe-intensive” government functions are either being reduced or remain at the same level.

Management of the state owned enterprise sector

The transition period has witnessed continuous efforts to monopolize the most profitable Ukrainian markets through the establishment of governmental and quasi–private structures and compulsory procurement schemes that envisage direct restriction of market access.

Formation of powerful elite monopolies is accompanied by a large system of selective governmental support of enterprises. The combating of biased support, such as government investments, donations, subsidies, tax privileges and tax crediting, has resulted in a multitude of additional (more sophisticated) forms of support. These forms include establishment of monopoly niches, government guarantees for bad credits, price protectionism, debt restructuring, mutual debt cancellation, and acceptance of in-kind tax payments.

Government-sector enterprises and privatized corporations are relatively free of property liability. Bankruptcy procedures are not used in cases of insolvency. Instead, the old government mechanisms of administrative control are being maintained, and government departments invent new procedures and sanctions that are used selectively. This makes entrepreneurs constantly "guilty" of violating some regulations.

Private capital structure

The high level of government intervention and abuses in this area determine the behavior of private capital. Only the capital accumulated while cooperating with the government bureaucracy is able to survive. Impediments to creation of independent private capital are blatant. In the early stages of privatization, this was done through the establishment of closed joint-stock enterprises and other similar structures established in the process of privatization. Later, the same goal of thwarting privatization was achieved by establishing numerous procedural and organizational barriers that blocked the sale of large packages of shares to outsiders.

From the perspective of the bureaucracy, foreign capital became *persona non-grata*. Despite its flexibility, foreign capital is unable to adjust its patterns of operation in order to please the bureaucracy to the same degree that local capital does. Therefore, Ukrainian financial intermediaries tend to win the large package deals.

Microeconomic reforms

The government's involvement in microeconomic reforms has been characterized by endless direct interventions into particular economic activities and by distortions of the overall economic environment. This involvement does not stem from ideological resistance to liberal reform. On the contrary, the bureaucracy seeks to prolong the process of reform. The present transitional, non-transparent economy provides a perfect environment in which illegal transactions can be performed. It must be emphasized that microeconomic reforms are necessary in order to facilitate the favorable entrepreneurial investment climate, particularly in the areas of deregulation, bankruptcy procedures, liberalization of taxation, and enhancement of corporate rights protection.

When viewing the transition period as the process of reallocation of economic controls from the government to the private sector, we may conclude that the private sector "lost" the second round of transition (1995 through 1998). The country witnessed the formation of bureaucratic capitalism in which production and capital investment activities are determined by the government.

6. Inefficiency of public and political control mechanisms

The change in the form and scale of the government's illegal income did not account for the rise of its status in Ukraine. The bureaucracy has transformed itself from an object of economic power into its "subject." One of the main reasons behind this evolution is that ***Ukraine failed to rapidly establish a democratic alternative to the Communist Party.*** There are, of course, objective causes behind this. The establishment of many institutions of democracy requires long time; their complex structures cannot be easily replicated in a short period. Despite this, the Central European countries and the Baltic states have managed to rapidly establish relatively efficient new socio-political mechanisms. At the same time, Ukraine, Russia and Belarus failed to create democratic political mechanisms. This difference is a clear demonstration of the difference in the political maturity of these societies.

Ukraine's state administration has maintained the old cadre, values and procedures of the Soviet system. Weak mechanisms of social and political controls have enabled the government to claim full economic power, thus allowing government officials to channel resources to their own interests.

7. Reform strategy

The aforementioned facets of post-communist economic development in Ukraine make the following steps in reform necessary:

Constructive, action-oriented political evaluation

Constant attacks on high-level authorities regarding their alleged political unwillingness and inability to introduce reforms are superficial and ineffective. They may feed into political games, but they do not allow for constructive, action-oriented measures that would effectively address the present weaknesses in reform policy.

Development of civil society

This process should be considered the most important factor in reform policy. Underestimation of the vital role that civil society plays in reforms has, to a large extent, contributed to Ukraine's present condition.

Reformers did not take into account the deeply ingrained attitudes that the socialist system left within the middle-aged and older generations. For those people, such terms as private ownership, entrepreneurship, personal responsibility, and economic self-reliance still have pejorative connotations.

Unity of society is based on a unified system of values (though, certainly, it embodies diverse social views and the struggles between these views). It is impossible to successfully implement liberal and democratic reforms without sufficiently educating people about these reforms. It is necessary to drastically change education policy in the humanities at all levels to incorporate liberal and democratic ideology.

Administrative reform

Administrative reform is a complex process of changes in the legislative base of government activity, its functions and procedures. Administrative reform must establish a new mechanism subject to public control and focused on public goals. **The main threat Ukraine faces in this sphere is the de-politicization and "de-ideologization" of administrative reform,** i.e., its reduction to purely mechanical procedures, such as downsizing staff, and streamlining its activities by reallocating functions between departments or merging several departments into one.

The mechanisms of political processes need to be strengthened so that elected political leaders are able to control the state bureaucracy and ensure it acts to achieve political goals. This should be a key element of administrative reform. World democratic experience provides various patterns of party and parliamentary control to achieve this goal. Policymakers from political parties (the agendas of which are endorsed by citizens) should form the government. The Cabinet of Ministers should be formed through agreement among the parties of the ruling coalition. The Constitution does not obligate the President of Ukraine to use such a procedure to form the government. Nevertheless, the President could opt for this procedure (despite the lack of its historical precedence in Ukraine), in order to remove the destructive tendencies that now plague the reform process. This procedure would entail strict adherence to the Constitution of Ukraine in the selection of ministers and members of the parliament.

The establishment of a politically responsible and publicly controlled upper layer of state administration would involve the explicit specification of service term limits and rotation, and would thus improve the level of competence of public servants.

Administrative reform can be designed as either "narrow" or "comprehensive." The objective of the **narrow reform** is to make state administration more effective and less expensive. This can be accomplished by downsizing, reorganizing, etc. In addition to these, the **comprehensive reform** would have to establish a mechanism that would subject the state to public controls and would force/enable the state to pursue public goals (as determined by voters). This mechanism has never been established in modern

Ukraine. To achieve this, one should, first of all, establish a clear-cut separation between the policy decision-making process on one side, and its implementation on the other. The former should be a task for the politicians who are accountable for their activities; the latter should remain in hands of politically neutral professionals (civil servants). This separation is not defined by Ukraine's Constitution.

The narrow reform could not be successful unless it was accompanied by the political tasks fulfilled by the comprehensive reform. As long as government bureaucracy is free to make decisions by fiat, it remains incapable of reforming itself. Such a task can be undertaken only by a political power with no vested interests in the reform outcome. Hence, such a power ought to be established at the first stage of administrative reform. The main threat for the success of this undertaking is the confusion of the two kinds of administrative reform (narrow and comprehensive), which may lead to degeneration of this reform to its purely technocratic aspects.

Microeconomic reforms

Market reforms contradict government interests. Yet, ironically, these reforms cannot be done outside the government system. This contradiction can be partially overcome by the establishment of departments whose only responsibility would be elaborating and implementing certain reforms. A special provisional status that grants job security to personnel and secures certain level of financial independence should be granted to these departments. The Anti-Monopoly Committee, State Property Fund and the State Committee for Entrepreneurial Activity have already obtained such status.

The following are additional measures that should be followed in microeconomic reform:

- Liberalization, or the process of decreasing state regulations and obligatory state services
- Judicial reform that provides business and the state with equal rights in resolving conflicts
- Consistent policy that will enforce property responsibility and implement bankruptcy procedure when mandated
- Consistent policy that supports and protects private/venture capital, small business and a healthy environment for investment

The process of improving the business and investment environments is of a long-term nature; it must be supported by a demonstrative political will of government.

8. Privatization model for Ukraine

The principal goal of privatization during its next stage is the sale of several hundred of Ukraine's largest enterprises. The total asset value, economic capacity, and social significance of these enterprises is greater than that of the 60,000 enterprises privatized to date. (See Appendix for description of the history of privatization in Ukraine.)

The strategic direction of privatization remains unchanged. It is aimed at privatizing the entire manufacturing sector, regardless of the obstacles created by the current legislation. The state has failed to become an efficient owner. A recent analysis of data for 111 countries, for 1978-1991, confirms a negative relationship between the size of the state owned production sector and the pace of GDP per capita growth.[2]

The majority of the largest enterprises that have been earmarked for privatization are monopolies that have strategic importance for Ukraine. This fact gives bureaucracy ideological ammunition in its struggle for preserving state controls over these enterprises. The following schemes are used:

1. Transforming enterprises into companies owned entirely by the state through the Treasury
2. Transforming state enterprises into corporations in which the government maintains a majority interest of at least 50 percent plus one vote, and
3. Retaining a blocking share of at least 25 percent

The State Treasury is not able to manage a large number of enterprises. It would be reasonable to keep under the Treasury (scheme #1) only those enterprises providing direct services to the state (for example, the mint). There may be several dozen such entities.

The creation of a state corporation (scheme #2) may be used only as as an interim step in the privatization preparation of an enterprise, given that competent and responsible private managers are hired. Otherwise, the enterprise may end up being registered as a privately-managed enterprise, while still retaining the inefficient structures and organizational arrangements common for most large state-run firms. Thus, the reform of the firm from within must coincide with the process of privatization.

When the government retains only a minority block of shares in an enterprise (scheme #3), it frees itself of the overall responsibility for that enterprise, yet retains the right to interfere in the attempts of

[2] A. Illarionov. 1998. "Criteria for Economic Security" (in Russian), *Voprosy Ekonomiki 10: 51-52*.

the new ownership to implement its market strategy. The only reasonable argument for such an arrangement is the possibility for the government to sell its shares for a profit at a later date; however, government participation itself lowers the value of the stocks, and government interventions are likely to hinder the increase in stock values. A better way for protecting the interests of the state is through a system of two- to three-year contracts with the new ownership of a privatized firm. These contracts may disallow the liquidation of entire enterprises, and contain stipulations as to specific production targets and the exercising of mutual responsibility in fulfilling orders from the government.

Clearly, only a small portion of enterprises presently in state hands should maintain substantial state control through one of the three scheme outlined above. Other enterprises should simply be privatized. Most of the large enterprises still under state control should be privatized on a case-by-case basis without taking into consideration either the general conditions of a specific sector or the needs of the economy as a whole. The key element of market adaptation is the replacement of management and the adoption of regulations that permit specific requirements of community and consumer demand to be met, especially with respect to issues of pricing, accessibility or environmental protection. As can be expected, financial scandals, failures and temporary digressions from the reform path complicate the process since firms are struggling to adapt to a distorted market environment with few alternatives at hand.

The privatization strategy should be focused on seeking a strategic investor or investor group capable of bargaining with the state. In privatization tenders, the preference should be given to the largest international producers in a given area. In the case of commercial tenders, the winner should be granted a controlling block of shares with a minimum of non-price conditions.[3]

As a result of such a privatization strategy, the largest Ukrainian enterprises would be purchased by big foreign companies that are connected to new Ukrainian capital legally, rather than through the shadow economy. Any negative risks, i.e., a potential threat for national security, can be eliminated through a well thought-out system of market regulations by the government. Therefore, improvement of this system based on liberal economic experience is both an important prerequisite and component of the current stage of privatization, as well as a significant component of administrative reform.

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[3] Thus far, in the majority of such cases, the winner has undertaken deep reconstruction and modernization of the enterprise in order to make it competitive on the open market - reconstruction that is much more successful when not hindered by official investment requirements of the state bureaucracy.

Positive consequences of massive expansion of foreign capital are obvious. If this stage of privatization is accomplished quickly enough (between three and four years), a critical mass of private production capital will be formed in Ukraine. This capital will:

- Be independent from government control and be able to both protect its interests in the current conflict with bureaucracy and help implement strategic changes in legislation and regulation
- Be more inclined toward long-term investment than domestic capital is, and
- By its mere presence, through its technological and financial connections, contribute to Ukraine's integration into the world's international economic community

It can be expected that an increased presence of foreign capital in Ukraine will foster a competitive environment also for domestic investors and subsequently will reduce the size of the shadow economy. In this respect, there would be little basis for the corporate sector being called as "unpatriotic," sacrificing national sovereignty or the interests of domestic producers.

There are countries where the combination of a well developed capital market and local bureaucracy did produce favorable results. However, this seems to have been the case in countries with an economic culture different from that in Ukraine, such as the countries of East Asia. However, recent developments in the Far East have demonstrated the universal need for eradicating corruption and fostering enterprise governance and accountability, while limiting the pervasive intervention of government bureaucracy.

The sale of large state enterprises is a fundamental step in the overall reform process of creating conditions for commercial behavior. This sale should enable/improve: product advertising, enterprise reorganization and modernization, market analysis, market expansion, etc. Privatization should not be treated as a discrete end goal in and of itself, but rather as a part of a continuous process within which the firms keep changing and adjusting to the changes in the overall economic situation.

The privatization process should complement other reforms. In parallel to preparing enterprises for privatization, enterprise management goals should be explicitly identified and met as quickly and efficiently as possible. For example, large state firms slated for privatization should aim to increase their market value and liquidity in preparation for entry into the market. The active participation of both domestic and foreign mediators and consultants should be used to assist in management, corporate strategy development, and actual change in ownership. These actors should bear the burden of material responsibility if they fail in their task.

During the next stage of privatization the following tasks should be accomplished—to the extent that they can be given constraints placed on the process so that it is socially acceptable:

- Conduct the sale of blocks of shares of state owned enterprises through legitimate privatization means
- Resolve the issue of non-liquid state owned shares by offering them at auctions, or liquidating them through the introduction of amendments in the statutory funds
- Widen the practice of selling bankrupt companies or subsidiaries through auction (providing that consistent bankruptcy procedures are applied to state owned enterprises)
- Sell small firms and unfinished construction projects through auctions at fair market value
- Complete the process of certificate privatization and prohibit their further circulation as a means of trade
- Enact regulations ensuring cash dividends for owners of privatization certificates and protect the value of these certificates even after their withdrawal from circulation

To sum up, market reforms should not be so narrow in scope as to merely serve as organizational and technocratic measures. Reforms, as a continual process, must be aimed at strengthening the formation of social forces and political will that both adhere to and encompass the spirit of reform. Otherwise market reforms will serve to strengthen and solidify the power of state bureaucracy rather than the emerging private capital, and thereby jeopardize Ukraine's transition to democracy and market.

APPENDIX

Description and History of Privatization in Ukraine

A1. Introduction

Privatization of the economy implies both the deregulation of economic processes and a decrease in the share of state property in the country's national wealth. The latter results from both growth of new non-state capital and the sale or transfer of state property to private owners. This is, actually, a definition of privatization in its narrow sense. It is in this sense that privatization is considered in this chapter.

Ukraine's enterprise sector, which produces goods and non-financial services, constitutes the subject of this analysis. The banking sector, agriculture, land, and housing all have their own specifics and are not covered in this analysis.

A2. Privatization methods and structures

Parliament's approval of the "Concept of de-statization and privatization of the property of government enterprises, housing stock and land" established privatization policy in Ukraine at the end of 1991. In March 1992, the main privatization laws were adopted – "On Privatization of Property of Large Enterprises," "On Privatization of Small Government Enterprises (Small Privatization)" and "On Privatization Certificates". In June 1992, the parliament approved the first government privatization program. June 1992 could be considered as the beginning of an official process of transformation of ownership rights in Ukraine.

The following characteristics of the privatization process were important for ensuring the rapid adoption of privatization:

- Creation of the State Property Fund (SPF), which was to oversee the mass privatization process and was entitled to a monopoly right of representation of the state as proprietor in the production sector
- Separation of the old system of branch administration from the privatization process
- Introduction of irreversible privatization procedures (something like a trigger mechanism)
- Enabling privatization of enterprises at the initiative of any interested party
- Official valuation of the objects of privatization based on their book values (such valuation did not require a lot of time and thus did not delay the privatization process, and it made privatization objects cheaper, which facilitated the process of their sale)
- Use of privatization proceeds solely for the purposes of privatization and restructuring of privatized enterprises
- Quantitative privatization targets mandated by a special government program

Privatization was expected to occur throughout all branches of Ukraine's economy. The largest concentration of enterprises eligible for privatization was located within the branches with the highest impact on consumer-market development, such as trade, public catering service, household services, food industry and light industry, and processing of agriculture products. Enterprises that were impeding economic growth, such as loss-making enterprises in all branches, unfinished construction sites, etc., were also slated for privatization.

The goal of rapid privatization automatically ruled out the use of a classic model of privatization (through sales made on property and stock markets). In a country without private capital or market infrastructure, and with no public confidence in the institution of private ownership, privatization could only be implemented as a state controlled process. The implementation of a voucher privatization model facilitated the resolution of this problem in the Czech Republic, Slovakia, Russia and Lithuania. The voucher model was also approved for Ukraine. Aside from simplifying the process, the voucher model not only received the support of the entire population of Ukraine by assigning each citizen an equal amount of "privatization money," it also met social expectations. Raising awareness among the entire population about privatization was a good way to enlighten people about both the investment process and the risks that accompany it.

The legislation defining the voucher model underwent a substantial change (distortion) due to political (bureaucratic) and social compromise. This, on one hand, allowed the process to begin immediately. On the other hand, however, it caused some negative ramifications for the entire privatization process.

Firstly, Ukrainian voucher-privatization certificates were not transferable. They were bearer certificates and initially existed as deposit accounts (the paper form was introduced in 1995). Later, illegal forms of freely circulating vouchers developed, which contributed to a substantial growth of the shadow economy.

Secondly, nobody clearly planned which property would be sold for vouchers and which would be sold for cash. Bureaucrats were in charge of these decisions. A spirit of compromise permeated the entire privatization legislation. Privileges to enterprise employees, restrictions on investors' activities and a high bureaucratization are three main types of deviations from a liberal model of voucher privatization.

The main privileges for enterprise employees were as follows:

- Competitive and non-competitive methods of privatization were envisaged for enterprise employees, including buy-outs and financial leases (of the entire enterprise), as well as various modifications in buying an enterprise at a nominal price, and offering additional privileges for spreading the payments over time

- Special citizens' associations, such as consumers' societies or lessors' organizations, were given priority rights in the privatization process, and became mechanisms through which others could gain privileged access to the privatization process[4]
- The employees of an enterprise were entitled to a priority right of purchasing the shares of their enterprises for the amount of a privatization certificate, or for half of the share price if paying in cash, and
- Communal property that was acquired or built using the profits made by a privatized enterprise could be turned over to employees, to be treated as collective ownership

Restriction on investors' activity included the following:

- According to legislation, the privatization authorities were allowed to include numerous clauses regarding additional investments, debt payment, preserving jobs, maintenance of social objects, etc., in sales agreements, the duration of which is less than three years
- Ban on free circulation of certificates and special rates to be observed while exchanging foreign currency into Ukrainian hryvnias (which eventually led to a large increase in enterprise costs) were the two main factors that restricted foreign investors' participation. Later, shadow schemes of certificate circulation effectively eliminated the first restriction, whereas the second restriction was abolished through legislation

Bureaucratization of the privatization process was characterized by the following:

- Absence of strict schedules of privatization, numerous plans for privatization of each enterprise, and the possibility for bureaucrats to choose one or a combination of these plans
- Long bureaucratic procedures, and
- Lack of transparency in the decision-making regarding non-competitive privatization methods and non-commercial (investment) tenders

[4] Due to a number of events caused by the undefined status of these quasi-societies, this norm was abolished.

A3. Amended legislation and actual practices

Six and a half years of privatization have seen seven governments and three terms of the *Verkhovna Rada*. However, the differences in the policies of the executive and legislative branches in the area of privatization remain stable. The former was supportive in carrying out the privatization process. Although the normative acts adopted by executive power have bureaucratized the privatization process (which is quite natural), they still contributed to its streamlining by providing these processes with some dynamism. The Ukrainian Parliament, on the other hand, remained in steady opposition to privatization.

Throughout the entire period, the privatization process was seen as a field for an intense political battle. Initially, the battle was to restrict the privatization process. Later, when its irreversibility was accepted, the campaign against privatization was transformed into a battle aimed at using privatization in the interests of the political pressure groups.

The most important events of this battle were:

- *Verkhovna Rada's* moratoria on privatization. While approving the first privatization program, the *Rada* blocked cash privatization until the introduction of a new monetary unit (the hryvnia). The longest privatization moratorium announced by the *Rada* in July 1994 lasted until May 1995.[5] As a result, the speed of privatization was decreased by a factor of 2.5 times in comparison with the previous period. In 1996 a temporary ban on privatization was introduced due to the need to correct the list of objects that are not subject to privatization.[6]

- The *Verkhovna Rada* consistently increased the number of objects excluded from privatization. Eventually, the maximum number of these objects reached 6,000.
- The battle between branch ministries and departments and other government administration bodies eventually precipitated an increase in their role in the privatization process. A ministry was given a priority right of sale of the property of corporate enterprises;[7] later, the ministries acquired the right to include their representatives in the privatization commissions and supervisory boards of

[5] Resolution of the *Verkhovna Rada* of Ukraine from July 29, 1994, #149/94-VR "On Improvement of Privatization Mechanism in Ukraine and Reinforcement of Control over its Implementation.."
[6] Resolution of the *Verkhovna Rada* of Ukraine from November 22, 1996, #542-VR "On Amendments to the List of Objects not Liable to Privatization due to their National Significance."
[7] Decree of the President of Ukraine from June 15, 1993, #210/93 "On Corporatization of Enterprises."

> incorporated enterprises, as well as the right to administer blocks of shares that belonged to the government.[8]

The SPF was deprived of the monopoly right to represent the state as a proprietor in the privatization process. Later, the executive and legislative branches were in a steady battle aimed at elimination of the SPF's special status, which initially ensured its relative independence from other bodies of the executive branch in privatization policy.

In the period between 1992 and 1998, the State Property Fund changed its subordination from the *Verkhovna Rada* to the Cabinet of Ministers of Ukraine three times. The Constitutional Court of Ukraine[9] ruled the SPF's subordination to the *Verkhovna Rada* to be unconstitutional. In full compliance with this decision, the Decree of the President of Ukraine established that, as a central organ of executive branch, the SPF was to operate under the Cabinet of Ministers of Ukraine.[10]

The *Verkhovna Rada* was particularly active in extending the sphere of privatization to employees. Fifty legislative and subsequent normative acts alone were devoted to the issues of lease and lease-with-right-to-purchase. As of 1992, seven legislative acts restricted and renewed the special rights of the lessees to buy out the leased objects. It was not until February 1997 when, with the adoption of a new law[11] buy-outs that entitled the lessee to special rights in purchasing the leased objects were ultimately eliminated as a method of privatization. After that, leased objects would be privatized according to general privatization legislation. Additional privileges for mid-sized enterprises were introduced. Managers received the primary purchase right for five and, later, ten percent of shares in their enterprises.

The most radical step in privatization of agro-industrial complex enterprises (AIC)[12] was made in 1993. The relevant law entailed the following:

- Free transfer of agricultural enterprise property to employees

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[8] Decree of the President of Ukraine from September 19, 1995 #459/95 "On Administration of the National Property in the Process of its Privatization." Currently the right for administration of the government blocks of shares is given to the National Corporate Rights Agency. Decree of the President of Ukraine from July 7, 1998, #752/98.

[9] Constitutional Court. Decision from July 1, 1998, #9-РП.

[10] Decree of the President of Ukraine from March 13, 1999, #250/99 "On Changes in the System of Central Bodies of the Executive Branch of Ukraine".

[11] Law of Ukraine from February 19, 1997, #89/97-BP "On Privatization of State Property".

[12] The number of state enterprises in AIC, before privatization was 9,000, including 2,500 state agricultural enterprises.

- The participation of employees of agricultural enterprises in the privatization of processing enterprises (through free transfers of shares of property according to certain quotas)
- Restrictions on implementation of competitive privatization methods
- Restriction on outsiders' participation in privatization processes

Numerous efforts to privatize non-agricultural land proved unsuccessful. Initially the plan was to sell the land together with unfinished construction sites and gas stations.[13] However, due to the *Verkhovna Rada*'s failure to enact a document authorizing the right to private ownership for non-agricultural land, these objects were sold without land.

Only a small portion of land plots was privatized on the basis of the July 1995 Presidential Decree.[14] Privatization was actually blocked by the local self-governing bodies.

A Decree of the President, issued in January 1999, launched a new attempt to privatize the land under enterprises and unfinished construction sites.[15] The plan was to sell roughly 500,000 hectares of land (less than 1 percent of all land in Ukraine), the estimated value of which was UAH 40 billion. It was expected that the different levels of government would receive up to UAH 1 billion in the first year after the decree's implementation.

Considering the rather high prices for the plots of land, and the fact that the proceeds from their sales might replenish the local budgets in a rather short time (provided that the budget policy is tight), it was assumed that the local bodies would not block the process.

As of 1993, the idea to use privatization to cover the budget deficit has become the foundation of the government's policy. The share of revenues from privatization allocated to the budget had been increasing, from 50 percent in 1993 to 90 percent in 1999. Intentions to use these proceeds to carry out post-privatization restructuring of enterprises had been postponed until better days in the future.

Compensation certificates, a new means of paying for privatization objects, were introduced into circulation in 1994. The government intended to use the compensation certificates as compensation to the citizens for the inflation-eroded money that was placed in accounts of

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[13] Decree of the President of Ukraine from October 14, 1993, #456/93 "On Privatization of Unfinished Construction Sites."

[14] Decree of the President of Ukraine from July 12, 1995, #608/95 "On Privatization and Lease of Non-Agricultural Land Plots for Entrepreneurial Activity."

[15] Decree of the President of Ukraine from January 19, 1999, #32/99 "On the Sale of Non-Agricultural Land Plots."

the state bank and the state insurance company.[4] Injections of this new type of "privatization money" into the effective mechanism of privatization, along with the *Verkhovna Rada*'s removal of a considerable number of objects from the privatization list, destroyed the balance between the property which may be privatized and the value of all privatization papers. The latter suffered depreciation. According to the Presidential Decree, the nominal value of a compensation certificate amounted to ten hryvnias, whereas the market value was four to five times lower.

The introduction of compensation certificates was positive in terms of the rate and depth of privatization. Legislatively imposed restrictions on transfer of privatization certificates did not apply to compensation certificates. Compensation certificates could be traded. Auctions with the use of compensation certificates contributed to formation of equilibrium prices. This allowed for the sale of a large group of objects that otherwise could not easily be sold. The circulation of compensation certificates was suspended in 1998.

A4. A chronology of privatization

It would be worthwhile to divide the process of transformation of ownership in Ukraine into four principal stages:

- Pre-privatization stage (1988-1992)
- Case-by-case stage (1992-1994)
- Mass privatization stage (1995-1998)
- Individual cash privatization (since the beginning of 1999)

The first stage began in 1988 within the former Soviet Union, permitting private business in the form of co-operatives. In 1991, a number of laws were passed in Ukraine to create a legislative basis for business. Given weak government control, every business unit developed both legal and shadow activities. Small capital owners attempted to create niches for themselves in the underdeveloped consumer market, while middle and large capital owners benefited from the inequitable exchange between the state and private sectors of the economy. In the period of 1991-1993, the process developed into a semi-legal activity. Thousands of so-called small businesses were set up in the form of subsidiary firms of the large state owned enterprises and departments. Moreover, top managers established some small businesses in the form of dummy businesses. Previously created co-operatives have also contributed to this

[4] Decree of the President of Ukraine from November 24, 1994 #698/94 "On Compensation of the Citizens of Ukraine for the Losses of their Savings Placed in the Establishments of the Savings Bank and Ukrhosstrakh."

process. Profits were channeled through these “small businesses,” trade monopolies and financial firms of mixed (state and private) form of ownership, and state property. In 1993, the process shifted entirely to the shadow sector because of changes in legislation. However, the scheme of initial accumulation of capital still remains significant for the accumulation of large private capital in Ukraine.

Based on the underdeveloped rental legislation, the collectivist approaches to privatization received wide acceptance. Managers pioneered worкers’ buy-outs of large enterprises by using the funds of those enterprises. At that time, a conflict between the legislation on renting and the legislation on privatization arose. At the stage of mass privatization, this conflict was resolved at the expense of the latter.

In the second stage, 11,000 enterprises were privatized. However, the government failed to achieve the rate of privatization targeted in the Privatization Program. The structure of the privatization process, in particular the ratio between mass and large privatization was distorted. In the course of this stage, mid-sized and large enterprises constituted a majority of those enterprises shifted to the non-government sector of the economy. The privatization process began to take on unusual forms. In contrast with other countries, Ukrainian trade, services and public catering were not subject to immediate privatization. Instead, industrial giants and monopolistic enterprises (usually those documented as the enterprises on lease-with-right-to-purchase) became the main privatization units, although they belonged to those industries that should have been privatized later, when the market environment had matured.

Introduction of non-tradable paper privatization certificates hampered the development of the securities market. The privatization process was slack and passive in character. It was initiated from below and to a large extent, its development was determined by the conditions dictated by worker collectives. The transformation of ownership occurred in the form of “random privatization” of randomly selected objects. Chaotic shrinkage of the public sector destroyed technological and economic connections, and led to crisis.

In 1994, the government attempted to carry out privatization on a mass scale. For this purpose, the methodology of “two waves” of privatization was developed. This methodology aimed to achieve an uninterrupted and regular privatization procedure: while one group of enterprises was being privatized, the next group would be in the process of preparing to be privatized (i.e., in the transition to a form of join-stock companies) so as to ensure the continuous process of mass privatization of enterprises. However, this idea was never implemented because of the lack of a legislative base, and also because ministries failed to reach targets of enterprise incorporation.

During the stage of mass privatization, the average annual rate of privatization doubled. During the period of 1995-1998, some 50,000 enterprises were privatized.

International organizations gave a great deal of assistance for the purpose of carrying out mass privatization. The International Financial Corporation (IFC) – an independent member of the World Bank Group – participated in a small-scale privatization project. Small enterprise privatization intensified at the end of 1994 and the beginning of 1995, at which time several Presidential Decrees regarding the acceleration of the privatization process were issued.

The Decrees contained the following measures:

- Small enterprises being privatized would be sold always with their premises
- The bureaucratic associations of small enterprises in the sphere of services, trade and public catering would be disbanded
- Eighty percent of privatization revenues from the sales of small enterprises would be allocated to the local budget for the purpose of financing social payments and creating incentives for local authorities to continue the privatization

As a result, more than 90 percent of all the enterprises engaged in trade, services and public catering were transformed into private enterprises.
The average annual rate of small-scale privatization for that period increased by 2.8 times. During the period of 1995-1998, 4,400 small enterprises changed the form of ownership.

The international consulting firm PriceWaterhouse received financing from USAID to participate in the development of privatization legislation and to provide technical assistance in the implementation of the Mass Privatization Program for large and mid-sized enterprises. The firm helped establish the network of certification auction centers throughout Ukraine (including 25 *oblasts* and the cities of Kyiv and Sevastopol). In a period of four years, the shares of more than 8,000 enterprises were listed at the certificate auctions, and more than 33 million citizens (or 66 percent of those entitled to have the certificates) exercised their rights to obtain a share of state property.

These measures made it possible to nearly double the average annual pace of privatization, i.e., 8,100 enterprises were privatized within the period.

At the beginning of 1999, when the Fourth State Privatization Program was approved, privatization entered its fourth stage,[17] primarily using private capital.

The following factors accounted for this shift:

- Most of the issued privatization certificates were invested in privatized objects (91 percent, or 46 million certificates)
- 90 percent of small enterprises were transferred to private ownership, and
- The privatization of large and medium-sized enterprises was being completed

During this stage large engineering, transport, telecommunication, oil and gas processing complexes are to be privatized.

It is recommended that Ukraine use an individual approach to privatization, aimed at increasing the attractiveness of objects to be privatized and the liquidity of securities issued, due to the restructuring of enterprises and their debts.

An additional facet of the privatization process was the significant expansion in the types of financial organizations participating in the sale of objects slated for privatization. In addition to the traditional sales on the stock exchanges, auctions and tenders, some additional ways to sell shares appeared:

- On international markets (in accordance with their rules)
- Through securities traders on a contractual base, and
- Through direct international agreements (in a manner prescribed by the Cabinet of Ministers of Ukraine)

In the process of monetary privatization, the SPF would maintain a principle of trying to offer blocks of shares that are as large as possible.

A5. Quantitative results of privatization

In 1992-1998, 61,591 enterprises were privatized in Ukraine.[18] Small enterprises constitute the majority – 49,519 (or 80.4 percent); mid-sized and large enterprises account for 10,840 (or 17.6 percent); and uncompleted construction accounts for 1,232 (or about 2 percent).

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[17] Decree of the President of Ukraine from February 2, 1999, #209/99 "On the State Privatization Program for 1999".

[18] According to data as of January 1, 1999, which excludes 758 enterprises that were withdrawn from the privatization process (for non-meeting privatization requirements) by privatization authorities.

Five *oblasts* of Ukraine (Donetsk, Lviv, Dnipropetrovsk, Kharkiv and Odessa) and the city of Kyiv are among the leaders of privatization; 45.2 percent of the total number of the privatized units are located in these regions.

Non-competitive ways of selling a property (buy-out by company of purchasers and rent-with-a-right-to-buy-out) dominated the other ways during the process. As of the first of January 1999, the percentage of non-competitive and competitive ways of privatization (tenders, auctions and sale of shares) were 62.5 and 37.5 percent respectively.

The process of transformation of ownership was especially intensive in trade and public catering (27,776 units), household services (11,256 units), industry (6,760 units), construction sites (3,181 units), agriculture (2,956 units), and housing/communal sphere (25 to 32 units).

The sale of shares of joint stock in companies became the principal method of privatization in industry (61 percent of the total number of the privatized units in the branch of industry). This indicator was even higher in specific industries: 80.8 percent in electric power, 72.2 percent in engineering, 70.5 percent in ferrous metallurgy and 70.2 percent in the food industry.

The buy-out by associations of purchasers (primarily by insiders) dominated in the course of privatization of cultural establishments (77.6 percent), household services (56.1 percent), trade and public catering (46.4 percent).

A6. Results of privatization on enterprise performance

Results of privatization on enterprise performance are unclear. The enterprises undergoing small privatization, such as trade, public catering, household services achieved the most favorable results. Typically, it takes a certain period of time to see any change in the performance of the privatized enterprise after the change of their ownership. Hence, it would not be wise to expect immediate changes.

Research conducted by an IFC survey showed that most small enterprises (73.9 percent) increased their volume of sales and services, as well as the number of their clients. Differences in post-privatization performance of enterprises are correlated to methods of privatization. Enterprises that were privatized on the basis of competition performed better than those purchased by worker collectives.

While making assessments of mid-sized and large enterprises, the following should be considered:

- The post-privatization period for most of the enterprises is less than three years
- In one-third of privatized enterprises, the government owns 30 percent of the shares
- The government continues to establish prices in the energy and oil-extracting industries, as well as in some branches of the food industry
- Employees are the main owners of most mid-sized and a considerable number of large enterprises (a survey of 200 enterprises, conducted by the Institute of Reforms, shows that employees and managers own about 55.2 percent of the shares)

Since 1997, early signs of differences in the performance of the government and corporate economy sectors have begun to emerge. A comparison of the branches with no government regulation of prices shows that, when adjusting for decreases in volume indicators, non-state enterprises have used their labor and capital better, and thus achieved higher profitability.[19]

[19] Janusz Szyrmer, Vladimir Dubrovskiy, and Tamara Shygayeva. 1999. "Is the Private Sector More Efficient?". *Policy Studies*, No.1, January, International Center for Policy Studies.

Building a Pro-Reform Coalition in Ukraine: Reducing the Bargaining Power of Bureaucracy

Arkady Toritsyn

1. Introduction

As the 1990s demonstrated, significant obstacles face countries that are engaged in programs of democratic and economic reform. This is especially true in the context of the former Soviet Union, where institutional legacies from the Communist era inhibit the development and, more importantly, the implementation of political and economic reform. This chapter examines these aspects in the case of Ukraine, placing special emphasis on the relationship between the central authorities (or principal decision-makers in the government) and the bureaucracy. The chapter starts from the literature review on sources of obstacles to economic reforms and evaluation of the "winners/losers" dichotomy in the context of the Former Soviet Union (FSU). I argue that the peculiarities of the Soviet economy enhanced the political, organizational and economic power of the bureaucracy and made it an independent and strong anti-reform agent. To confirm this statement, I examine relations between the central authorities and the bureaucracy under the Soviet Empire and in post-Soviet transition. I contend that simplistic approaches to reform, which often neglect the bargaining patterns of Ukrainian economic policymaking and particularly strong position of the bureaucracy, increased bargaining capacity of the bureaucracy that is a main obstacle to reforms and ultimately limited the government's capacity and willingness to implement a comprehensive reform program. I conclude the chapter with a set of policy recommendations on how to speed up the reform process in Ukraine, keeping in mind the quasi-independent status of bureaucracy.

2. Economic policymaking in the FSU as a bargaining process

Following the collapse of the USSR, most FSU leaders, who were tied either to the Communist Party or the Soviet bureaucracy, had to generate political support within powerful societal agents. Most commonly, they sought this support from the political and economic elite and state bureaucrats held over from the Soviet system. Since there were no other powerful interest groups focused on speeding up the reform process, and new pro-market democratic institutions were too weak to rely on, FSU leaders had to resort to tactics and patterns of building political support left over from the Soviet era.

In the more authoritarian states, such as those in Central Asia, any domestic political opposition was often seen as a threat to positions of the leaders. Accordingly, leaders often employed harsh and repressive tactics including, among other things, the oppression of particular opposition figures, the banning of political groups capable of challenging the regime in power and strengthening the executive authority not recognized by the state, and the restructuring of the legal system.

In contrast, leaders in the western part of the FSU faced a more open political system. To ensure their political positions, they had to adopt policies that would alleviate domestic political and economic problems, making sure that these policies were acceptable to the citizens and that they were able to mobilize other powerful individuals and bureaucrats in favor of such policies. Since the relations between the central authorities and interest groups were more complex in the Western FSU than in Central Asia, leaders had to bargain more extensively with interest groups and state bureaucrats for their political survival. In order to evaluate the relative power of various groups involved in bargaining with the central authorities, I analyze competitive approaches that can be used for examining agents who are the major obstacles to reforms, and I assess the applicability of these approaches to the context of the FSU.[1]

3. Approaches to understand major agents opposing reform

Traditional vision

When most of Sub-Saharan Africa, Latin American countries, and

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[1] I am aware of the fact that the central authorities are not always willing to conduct comprehensive reforms. Their willingness depends on a wide range of factors that include such issues as degree of regime legitimacy, ability of the government to extract economic resources, character of central authorities' relations with opposition, etc. Since the task of evaluating the central authorities' willingness to conduct reforms is a complex analytical enterprise, this chapter is focusing on a set of situations when the central authorities are willing to conduct reforms. In other words, I make an assumption that the task of economic reforms is prioritized by the central authorities.

some Asian states encountered economic difficulties in the 1980s, their policy responses varied considerably. Some countries launched programs of comprehensive structural reforms, while others preferred to pursue piecemeal reforms – with varying degrees of success. Analyzing such various experiences, scholars discovered that reforms make things worse before the situation can get better. At the initial stages, reforms generate high transitional costs because they bring increases in prices and unemployment and a decrease in production output. Costs of reforms are immediate and often concentrated on particular groups, or what we can call "losers." Dramatic cutbacks in subsidies, growing social inequality, and rise of unemployment produce large possibilities for populist politicians who would appeal to the public, advocating such issues as protection of declining industries, wage increase and expansion or restoration of subsidies. Logically, the short-term losers are inclined to support these populist politicians and to vote against reform during the coming elections. It was also discovered that reforms produce uncertain and often diffused benefits. Thus, it was recommended to protect the reformist state from the pressure of the short-term losers (Haggard and Kaufman, 1989; Skidmore, 1977).

It is logical, within this approach, to argue that authoritarian regimes are better positioned to introduce macroeconomic stabilization and liberalization programs, since they can ignore opposition from short-term losers. Only a strong government can implement rapid, comprehensive and simultaneous reforms. Since the government can neutralize or ignore the opposition, it may disregard the interest groups and continue its long-term reform strategy. When reforms create a constituency of winners politically strong enough to support the state in its actions, such insulation of reformers becomes unnecessary.

A more sophisticated approach within the traditional "winners - losers" paradigm, assessing the impact of a particular regime on the success of reforms, distinguishes between the first stage of reform, when stabilization and liberalization are implemented, and the second, when institutional changes are made. According to this approach, the first stage requires a significant concentration of political authority to neutralize opposition that favors maintaining the status quo and to push through a reform package with little or no public preparation. At the second stage, when more complex measures requiring institutional and legal changes such as privatization of state enterprises and restructuring of social security system are implemented, political dynamics get more complicated – elections are coming, the previously disabled opposition reorganizes and new interest groups demanding their pieces of the economic pie emerge (Haggard and Kaufman, 1992). So, the development of democratic institutions is highly desirable for long-term success of reforms at the second stage.

Joel Hellman's approach

Joel Hellman questions the validity of the above logic for the case of partial reforms in post-communist countries. He discovered that instead of those who traditionally suffer from reforms, such as pensioners and unemployed workers, the major opposition to reforms was created by the "actors who enjoyed extraordinary gains from the distortions of a partially reformed economy [who] have fought to preserve those gains by maintaining the imbalance of partial reforms over time" (Hellman, 1998, p. 232). According to Hellman, the sources of such resistance to reforms are different and include the following short-term winners:

- Enterprise insiders who have become new owners only to strip their firms' assets
- Commercial bankers who have opposed macroeconomic stabilization to preserve their enormously profitable arbitrage opportunities in distorted financial markets
- Local officials who have prevented market entry into their regions to protect their share of local monopoly rents
- So-called *mafiosi* who have undermined the creation of a stable legal foundation for the market economy (Hellman, 1998, p. 204)

So in order to be successful, the reformist governments have to restrict the winners of reforms in the early stages of reform.[2]

Bureaucracy as a main obstacle

Political scientists argue that a government is not a single, rational decision-maker (Krueger, 1993). Within this discourse, some experts highlighted the importance of a divided government for achieving long-term economic reform, where there were both economic reformers committed to market reforms, and representatives of industrial and agricultural interests favoring the preservation of the status quo. Since the government was divided internally, it was argued that "aid should in fact be used politically, to strengthen the members of the government committed to reforms against the members of the government not committed to reforms. Under this model, what aid

[2] According to Khryshtanovskaya (1996, p. 5), 61 percent of the Russian business elite originated from the ranks of Soviet *nomenklatura*.

buys is good economic policies and not direct increases in GDP" (Boycko, Shleifer, and Vishny, 1996, p. 774).

In this chapter I go further and disaggregate the post-Soviet state. I suggest that the advice to restrain winners is impossible to implement in FSU economies because bureaucracy that should be put in charge of implementing this task is the main obstacle to the progress of economic reforms.[3] Vertical personalized bureaucratic networks represent a powerful, essentially anti-reform agent involved in shaping and implementing economic policies. Thus, reforms are designed and implemented in favor of potential winners, who are mostly of bureaucratic origin. Such potential winners intentionally shape the content of policies and, due to their ability to control post-communist transition, distribute the benefits of economic reforms in their favor. When the continuation of reforms may challenge the integrity of bureaucratic networks, they bargain with the central authorities to abort the reforms.

4. Why bureaucracy has such significant bargaining power vis-à-vis central authorities in the FSU: an institutional argument

Various bureaucratic groups enjoyed extremely influential positions vis-à-vis the central authorities in the Soviet system. Since the present bargaining patterns of economic policymaking grew out of relations dominant in the Soviet system, the learning process of post-Soviet leaders and interest groups on how to optimize their goals relied on Soviet-era legacies. In this section I analyze the logic of political and economic relations between the central authorities and bureaucracy longitudinally and try to separate those elements of these relations that may have survived the imperial collapse. I analyze particularly the immediate context and conditions of post-Soviet transition under which past legacies may shape the calculations and choices of the ruling elite and bureaucrats (Crawford and Lijphart, 1995).

Institutions and their capacity for "identical reproduction"

Traditionally, institutions are defined as rules, procedures and norms that allow, prescribe or proscribe certain behavior, define

[3] Thomas Callaghy (1989), arguing that bureaucracy is an interest group in the Third World, writes: "State officials can quietly undercut the effectiveness of reforms by not fully implementing them of by providing "back-channel" input to non-state actors, domestic and foreign, that want to blunt them" (p. 131). In this chapter I argue that bureaucracy in the FSU enjoys particularly strong anti-reform power and it is able to abort a comprehensive reform effort.

expectations, limit and facilitate opportunities, provide information and shape human interaction (Alt and Shepsle, 1990; North, 1990; Powell and DiMaggio, 1991). There is a wide variety of institutions existing in the modern society: the government, business, the educational system, the hospital, the church, marriage, etc. Institutions introduce the rules of political and economic games and reduce the level of uncertainty by providing a structure for economic, political and social exchange.[4] They reconcile rationality on the part of individuals with rationality on the part of society, where sanctions can be employed by the institutional hierarchy in order to make the self-interested behavior of individuals consistent with the collective good.

Institutions establish standards, both cognitive and normative, regarding what should be expected and how people have to behave and relate to each other. They develop and maintain complex codes of behavior regulating who is supposed to do what and where that relieve all members of society of the necessity of engaging personally in many decision-making and conflict management processes. All members of the community share knowledge about expectations and codes of behavior associated with certain institutions, which help in understanding the situation correctly and anticipating what is more likely or unlikely to happen.

Institutions can be characterized by relative stability that is usually captured by a mechanical and static metaphor, “inertia.” Claus Offe offers a better metaphor, drawn from biology, that implies a process, “identical reproduction” (Hausner, Jessop, and Nielsen, 1995). This means that institutions are capable of reproducing themselves because they are not only the products of human activities, but they also make people accept the rules, norms and values embodied in them. Institutions shape people’s minds, cognitive mechanisms and moral principles. Since people cannot change their beliefs, values and norms overnight, they tend to follow for some time the old patterns of relations and expectations of human behavior after the institutional arrangements have been changed (Thelen and Steinmo, 1992). Moreover, institutions may produce vested interests to keep these institutions alive. Once people are socialized to a specific institutional pattern, formal and informal networks are established; institutions continue to produce acceptable outcomes and to maintain a set of rules and expectations; and the costs of institutional innovation and resultant uncertainty may be too high to be readily accepted by those who

[4] New institutionalism, in addition to traditional emphasis on organizational characteristic of state and society, takes into consideration such issues as norms, social obligations and communicative actions (March and Olsen, 1989).

benefit directly from these institutions.

Bureaucracy and its bargaining relations with central authority under the Soviet system

Bureaucracy as a quasi-independent interest group, or more accurately, a set of diverse vertical personalized networks that was extensively involved in bargaining with the central authorities over the content of economic policy, emerged in the post-Stalinist USSR. Political authority had been dispersed, and different bureaucratic groups within the central authority and on the republican level enjoyed various degrees of autonomy from the top leadership. Because the Soviet regime could not resolve all its problems by traditional means of terror, it had to give more power and autonomy to bureaucracy and local authorities. This allowed the local authorities to operate opportunistically and exploit any devolution of additional control rights over the vertical administrative system of economy in order to acquire organizational and economic assets.

The power of bureaucratic vertical networks grew also as a by-product of constant competition for power among senior political leaders in the *Politburo*, who relied on the political support of various interest groups, such as military-industrial complex, heavy industry and agriculture (Gelman, 1984). The importance of interest groups increased because the rules of the political game changed and any leader of the Communist Party after Stalin could not enjoy any more virtual autonomy in policymaking. Although the leader had a large say in picking the committee’s members and in framing policy, his power was not absolute – he had to secure a voting majority when any major action had to be taken. Working in these new circumstances, political leaders had to master their skills of mobilizing active coalitional support, because the constant uncertainty surrounding the top level decision-making bodies made the danger of leadership succession permanent. Each bureaucratic vertical network, therefore, was recognized by the central policymaking authority and incorporated into the political processes through formal and informal links.

How bureaucratic vertical networks functioned in the Soviet system

Generally speaking, the competition of interest groups in the Soviet political context has been limited by the structure of interest intermediation, which made the policy trade-offs among different bureaucratic networks quite stable and predictable. Eventually these patterns of relations among the interest groups, including republican authorities, and the imperial center have been institutionalized and produced a code of behavior, or repertoire of actions, that the interest groups had to follow in order to obtain different forms of benefits from the center.[5] More specifically, if any bureaucratic network was willing to have selected the policy option most favorable to its members, it had to display loyalty and offer political support to the most influential *Politburo* members.

In any political and economic system loyalty, or the subordinate's unconditional support for any position taken by his or her superior, is rewarded. In the Soviet system, however, where transparent rules were virtually absent, it was definitely rewarded more lavishly than other attributes of the subordinate's performance. Loyal subordinates were particularly needed by top officials in their intra-party or intra-bureaucratic games aimed at attaining better political power positions and higher economic rents.[6]

Loyalty and displays of loyalty to superiors through the whole vertical system were institutionalized as the main rules of the bargaining game. The design of the Soviet system imposed a set of specific rules on the competition among different interest groups, ministries and republics for investment and other scarce resources. Leaders, or more specifically the most influential *Politburo* members, played a key role in this competition and extensive bargaining, and were a source of stability and change. To a large extent, such dependence of interest groups/republican authorities on the *Politburo* was enforced via a planning and administrative system that could be easily manipulated by the *Politburo* members under conditions promoting irresponsibility and limiting incentives.[7] As a result, the centralized Soviet decision-making structure always tended to produce substantively less rational policies, because the ultimate decisions were usually made on the basis of the information possessed by the Politburo members, which was bound to be incomplete and tended to be biased toward their personal interests, views and experiences.

Under close supervision of the top Party organs, the State Planning Office produced a fully detailed plan for the whole national economy. The plan was presumed to be both internally consistent and optimal from the perspective of the top political leadership. Since the plan operated on the aggregates described, addressees, or the different ministries and agencies, allocated their plans for every directorate heading a sector or sub-sector. Ultimately, when the plan

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[5] Approaches combining the institutionalist and coalition-building approaches may be found in Gourevitch (1986) and Katzenstein (1985).

[6] Networks based on loyalty played an important role in reproduction of the elite in Poland (Wasiliewski and Wnuk-Lipinski, 1995).

[7] The socialist economic organizations may be viewed as self-legitimating bureaucracies (Milenkovitch, 1992).

had been enacted into law, the directorate transmitted a compulsory plan to the individual firms it controlled by issuing legally binding, operational instructions that had to be obeyed and fulfilled.

Even though economic decision-making was highly centralized, the plan grew out of a long and complicated succession of steps. Since the competence and performance of all participants in the process of planning were ultimately assessed by their success in fulfilling or over-fulfilling the plan targets assigned to them, all of the participants, except for the central decision-making authority, were interested in minimizing the plan targets set for them. Every subordinate had an interest in being assigned a plan with generous allowances for machinery, labor and materials, but with low-output targets. On the firm level, each firm tried to maximize credit, investment and inputs and strove to minimize its supplies to other firms. Firms sent false signals to superior bureaucratic levels to obtain easier production targets and more inputs; therefore the final plan represented the outcome of extensive bargaining and bureaucratic compromise between the interest groups and the central authority.

All parties involved in the economic activities under the Soviet system, and particularly top-level policy makers, tried to personalize exchanges among different agents. In a democratic capitalist system, where the variety and number of exchanges are high, the personalization of exchange is difficult to achieve, while the socialist system with its restricted number of exchanges and vertical integration of enterprises, facilitated such attempts. Legally, personalization was achieved by issuing regulations, laws, rules and decrees that often were contradictory and unenforceable. This system was intended to make any manager, local or republican official, subject to dismissal at any time as a result of discretionary application of sanctions for nonobservance of these regulations. If all the laws and regulations were to be strictly observed, operations of the firms, branches of the economy and the republics' economies could come to a standstill. Since this was not acceptable to anybody, managers and other officials directly responsible for plan fulfillment had to disregard formal procedures and secure their positions by maintaining personalized relations with their superiors based on loyalty (Milanovic, 1989). The loyalty could be expressed differently. For instance, if any manager at the firm level undertook any successful economic activity, she had to attribute her success to a particular economic or political superior. These forms of behavior, emphasizing patronage and co-optation as a source of success, constituted the cultural and moral foundations of the Soviet institutions.

The web of personalized connections existing vertically as well as horizontally was established among people sharing similar social and bureaucratic biographies, which contributed to the cohesiveness of such informal links. Without these informal ties based on loyalty/displays of loyalty, the task of meeting plan targets at the enterprise, local and republican levels would be quite difficult to achieve; the centrally planned economy, with its ineffective bureaucracy, could not manage this process effectively. Moreover, the system did not improve its efficiency, and the ruling elite failed to check the erosion of its authority and restore its reputation by disciplining local authorities and low-level bureaucrats during Gorbachev's *perestroika* (Solnick, 1998). The reforms that were introduced did not challenge the existing property structure, and allowed bureaucracy and *apparatchiks* to maximize their rent (Winiecki, 1990).

5. How bureaucracy strengthened its position in post Soviet transition

Institutional transition in the post-Soviet space clearly indicates that legacies of the past continue to matter. Initial expectations of some post-Soviet leaders and their Western advisers to create capitalism and democracy by design through the mere replication of some tried and trusted models operating in the Western hemisphere, have not been completely realized. Instead of an institutional vacuum open to any kind of institutional design, reformers faced the resistance of informal networks formed under the Soviet regime. Such networks developed their own practices and routines, as well as social ties and patterns of making credible commitments.[8]

The remnants of the old institutional arrangement constitute a barrier that does not allow the new institutions to function properly – a set of expectations and assumptions that dominated under the Empire still matters.[9]

Just as there can be no market without property rights, so there can be no market without people. And just as the macroeconomic system affects individual behavior, collectively the behavior of individuals has an impact upon the macro-economy. In the unique circumstances of

[8] It is no wonder that the reformers' mantra - democracy, civil society and market economy has not produced the desired outcomes in many places, since reformers have failed to understand that institutions of the past matter (Aligica, 1997).

[9] Although I examine here only one aspect of Soviet legacies, I would agree with Philip Roeder (1993) who introduces the broader perspective: "In all republics, regardless of level of social modernization, the legacy of the Soviet institutions may make the bureaucratic survivors a potent base for new bureaucratic authoritarianism, although the exact balance of bureaucracies in each republic is likely to differ from the constitution of Bolshevism" (p. 250).

these societies, we cannot rely upon the experience of Western societies, and especially of Anglo-American societies, to tell us what will happen in societies in transformation (Rose, 1993, p. 419).

The closed networks of former Communist party functionaries and Soviet bureaucracy constituted the core of the transitional elite, thus bureaucratic vertical networks constituted a powerful constituency capable of bargaining with the central authorities over the content of economic policy. The strength of bureaucratic networks became especially visible during the last years of the Soviet Union when the integrity of the communist system was in flux, given its declining ideological appeal. Central authorities were unable to maintain their narrow base of political support, and interest groups and other bureaucrats demanded material benefits in exchange for their political support. This had traditionally been how the communists maintained their political control over the former Soviet Union, but the bargaining position of the central authorities weakened primarily because of budgetary limitations and inefficient economic structures, which inhibited direct access to societal resources. So the institutionally empowered bureaucracies at all levels enjoyed significant bargaining power in intensive struggles against the central authorities (Brubaker, 1994, p. 61).

Unlike successful cases of transition in Central and Eastern Europe, the alternative vision and patterns of politics did not become dominant in the majority of transitional post-Soviet states; even the mobilization around national and ethnic issues failed to breach patronage networks inherited from the Soviet Union. Reforms aimed at enhancing the economic efficiency of a country often threatened the interests and positions of influential social actors (mostly of bureaucratic or *nomenklatura* origin) from the previous system, or the “stakeholders” (Shleifer and Triesman, 2000).

Forging a relationship with the major actors in the FSU is paramount for the successful reform of a country, as they have the potential to undermine the reform process both directly and indirectly. They may either thwart the enactment of reform programs by subverting the policy process and safeguarding existing inefficient arrangements, or they may resist the implementation of reforms through decentralized actions during the process of reform. Since the majority of short-term winners were of “bureaucratic origin,” and the rules of the economic game institutionalized under the Soviet system survived the system collapse, they attempted to build their own closed vertical networks and limit the degree of competitiveness in such a system. This realization is not new by any means, and has been observed most candidly in the case of Russian economic reform. As Anders Aslund (1995), economic advisor to the Russian government from November 1991 to January 1994, observed, “a mutual, silent hostility prevailed between the reform ministers and the bureaucrats. Rather than opposing the reforms overtly, the old bureaucrats sabotaged them discreetly. The reformers faced an impossible dilemma. Because they knew few of the old civil servants, it was difficult for them to find the right people to appoint and promote. The reformers therefore often selected ineptly, which further demoralized the old staff. When the reformers appointed young colleagues to senior positions, staffers of the old apparatus naturally regretted it. No matter what the reformers tried to do with the old administration, they encountered quiet resistance and failed” (pp. 90-91).

Benefiting from the vertical structure of personalized networks, and relying on the patterns of behavior institutionalized under the Soviet Empire, when economic and political institutions were unstable, the bureaucracy acquired a wide variety of mechanisms that allowed them to be directly involved in the economy and to pursue private gains with official means (Paskhaver, 1999; Dubrovskiy, 1999). Each “renovated” bureaucratic vertical network established its own rent-maximizing system, which was capable of preventing higher-level authorities from reviewing and intervening in what was going on below. It has been reflected, particularly, in dramatic expansion of rent seeking (see Table 1). Once the bureaucrats adjusted their rent-maximizing techniques to new political and economic circumstances, they developed vested interests in maintaining the status quo. This explains why we do not have resentful former state bureaucrats in the ranks of short-term losers vigorously opposing the reform process – the bureaucracy possessed strong bargaining capacity in dealing with the central authorities that allowed it to adjust reform programs to its needs and create short-term winners within their closed ranks.

Privatization, for example, enhanced the power of the bureaucracy – bureaucrats became the new owners and, benefiting from re-interpretation in their favor of privatization slogans, they stripped the best assets of the former Soviet economy. Mostly they have done little with their properties, and have continued to exploit their good connections with their old buddies in the bureaucracy to get subsidized credits; tax breaks and privileges (Frydman, Gray, and Rapaczynski, 1996; Blasi, Kroumova, and Kruse, 1997).

Table 1

“Unofficial” Payments by Enterprises for Official Permits,

Licenses and Other "Favors" in Ukraine and Russia, 1996 and 1994

	Ukraine				Russia	
	Average unofficial fee required for favor		Percentage of enterprises admitting need to pay unofficially		Average unofficial fee required for favor	Percentage of enterprises admitting need to pay unofficially
Type of license or "favor"	1996	1994	1996	1994	1996	1994
Enterprise registration	$176	$186	66	64	$288	44
Each visit by fire or health inspector	$42	$40	81	72	$67	23
Each regular visit by tax inspector	$87	$91	51	56	$250	21
Each phone line installation	$894	$550	78	95	$1,071	100
Lease in state space (sq. meter per month)	$7	.	66	88	$26	39
Each export license registration	$123	$217	61	96	$643	43
Each import license registration	$278	$108	71	93	$133	50
Each border crossing (lump sum)	$211	$194	100	90		
Domestic currency preferential loan (percentage of value)	4%		81		8%	38
Hard currency preferential loan (percentage of value)	4%		85		23%	53

Notes: Average "unofficial" fee required for "favor" is measured as the average among those who admit making unofficial payments. Preliminary data based on March 1996 survey of 150 state or private enterprises in five large Ukrainian cities, and 50 enterprises in three large Russian cities. Caution should be exercised in interpretation of the data, which are not representative of the whole country (particularly in Russia, where the sample is small). The mid-1994 survey results for Ukraine are based on a similar survey instrument.

Source: Kaufmann (1997, p. 7).

Particularly impressive were the achievements of bureaucrats in making personal profits from loss-making and inefficient enterprises. One of the most widespread devices was to spin off private "daughter companies," owned by managers and their close allies. Such companies acquired the output of the enterprise and sold it at market prices. Meanwhile, the main enterprise accumulated debt, held taxes and delayed wages.

Given the above analysis, it is analytically superficial to view bureaucracy in the FSU as a hierarchy that implements the government's economic decisions. The bureaucracy, which relies on its special quasi-independent status inherited from the Soviet times and economic power enhanced during privatization and stabilization, has substantially increased its bargaining power in dealing with the central authorities during transition. In other words, bureaucracy becomes "a maker of the rules of the game" instead a "rule follower" (that is, bureaucracy becomes the initiator of the rules rather than one who is subject to the rules but does not initiate them), as is traditional in other societies.

6. Policy recommendations

Although it might sound provocative, the central authorities should be insulated from the pressures of bureaucracy in developing and implementing policies. Instead of building a bureaucratic apparatus that is reasonably well isolated from political power (Haggard and Webb, 1993), I argue that bureaucracy should be subject to political pressures; however, the central authorities have to assure the emergence of a strong enough pro-reform constituency capable of exercising pressure on bureaucracy. Given my analysis above, I doubt that traditional measures of making bureaucracy accountable and its activities transparent, brought from Western practice, can bring dramatic improvements – the logic and patterns of operating of bureaucracy are fundamentally different in the FSU from those in the West, where the rules of the game are transparent and bureaucracy does not have any significant political or organizational capacity to promote its interests and impose its own rules of the game. Thus, programs improving the quality of the state personnel, improving information flows within the bureaucratic system, and improving audit and review operations within the state apparatus hardly can bring dramatic changes.

I doubt also that administrative methods of improving bureaucratic performance adopted from the Soviet era can achieve their goals. Strengthening the power of the central authorities can only partly reduce the anti-reform bargaining capacity of bureaucracy. They will be unable to break the vertical bureaucratic networks with their own patterns of behavior. As the Soviet attempts at improving the bureaucratic performance demonstrated, the central authorities were technically unable to control each and every bureaucrat at all stages of decision-making and implementation.

The central authorities alone cannot cope with the problem of bureaucracy. They have to produce and support a politically and economically strong partner; or more specifically, they have to promote a domestic constituency interested in reforms and possessing enough political power to support its interests. In practical terms the government, with the donors' assistance, can expand the ranks of a pro-reform constituency by changing the existing opportunity structure. Although the reform process undermined traditional bases of economic security of society and imposed high short-term transitional costs on the population at large, individuals tend to evaluate governmental performance by assessing their short- and long-term economic opportunities (Kullberg and Zimmerman, 1999).

By launching reform measures supporting the pro-reform constituency and reconfiguring the economic opportunity structure, the government may eventually build support for the entire package of reforms, as well as assure the emergence of institutions facilitating control of these constituencies of bureaucracy at all levels. The government may signal in advance its reform commitment through careful packaging of reform measures that enhance public perceptions of positive economic changes.

Someone might argue that the government may benefit if it reduces the size of the coalition in order to decrease the degree of incompatibility of interests within the coalition and lower the amount of resources needed to hold the coalition together (Waterbury, 1989, p. 40). However, in Ukrainian circumstances the leaders have to create a pro-reform constituency large enough to secure a long-term reform process and eliminate dependence of the government on those interest groups that oppose the reform process.[10]

A pro-reform coalition may include four groups:

- Small and medium-sized enterprises' owners and employees, as well as market-oriented farmers
- All segments of the population who are not satisfied with the status quo and seek change
- Large market-oriented businesses
- External economic agents

Small and medium-sized enterprises' owners and employees, as well as market-oriented farmers as a broad basis of the pro-reform coalition, have to be supported by reduction in tax burden and other measures.

[10] I completely agree with Hector Schamis (1999) who invites us to put societal interests at the forefront of our theorization in political economy and to treat the politics of economic reforms as the "politics of empowering the winners".

How can this task be accomplished? Let's examine the situation with the small- and medium sized enterprises (SMEs). The existing climate for SMEs may be characterized by outdated policies, confusing regulations, oppressive tax burden and corruption, which make this type of business activities virtually unprofitable. Managers in Ukraine "face worse bureaucratic corruption, more mafia extortion, higher taxes, and a less effective court system" (Johnson, Kaufmann, McMillan, and Woodruff, 1999, p. 2). Although simplified tax procedures envisaging tax reduction may be adopted, this measure is not sufficient to assure the long-term reform process. Thus a set of more comprehensive measures is definitely needed.

Even if SMEs are supported by a drastic reduction in tax burden and through extensive deregulation, these enterprises may not necessarily join a pro-reform coalition in the short-run: the costs of creating new institutions and linkages, measured in terms of time, resources and ambiguity associated with such processes, are high. Since the managers of viable enterprises operate in an institutionally dense environment with clearly defined rules of the game, the ambiguity associated with radical institutional innovations significantly reduces the chances for collective support of a radical reform program because every member of a pro-reform coalition will have an incentive for free-riding and giving up his political position in exchange for the ability to conduct business (being freed from bureaucratic pressures, for example). Therefore, even if the government announces a reform initiative lowering tax rates and abolishing remaining distortions and bureaucratic involvement, this decision might not be as credible as is initially expected because the private sector, keeping in mind the pattern of economic policymaking in Ukraine, could anticipate a return to high tax rates once it had joined the official economy. Moreover, the declining share of small-scale, privately owned industrial enterprise output would not allow these potential supporters of reforms to mobilize sufficient economic resources to support their political interests (see Table 2).

Therefore, the central authorities should support SMEs institutionally and through macroeconomic policy.[11] For instance, it is impossible to expect the fast and massive development of SMEs when banks in Ukraine have neither the intention nor expertise to conduct a comprehensive, massive small business-lending program. Therefore, SMEs are financed from entrepreneurs' personal savings, savings of their families and through retained earnings of their businesses. Since banks are generally reluctant to engage in extensive micro-lending the government, with the technical assistance of Western donors, has to develop a program creating incentives for the banks to implement micro-lending programs.

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[11] For a comprehensive analysis of problems that small and medium-sized enterprises face in Central and Eastern Europe, see Pissarides (1998).

Table 2

Distribution of Small-Scale Industrial Enterprise Output, by Type of Ownership, 1991, 1995-1997

	1991	1995	1996	1997
All industry	100.0	100.0	100.0	100.0
By type of ownership				
Private	21.2	27.5	20.1	14.8
Collective	43.8	69.9	78.7	78.6
state-owned	35.0	2.6	2.2	1.8
Property of international organizations and foreign companies	-	0.0	0.01	4.8

Source: State Statistics Committee of Ukraine, Statistical Yearbook of Ukraine for 1997, Kyiv, 1999, p. 323.

The central authorities have to provide institutional support for those interest groups that are politically and economically weak but that can support the government in its policy of reforms. For example, business associations that can represent and lobby the interests of small and medium-sized entrepreneurs are institutionally weak. Usually they lack adequate analytical and lobbying capabilities to select those public policy options that would be beneficial for the development of small and medium-sized enterprises and promote these policies on the local and national levels. A particularly important problem is that entrepreneurs are often reluctant to join associations and unite their efforts with other businesses. Business associations should be considered by Western donors and the central authorities in Ukraine as the backbone of civil society. Since these associations can represent the interests of the community at large and promote the broadly oriented market reforms benefiting the majority of society, business associations can become an institution through which the community can participate in reforms on local and national levels.

In their regional policy, the central authorities have to encourage regional and local governments to promote SME. Although the laws facilitating the expansion of SME should be adopted on the national level, the local and regional governments, due to specific position of the bureaucracy vis-à-vis the central authorities in Ukraine enjoy a high degree of autonomy in implementing the existing and forthcoming laws. Since the central authorities lack the expertise and institutional capacity to monitor the local bureaucracies in order to ensure the full-fledged implementation of laws and regulations promoting the expansion of SMEs, the central authorities can establish a controlling mechanism connecting the central authorities with local business associations that can limit the extent of discretion the local authorities enjoy in deciding the degree and severity of enforcement, imposing sanctions and granting privileges (an Internet project, as an example of such institution is discussed below).

Although the reformist government can achieve better results if it appeals to the middle class and business rather than to a wider range of social forces, in particular Ukrainian circumstances where the middle class virtually does not exist, the reformist government should appeal to all segments of the population that are not satisfied with the status quo and seek change. Although the legitimization appeals of nationalist/state building may be applied in Ukraine, excessive exploitation of such techniques might generate ethnic tensions; thus, the leadership has no other options but to build its legitimization policy around the policy of economic reforms bringing benefits to everybody. The government should enhance positive public psychological perception of economic changes. It should send direct positive signals to those that will benefit from reforms and can be the most active segment of the pro-reform coalition.

If these changes are combined with an attractive package of incentives for large market-oriented businesses (the opportunity to make more profit), encouraging them to operate under the conditions of market economy when the rules of the game are transparent, the market-oriented large businesses and financial sector will join the pro-reform coalition. Since the central authorities should take into consideration the sector specificity in devising policies and attempt to break the linkages of bureaucracy with large businesses and focus on sectors in which a large number of economic agents operate (e.g., retail, financial service, media).[12] The central authorities may become an effective mediator between the Parliament and these businesses in developing a comprehensive set of laws, eliminating the possibilities of bureaucratic intervention and rent seeking. If large businesses realize that benefits of working in the market environment exceed those of being integrated in vertical bureaucratic networks, they might accept transparent market rules of the game. This move will eliminate opportunities for rent seeking and reduce the bargaining power of bureaucracy vis-a-vis the central authorities.

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[12] "The political economy of transformation should take into account different industrial sector profiles, and that large and diverse economies such as the Russian one will have different forms of "transition settlement" compared to the smaller, more specialized economies of Eastern Europe" (Lane, 1999, p. 93).

The government has to attract external economic agents to its pro-reform coalition. This can be accomplished by developing a coherent and cohesive Ukraine policy towards the International Financial Institutions, European Union, the USA and Canada, as well as foreign investors in general.

In order to keep the anti-reform constituency within tolerable limits, the government may consider some forms of compensatory payments to those who will be disadvantaged, partially covering the extent of their losses. In practical terms, this means that the government, as well as the donor community have to accept that some discretionary practices in resource allocation supporting these segments of the population will be adopted.

Institution-building efforts should support a new pro-reform constituency and establish direct connections between central/local pro-reform authorities and pro-reform constituencies bypassing bureaucracy. Although "institutional reform may cause considerable short-run disruption and prove hard to sustain" (Johnson, McMillan, and Woodruff, 1999, p. 1), the institutions created with the donors' assistance should help the agents presented, constituting a pro-reform constituency in resolving the collective action problem. Obviously, if too many individuals stand to gain from a particular policy, each of them may view the probability of gains, as being largely independent of his behavior, since the contribution of every participant will be relatively small in comparison with the total. Due to this difference, it is much easier to achieve collective action in small bureaucratic and oligarchic groups where a small number is to gain and the group members perceive their own contribution as mattering.

Such institutions tailored to the needs of pro-market actors will encourage cooperative behavior, reduce transaction costs and will not only coordinate the different aspects of societal life – namely, the extensive linkages between society and decision-making bodies through which societal demands are channeled to the political system – but also move the present power balance favoring bureaucracy to another equilibrium reflecting the interests of pro-market forces.

Particularly important for increasing the bargaining power of pro-market forces would be a country-wide Internet project that could make the flow of information on local and government levels transparent. Although the bureaucracy will resist these efforts, Western donors may capitalize on their high bargaining capacity to move this project through. In this regard, the Internet may be viewed as an "alternative" market institution, effectively by-passing the bureaucracy. The central authorities (ministries as well as local authorities) should be integrated into the Internet, which should make their activities transparent and reduce the possibilities for rent seeking.

If the broader constituencies that are empowered institutionally become an integral part of the reform process, they can contribute their knowledge and understanding of specific local conditions, and become personally involved in development that ultimately increases commitment on the part of broad audiences (World Bank, 2000). The reform strategy, however, should not dramatically (instantly and wholesale) challenge the existing structure of power relations; rather, it should create political popular pressure for reforms. That is why the proper sequencing of reform measures is essential in securing the long-term prospects of reform measures. The reform program should not injure the interests of all actual and potential members of the pro-reform coalition simultaneously. Although the interests within the potential pro-reform coalition vary, the government, by carefully selecting and sequencing rewards and punishments, may maintain the acceptable degree of cohesiveness within the coalition. Although the tasks of pro-reform coalition management may not always correspond to the optimal economic logic, if a broadly based pro-reform constituency is not created, there is a probability that despite implemented economic reforms, the reversibility of enacted reforms will not be reduced.

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Government Program: 'Reforms for Welfare'

Inna Golodniuk

1. Introduction

History and lessons of economic reforms in Ukraine

Since achieving independence in August 1991, Ukraine has been struggling with many fundamental problems: a large defense sector and energy intensive heavy industry inherited from the Soviet Union; the interruption of relationships with consumers and suppliers from other former Soviet republics; and the generally socialist nature of the economy, where allocation of resources was based on political decisions rather than prices and private ownership. All these factors necessitated the undertaking of serious reforms to create principles of economic relations that are needed for developed market economies.

These reforms included primarily improvements in the burdensome and non-transparent tax system, and regulatory measures to stimulate economic development and get business out of the shadow economy, as well as reforms of government finance and pension systems. In other words, the situation required government commitment to long-term systemic socio-economic transformation. But in the early years of independence neither the Cabinet,[1] nor the Parliament had enough understanding and capacity to formulate and implement reforms, consistent with market institutions that would lead to steady economic growth.

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[1] The Cabinet of Ministers is the highest executive power body in Ukraine. The Prime Minister (the head of the Cabinet) is appointed by the President and has to be approved by the Parliament.

The first serious challenge the Government had to face was a large state deficit financed through highly inflationary borrowing from the National Bank. Fortunately, policymakers were able to curb inflation and to successfully introduce a new currency, the hryvnia, in 1996.

However, the addiction to excessive public consumption was not given up, and Ukraine's budget deficit persisted. This deficit has largely been the result of excessive spending on inefficient social programs and subsidies to noncompetitive industries, coupled with inadequate revenue collection. Financing was achieved through a combination of issuance of T-Bills to domestic and foreign investors, assistance from international financial institutions, and accumulation of wage and pension arrears. With the onset of the Russian financial crisis, however, the market for government debt largely dried up, and at that time the Government had to rely upon credits from international financial organizations, especially the IMF and World Bank.

The situation was exacerbated by a weak budget policy. Budget expenditures were not thoroughly planned. They were idiosyncratic - depending on the shifts in current political situation.

Macroeconomic imbalances were intensified by half-hearted and inconsistent attempts of structural reforms that brought about inadequate regulation, lack of transparency, and inconsistent application of the law. No fundamental change occurred. Numerous cosmetic changes and the general failure to effectively implement economic reforms led in 1998 to a deep depreciation of the hryvnia and jump in the prices, resulting in annual inflation of some 20 percent for 1998. The exchange rate relative to the U.S. dollar, which had remained relatively steady in 1996 and 1997, dropped by approximately 40 percent during August and September of 1998, as financial crisis spread from East Asia, through Russia, to Ukraine.

While trying to correct this failure, the National Bank reinforced efforts to reduce liquidity by raising bank reserve requirements and increasing control of foreign exchange operations. The latter had a negative implication for economic activity. All businesses in Ukraine, foreign and domestic, were barred from making advance payment on import contracts, and commercial banks were forbidden to give residents credits in foreign currency. The NBU imposed a mandatory sale of 50 percent of hard currency earnings of enterprises. At the same time, the ability of private banks to purchase foreign currency was significantly restricted by NBU regulations. Such restrictions have produced significant hardships for foreign and domestic firms doing business in Ukraine.

Throughout 1999 economic decline continued and annual inflation remained at a relatively high level (about 19 percent)

This was the situation that the Government headed by Victor Yushchenko had to deal with after coming into office in December 1999. The new team led by the former central bank governor was dubbed a “government of young reformers” because of their fresh and progressive approach to reform strategy.

They stated explicitly that Ukraine urgently needed to replace control-based traditions of the past with policies that would facilitate market-based production and growth. The country should introduce and develop an institutional infrastructure needed to design and implement the necessary policies if it wished to reverse the staggering decline of over 60 percent in national product, and the consequent sharp deterioration of living standards.

Such reforms were also urgently needed if Ukraine wanted to move along the path of integration with Western economies through the development of globally competitive production systems with market-friendly legislation.

However, market-oriented reforms could be implemented only when the policymakers and the people of Ukraine truly understood the urgent needs for such reforms. The slow pace of reforms, or their surrogate, that had been taking place since Ukraine’s independence indicated that there was no “critical mass” of demand for reforms within the society.

On the basis of the market-oriented philosophy, Yushchenko’s Government, with assistance of the HIID/CASE Ukraine Project’s team prepared a government Program of action called “Reforms for Welfare.” Although the final version of the document was to some degree a compromise reconciling views of major Ukraine’s policymaking bodies, its substance did not significantly deviated from the strategy for the most urgently needed reforms suggested by the Cabinet in the original draft. Most of these reforms were supported by HIID/CASE advisors.

2. ‘Reforms for Welfare’: a new view on the reform agenda

The program of action is constitutionally mandated as the declaration of the Cabinet’s economic reform policy and measures to implement it. Although there were three government programs preceding the “Reforms for Welfare” Program, the latter is a quite radical government standpoint on the reform agenda.

The approach suggested by the Program shows considerable progress in understanding that these are essential institutional and structural changes, rather than only cosmetic fragmental adjustments, and these changes can truly reform the economy and bring permanent improvement in Ukraine’s economic performance.

The Program's concept rests on adherence to fundamental principles characteristic of market economy, such as transparency of economic relations, competition, private property and clearly defined property rights, entrepreneurial freedom, strict contract enforcement, openness to foreign trade, and hard budget constraint.

Serhiy Tyhypko, at that time the Minister of Economy and one of the program co-authors, said in an interview to "*Holos Ukrainy*" (March 28, 2000) newspaper when asked to comment on the Program:

The Government fully realizes that postponing decisive and deep structural and institutional transformations will lead to further deterioration in the country's economic situation and poverty. As world experience shows, the most effective path to growth and welfare is establishing a free market economy. The Government will carry out reforms aimed at gaining a foothold for market relations in the economy. Private property, entrepreneurial freedom, stability and competition are the major pillars of the developed market. These principles embody the conceptual core of the 'Reforms for Welfare' Program.

Another progressive feature of the program is its orientation toward complex reforms of the overall economic system rather than towards separate sectoral changes, as was the case with previous governmental programs. The program, for example, declares that equal rules of the game will be imposed on all enterprises regardless of property form and organizational status. Each enterprise will bear full responsibility, including property responsibility, for the results of its business activity. Under such constraints only well-performing enterprises will stay viable.

An effort to establish equal opportunities in competition is a very important step. This is the first time that the Government publicly admits that state support to a specific industry or enterprise may imply redistribution of wealth from 'value creators' to 'value subtractors'. As a result of such redistribution the society on the whole loses in welfare.[2]

Last, but not least, one should emphasize the Government's appreciation of the fact that market oriented reforms could be implemented only when the whole policymaking community and the people of Ukraine truly understand the urgent need for such reforms. This is especially important when transformations cause a short-term deterioration of living standards. The Cabinet declares adherence, as it puts in the Program, to the principle of complete openness of the policymaking process. Non-government organizations and independent experts will be actively involved in the reform decisionmaking process.

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[2] For further discussion of this issue see: "An Analysis of Fundamental Economic Problems in Ukraine and an Agenda for a Comprehensive Reform Effort" in this volume.

All these characteristics favorably distinguish the Program from its predecessors, which were written in a vague and obscure manner, focused on reforms of separate industries or even enterprises and specific categories of output thus failing to formulate a general market-oriented policy that could be implemented, monitored, and managed. (For more detailed comparison of earlier governmental programs to the 'Reforms for Welfare' Program, see Appendix.)

3. Overview of the Program reform strategy

The Program is a two-part document. The first part is a twenty-page text of policy statement. It is followed by a table of specific measures that stem from each policy direction declared in the policy statement.

This policy statement explicitly defines four strategic goals of Ukrainian society, as the Government sees them, and presents priorities and reform agenda for each of them.

The strategic goals are understood as long-term objectives that should be pursued by a democratic society. The four strategic goals named in the Program are: reducing poverty, increasing competitiveness of the domestic economy, human capital development, and gradual integration into the European Union. Although these goals are formulated in broad general terms, the authors provide criteria to evaluate the performance of the Government with respect to each of these goals. For example, the criteria for reducing poverty are the following: growth of real wages and pensions, increase of the minimum pension, and reduction in the percentage of population living below the poverty level.

Having defined the long-term destination point, the Program then describes where current Ukrainian economic and social systems are with respect to the strategic goals mentioned. The chapter entitled "Evaluation of the current economic situation in Ukraine" gives analysis of the most painful economic problems and their causes – distortion of the basic market principles like property relations, stability, competition, and economic freedom.

Based on the analysis of the roots of economic problems, the next chapter, "Priority tasks for the medium-term perspective," outlines tasks to be fulfilled in order to eliminate the sources of economic crisis and create opportunity for economic growth. Priority is given to the issues of political stability and strengthening government effectiveness, improvement in living standards, social justice and human development, economic growth, and competitiveness of the national economy.

Given the scale of necessary changes to implement priority tasks, the Program declares a package of reforms that will be the starting point for a significant socio-economic improvement. The most important reform steps declared are the following:

- Administrative reform will be accelerated.
- The Government will adhere to balanced/surplus budget.
- A radically new tax code will be introduced. Tax burden on enterprises and households will be reduced via elimination of tax privileges thus allowing a tax rates' reduction. Tax compliance will be simplified. The Government will establish and protect the equality of rights of taxpayers and tax collectors. All taxes will be paid in monetary form.
- Budget funds will be mostly channeled to support social security system and finance structural changes in the economy.
- To increase transparency of budget execution, the Government will publish quarterly reports on budget expenditures with detailed explanations for any deviations from planned expenditures. This will be closely monitored by the Accounting Chamber.[3]
- Government will strengthen the system of social security by increasing spending on education, healthcare and social security benefits. Overdue wages in the budget sector and pensions will be paid off by the end of 2000.
- Government will create favorable conditions for business activity. This includes guarantees for property rights and contract enforcement, creating efficient bankruptcy mechanisms, ensuring equal "rules of the game" to all market participants (monopoly regulation, eliminating soft budget constraints, reducing barriers to market entrance caused by government policy). The government will not intervene in business activity of an enterprise.
- Government will work to reschedule its liabilities on foreign debt and improve the debt structure. Debt management will concentrate on preventing further debt accumulation.
- Government will carry out basic structural changes necessary to reduce risks associated with transactions through the financial system and encourage inflow of savings into the economy.

[3] The Accounting Chamber is an independent state institution monitoring activities of executive governmental bodies and state enterprises. Its major task is monitoring state budget management.

- Reforms of the energy sector will establish market mechanisms within the industry and solve the problem of arrears in energy payments.
- Agricultural policy will be aimed at creating private property for land and developing market for agricultural products.
- Ukrainian legislation will be harmonized with European standards, law enforcement will be strengthened.
- Government will review its regulations to remove impediments to foreign trade, thus accelerating Ukrainian association with the EU.

The major results of Program implementation are expected to be 1-2 percent GDP growth in 2000, and the average GDP growth of 6.5 percent annually throughout 2002-2004. Real incomes of households in 2000 are to increase significantly. Another important outcome expected of Program's implementation is preservation of price stability. The average consumer price index in 2000 is to amount to 19 percent. During the period 2002-2004 the average annual CPI figure should not exceed 7 percent.

The Government is closely monitoring Program's implementation, which results are presented to the public on quarterly basis. The major achievements reported for the first half of 2000 are five percent GDP growth, 8.3 percent increase in real household incomes, increased availability of banking credits, paying-off pension arrears, foreign debt restructuring, and adherence to non-deficit budget.

The zero deficit is a questionable issue as many analysts show a hidden fiscal deficit that is maintained through arrears and printing money.[4] Printing money, in turn, leads to higher inflation. For the first six months the inflation reached 18.7 percent (price level of early July 2000 compared to that of the beginning of the year), while the Program authors expected inflation not to exceed 19 percent for the entire year.

4. Program's achievements

The slow pace of reforms for the first ten years of independence indicates that within the Government there was no capacity to design and implement solid market reforms. The authors of 'Reforms for Welfare' Program were able to go much further in

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[4] See, for example, Janusz Szyrmer and Anna Kolesnichenko, "Balancing the Budget Sector", in *Presidential Herald*, 26 September, 2000.

formulating a coherent and relatively well-organized policy statement:

- The Program has a clear logical structure: Goals the society wants to achieve ⇒ Current economic problems that have to be solved in order to reach these goals ⇒ Sources (causes) of the problems ⇒ Priority tasks to eliminate the sources of the problems ⇒ Expected results from the implementation of these tasks.
- Goals of economic reform policy are explicitly defined, as are some measurable or observable criteria to evaluate Government's performance with respect to these goals.
- The Program is the first attempt to design policy according to a priority task approach rather than a sectoral one.
- Market economy principles like competition, hard budget constraints, etc., should be uniformly applied to all economic agents and kinds of economic activities. All earlier programs attempted to regulate each individual industry, or even some individual enterprises, without any broad concept behind the regulation.
- The Program absorbed, to a large extent, policy recommendations and materials prepared by non-government participants, thus showing a good example of productive dialog between the Government, the "civil" society, and the experts. Program authors also firmly demonstrate Government's awareness of the importance of public support to reforms and stress policy directions in order to closely interact with the society and gain its support.
- For the first time the Ukrainian Government officially acknowledges its low institutional capacity to manage the economic transition process and speaks about the means to enhance it.
- The program declares many progressive measures, like removing soft budget constraints, fair rules of the game for all economic actors, government non-intervention into economic activity by direct means, reduction of tax burden and reforming budget process, and establishing private ownership for land.
- The authors do not use bureaucratic language. The Program is easy to read and can be understood by non-experts.

5. What should be corrected by policymakers elaborating future programs?

Along with the positive aspects mentioned above, there are several points that should be carefully addressed by a team drafting future policy documents. These mostly relate to the management of Program's implementation. To be manageable a policy should be well focused and prioritized. Measures that the Government plans to undertake under each priority should be chosen based on policy analysis and well sequenced in time. It is crucial for a policymaker to formulate a clear-cut scheme for management of implementation of the measures chosen.

From this viewpoint, the current Program would have been more efficient and implementable had the authors devoted more effort to narrowing the scope of priorities and thoroughly sequencing the measures. In particular:

- The current version of the Program contains many good measures, but their scope is too broad to be manageable. For example, the measures cover such areas as tax and budget policies, administrative reform, public service reform, reform of property relations, deregulation of the economy in parallel with tracing human development processes, establishing environment for long, healthy life and well-being, domestic market development, etc. Although all reforms included in the Program are undoubtedly important, for the sake of feasibility, the Government should have limited its attention to a few most urgently needed reforms as well as it should have stressed the hierarchy of their importance. Such selectivity would help at implementation and monitoring stage.
- The Program should also include a plan to time-order the Program tasks and public monitoring of their implementation. In other words, based on the provisions of the Program, the Government should have developed a concrete action plan
- The Program should be provided with a brief glossary so as to avoid the reader's confusion in interpreting its terms and notions. It would also help the writers avoid some terminological inconsistencies. For example, the notions of "institution" and "policy" sometimes are misused in the Program text, as are "risks" and "impediments". Authors talk, for example about "policy of legal protection of property rights" whereas they actually imply the institution of property rights. Or, in other words, a legally devised constraint that will force all economic actors, including the

Government, observe certain formal "rules of the game" in property relations.[5]

- The authors should have been more conscientious in making the suggested measures coherent with general principles declared. For example, the Government affirms its non-intervention into direct economic activity, yet at the same time, it wants to support "production of mineral fertilizers and herbicides, polymers and polymer-based goods", "improvements in the metallurgy exports through export orientation on final goods like pipes, fabricated metal products, sheets, and bars", etc.
- The Program should have determined explicit time frames of each reform. The Government should have indicated whether it wishes to enact a comprehensive program aimed at fundamental, rapid change in the economic environment over the next several months, or it opts for a more gradual approach, and the reforms will be spread over a longer period of time.
- The document does not mention the short-term consequences of fast reforms for different population groups. This understanding would have added to the credibility of the Government in the eyes of the people.

[5] Confusion of the words "policy" and "institution" very often reflects the perception of the role of the government in the economy. Institutions are constraints, both formal and informal, on economic behavior, or "rules of the game", that should be observed by all economic and political actors, including the government. Policy can be viewed as decision making within the given institutions, or strategy to play a game given its rules. In centrally planned economies the government enjoyed a lot of discretionary power and was not significantly bound by the institutions. Therefore, policy and institutions were perceived as lose synonyms. In market economies, the government makes policy within the frames of the existing institutions. Thus, the distinction between government's discretion (policy) and binding regulations (institutions) becomes very important and meaningful.

APPENDIX

Program of Yushchenko's Government, compared to earlier reform programs

The Ukrainian Government prepared its first program of action in 1996. It was followed by "The Program of Action of the Cabinet of Ministers of 1998" and then by the National Program "Ukraine – 2010", both prepared by Pustovoytenko's Government. The most recent Program, 'Reforms for Welfare', prepared by Yushchenko's Government, was formally approved by the *Verkhovna Rada* (Parliament) in April 2000 and now serves as the official Program of reforms in Ukraine.

The three earlier programs have not been implemented. Only the program of 1996 was formally approved by the Parliament as an official action plan of the Government.

Their quality was not very high:

- The programs lack explicit conceptual foundations. Their objectives, and following from these objectives priority tasks, expected results, and possible risks are not specified.
- They fail to follow some uniform principles, equal for all economic actors. Each industry/enterprise faces its own rules of the game. For example, the Program of 1998 envisages "creation of mechanisms obliging managers of wood processing enterprises to pay wages and taxes in timely fashion. Managers of food processing enterprises with declining output, wage and tax arrears are to be dismissed." The Government will also "elaborate mechanisms based on which banks should provide loans to light industry", etc.
- The programs define specific activities for many sectors of the economy and list measures to be taken with respect to some enterprises. These, for example, include "domestic production of C-32 standard digital equipment to be used by telephone stations of *Donets* and *Evrokvant* type produced by Dniprovsky machine-building factory, Kharkiv Shevchenko plant, and Romny factory of automatic telephone stations", repairs of shop for cold rolling of the "Zaporizhstal" metallurgy plant". Such planned-economy strategy is costly just to develop, let alone to implement.
- There is no clear understanding of fundamental structural distortions that cause economic crises. The causes were cited as unsatisfactory financial situation of enterprises,

decline in production, inflow of imports that undermine the performance of domestic producers, low household incomes, etc. As a result, the Government's effort was directed to confused policies that failed to solve the true economic problems. For example, the Government declares support to the national producer, improvement of financial performance, of the large enterprises by preventing bankruptcy, "stimulation" of commercial banks to provide credits to enterprises that should improve their performance and so on. At the same time, real roots of the problems, such as administrative intervention of the state into production, absence of fair competition, poor corporate governance and bad accounting standards, lack of reliable information and transparency, barriers to foreign trade are not given due attention.

- None of the three programs specify how to help create "critical mass" necessary to support the reforms.
- The programs have significant methodological flaws. They frequently list one next to another such general and very important (but not elaborated) issues as "preparation of the nation-wide program addressing social problems caused by restructuring of coal mines" along with some very specific and purely technical measures, such as "increasing the number of high capacity coal lava from 23 to 48"
- The concepts of the programs rest on central plan traditions like mentioned above measures that imply government intervention into activities of an enterprise, favoring state monopolies, soft budget constraints in the form of tax privileges and directed credits to "strategically important producers" etc.
- The programs do not present a complete and consistent set of instruments to implement the policy. For example, Program of 1996 states that the principal target of monetary policy is strengthening the domestic currency and increasing foreign currency reserves. However, some of the presented measures that are to help achieve this objective, such as restrictions on foreign currency transfers and on other financial operations, mandatory sale of export revenues, etc., are not only ineffective but, in a longer period of time, work in the opposite direction, i.e., they weaken the domestic currency and diminish the reserves.
- The programs do not single out those responsible for implementation and do not sequence measures' implementation.

The Social and Economic Policy Programs of the Russian Federation, with a Comparison to Ukraine

Edward Novoseletsky and Olga Ruda

Success with economic changes in the Russian Federation over the last 18 months demonstrates an increasing effectiveness of policy of the Russian Government. The main concepts of this policy are outlined in the "Program of the Government of the Russian Federation in the Area of Social Policy and Economic Modernization for the Years 2000 – 2001". Likewise, the Ukrainian Government is working according to its program "Reforms for Welfare", which was adopted last spring.[1] This effort is already showing some initial results, including positive growth of GDP for the first time since independence. Given that the economic situations in Russia and Ukraine are similar and therefore often require similar policy measures, it is interesting to compare the programs of the two countries and their approaches used to resolve similar problems.

All the measures of the Russian program along with the most important measures of the Ukrainian program are presented in Table 1. To the extent possible, we have tried to select and group similar measures together in the same rows in order to help readers in Ukraine to analyze and compare structures, formats of presentation, degrees of specificity, and formulations of goals and effects of the measures provided by the two programs. As can be noticed, the measures often significantly differ in their formats and contents. Frequently they are limited only to some plans to introduce laws on various topics and do not provide any information of their main ideas, goals, effects, etc., thereby making the programs, to a large extent, undefined/unknown.

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[1] See "Government Program: Reforms for Welfare" in this volume.

The two programs are similar in structure. Both documents consist of two major parts: text and a list of measures to be implemented. The major actions of the Russian government (the second part of the plan) include 119 measures; the list of "Reforms for Welfare" contains about 400 measures. The Russian program is for two years, 2000 and 2001, and the Ukrainian program is for four years, 2000-2004.

The whole Russian Program is available to the public. It can be found on the web site of the Center of Strategic Research (http://www.csr.ru). The Ukrainian program "Reforms for Welfare" is also presented on the Internet, but only the text part is published (http://www.kmu.gov.ua).

Table 1

Measures Included in Governmental Reform Programs, Russia and Ukraine[2]

Russia (all measures)	**Ukraine (selected corresponding measures)**
Major actions by the government of the Russian Federation in the area of social policy and economic modernization for the years 2000-2001	Ukrainian government program "Reforms for Welfare" for the years 2000-2004
Social Policy *Educational Reform*	
Increasing the amount of financial resources. August 2000 - February 2001.	
Increasing the number of economically independent educational institutions. January 2001.	
Introducing uniform state examination. January 2001.	
Introducing paid educational and social services as supplemental. February 2001.	
Establishing a new system of scholarships. February 2001.	

[2] Measures are listed with the specified terms of their implementation. Highlighted areas denote those measures in both programs that are similar in either their content or intentions.

Undertaking general experiment on establishment of new structure and content of secondary education. March 2001.	Adopting the laws "On pre-school education," "On higher education," "On extra-curricular education". Shifting to a 12-year secondary education. December 2000.
Competitively selected distribution of state orders for training of specialists and financing of investment projects for higher education institutions. March 2001.	Introducing state orders for training of specialists. Adopting the CMU resolution "On transferring the state-owned higher education institutions into jurisdiction of the Ministry of Education and Science". Revising the list of specializations through a CMU resolution. December 2000.
Developing an independent system of certification and control over education quality. April 2001.	Adopting the CMU resolution "On licensing and attestation of professional education institutions." December 2000.
Creating university complexes. April 2001.	Consolidating the higher education institutions. Optimizing the network of educational institutions, changing the system of training. Adopting the CMU resolution "On improving the network of higher education institutions". December 2000.
Providing minimal government funding for general education. October 2001.	Adopting the CMU resolution "On granting privileged long-term credits to young people for receiving higher education". 2000-2004.
Optimizing the network of rural schools with small number of pupils. November 2001	Regulating the network village schools. Implementing the Complex of measures for development of general education institutions in rural areas. 2000-2004.
Healthcare Reform	
Developing an integral system of medical and social insurance. November 2000.	Further developing the system of voluntary medical insurance. Ongoing.
Ensuring economic independence and enhancing the variety of institutional forms of medical institutions. March 2001.	Financing healthcare from various sources. Introducing the family medicine. Carrying out investment tenders for healthcare (with participation of foreign investors). Designing the healthcare development program. 2000-2004.
Streamlining the government program of free medical services. April 2001.	Establishing territorial principle for government-guaranteed free medical services (concept of "single medical space"). 2000-2004.
	Improving the legal framework for the system of healthcare. Ongoing. Designing the complex of measures for development of child cardio surgery. December 2000.

Policy in the Area of Culture	
Introducing targeted, contract and investment financing. February-September 2001.	Drafting the CMU resolutions "On the Museum Fund of Ukraine," "On rules for trade of antiques", "On registration, protection and preservation of state-owned portion of the Museum Fund of Ukraine". June 2000.
Establishing general monitoring system for cultural monuments. March 2001.	Preventing theft and illegal export of historical and cultural values. December 2000.
	Creating legal framework for functioning of museums. June 2000. Revising the Law "On culture" and adopting the Law "On touring concert activities." December 2000.
Development of Physical Culture and Sports	
Introducing targeted, contract and investment financing. March 2001.	
Establishing general monitoring system for citizens' health status. October 2001.	Drafting the Complex program of healthy lifestyle. Ongoing.
Social Protection Policy	
Monetizing the privileges of disabled and veterans. August 2000.	Establishing the environment conducive to rehabilitation and employment of the disabled. Providing subsidies to selected categories of disabled, based on their income (telephone, transportation, etc.). December 2000.
Converting in-kind privileges and transfers granted to civil servants, military servicemen and employees of law-enforcement agencies into a form of remuneration or cash transfers that are financed from the federal budget. August 2000.	
Eliminating socially unjustified privileges. November 2000.	Shifting from the current system of privileges to targeted system of aid to the needy categories of population. September 2000.
Replacing privileges by targeted forms of social support. November 2000.	
Changing principles and sources of paying the monthly child allowances to eligible families. Amending the Federal Law "On State Allowances to Families with Children." November 2000.	Introducing new methods for calculation of gross family income used for allocation of social assistance (including income from individual land plot). December 2000.

Concept of demographic policy. December 2000.	Drafting the program of protection of reproductive health. Undertaking measures aimed at supporting the orphan children, disabled children and homeless children.
	Securing the provision of social services to elderly citizens and disabled at their homes. During the year 2000.
	Finalizing the reorganization of social aid departments into territorial centers of social services to pensioners and lonely disabled citizens. December 2000.
Pension Insurance and Security	
Gradually increasing the wage-related coefficients used in determination of the pension levels. December 2000.	
Determining new norms and types of pensions and pension eligibility requirements for the state pension insurance system. December 2000.	
Introducing funded financing arrangements for early retirement pensions. March 2000. Introducing record-keeping of savings on individual personal accounts within the state pension insurance system, based on personal accounting principles. April 2001.	Introducing individual capitalized pension accounts. Introducing requirements for determining the amounts of pension payments based on the length of insurance. Adopting laws “On mandatory state pension insurance” and “On non-state pension funds.” 2000-2004.
	Reducing in-kind payments to the Pension Fund. Amending the Law “On Wage Payments.” August 2000.
	Imposing strict control over fulfillment of obligations by agricultural enterprises reorganized into private units, related to compensation of the Pension Fund’s expenditures for funding of privileged pensions and of pensions resulting from work accidents. May 2000.
	Financing the Pension Fund’s current expenditures for pension payments to privates, sergeants and officers of the regular service and members of their families, and to victims of Chernobyl Nuclear Accident exclusively from the State budget. Starting April 2000.

Housing and Communal Sector Development	
Improving the mechanisms and procedures of granting targeted housing subsidies to low-income families. December 2000.	Construction of 196 apartments in Kiev and Zhytomyr regions for families resettled from Chernobyl zones. Construction or purchasing of 91 apartments in Kiev region for families living in Chernobyl alienation zones. December 2000.
Simplifying the procedures for sales of housing, allocation of land plots, and issue of permits for housing construction. December 2000.	
Ensuring individual rights to housing ownership, lease, and rent. March 2001.	Adopting the Law “On associations of owners of apartment blocks and on societies of housing owners”. September 2000.
Eliminating the barriers to mortgaged loans. March 2000.	Designing the mortgaged loans mechanism for housing construction. (One month following the adoption of the Law “On mortgage.”)
Introducing efficient regulation of communal services enterprises (local natural monopolies). March 2000.	Implementing the state program for housing reconstruction. 2000-2001.
Establishing legal framework for investment into communal services enterprises. March 2000.	Creating mechanisms for investment of household savings into housing constructions. 2000-2004.
Eliminating the cross-subsidies system for tariffs. July 2001.	Streamlining the privileges granted to individuals for payments for housing and communal services. During the year 2000.
	Forecasting the housing development up to 2005, in terms of the regional development and funding sources. September 2000.
Labor Relations and Employment	
Paying the unemployment benefits from the federal budget. August 2000.	
Raising the minimum wage. December 2000.	Improving mechanisms of determining the minimum wage and minimum per-hour wage. December 2000.
Retraining the unemployed, improving their social support. December 2000.	Drafting the Guidelines of social policy up to 2004 (as a presidential decree). June 2000.
Raising gradually the amount of compensation paid to political appointees, federal civil servants and technical support staff of the federal government agencies. December 2000.	Implementing the constitutional rights of citizens to labor protection. Improving and streamlining the public supervision over labor protection. December 2000.

Improving the mechanism of mandatory social insurance for occupational injuries and diseases. May 2001.	Implementing the law "On mandatory state social insurance for work accidents and professional diseases causing disability". 2000-2004. Providing targeted privileges and compensations to the victims of Chernobyl Nuclear Accident. June 2000.
Determining the legal status of employers. May 2001.	
Reducing restrictions on use of fixed-term labor contracts and removing unjustified restrictions on lying off the excessive staff. June 2001.	
Improving the mechanisms of pre-trial and judicial settlement of labor disputes. October 2001.	
Economic Modernization ***Developing Favorable Business and Investment Climate*** ***Overall Conditions for Economic Activity***	
Creating organized markets, including exchanges, in order to prevent monopolism and distortion of market prices. September 2000.	Eliminating barriers to entry to the existing markets, particularly to monopolized ones. December 2000.
Simplifying the procedure for clearance and issue of permits to implement investment projects. November 2000.	
Reducing the powers and revising the functions of executive agencies (except for tax and financial authorities). November 2000.	Ensuring that executive agencies and local self-governments do not interfere in economic performance, removing legal and organizational barriers to business activity. June 2000.
Introducing competitive large-scale procurement by state-owned enterprises and organizations with state share. November 2000.	
Shifting to the "one-stop shop" registration procedure for legal entities. November 2000.	Reforming the system of state registration of businesses and establishing a government bank of information on economic entities. 2000-2004
Reducing the number of activities subject to licensing. November 2000.	Simplifying the procedure for issue of permits for foreign economic activities. December 2000.
Improving the legal framework to allow for free movement of goods, services, financial and labor resources within the Russian Federation. December 2000.	

Developing a new accounting system. January 2001.	Introducing international accounting standards. December 2000.
Specifying the functions of the government agencies related to business regulation. March 2001.	Approving the Program of small business development for 2000-2001. Stimulating private initiatives and entrepreneurship. Adopting the Law "On state support to small business." June 2000.
Protecting the rights of creditors and owners of liquidated and reorganized enterprises. July 2001.	Guaranteeing state protection to property rights of private owners, entrepreneurs, investors and creditors. Implementing the mechanisms for transfer of financial responsibility into property liability, simplifying the procedure for transfer of mortgaged property to the creditors. December 2000.
	Reducing the number of taxes and other mandatory payments, decreasing the payroll tax rate, widening the tax base through elimination of tax exemptions and reduction of VAT rate. Adopting the Tax Code. June 2000.
Development of Financial Markets and Institutions. Modernization of the Banking System	
Amending the legislation on banking and on bankruptcy of financial institutions. October 2000.	Amending the Law "On Banks and Banking". December 2000. Streamlining the structure of the NBU crediting by increasing the share of commercial banks refinancing. Ongoing.
Amending the legislation on the functions of banks. March 2001.	Reducing gradually the NBU discount rate. Ongoing.
Increasing competition and the number of guarantees for bank deposits. May 2001.	Adopting the Law "On Deposit Insurance Fund for individuals". Ongoing. Establishing a clear system for design of loan contracts, and introducing mandatory collateral of borrower's property. Adopting the Law "On crediting." June 2000.
Stock Market and Investment Institutions Development	
Introducing separate accounting for funds of professional security market participants and of their clients. September 2000. Improving legal framework for operations of professional stock market participants. November 2001.	Approving legal regulation of security market development. Revising the law "On securities and stock exchange", and adopting the laws "On derivatives," "On mutual investment institutions", and "On promissory notes." December 2000.

Strengthening control over transactions with related parties. October 2000.	
Strengthening the responsibility for violation of legislation, enabling the protection of minority shareholders rights. October 2000.	Drafting the law "On joint stock companies." December 2000.
Improving the state insurance and general insurance system. November 2000. Developing a legal framework for competitive mandatory insurance. March 2001.	Lifting restrictions on participation of foreign capital in the statutory funds of resident insurance companies. December 2000.
Introducing unified requirements to asset management. March 2001.	Implementing deposit receipts on the shares of Ukrainian companies to increase demand of foreign investor. December 2000.
Developing arrangements to attract household savings for investment, creating the favorable tax environment. March 2001.	
	Developing national stock index and methodology of its calculation. December 2000.
Macroeconomic Policy	
Developing the concept of efficiency of budget expenditures. August 2000. Increasing the budget transparency. January 2001.	Introducing the procedure of local self-governments reporting on the use of tax receipts to taxpayers. June 2000. Enabling rational use of funds of the State Budget and of local budgets. September 2000.
Eliminating or suspending the budget liabilities that are not funded or funded partially. August 2000.	Creating the budget based on targeted method of funding. June 2000.
Exempting the Bank of Russia from securities transaction tax for issue of its own bonds. August 2000.	
Redemption of payables of the main budgetary spending units and recipients. August-October 2000.	Providing for payment of taxes to different budgets in monetary form. June 2000. Introducing preliminary control over liabilities of budgetary units related to contracts for supply of goods and services. September 2000.
Lifting restrictions on issue of bond by the Bank of Russia. September 2000.	
Establishing guarantees for fulfillment of budgetary interests in the course of mandatory payments. September 2000.	Eliminating undisputed writing-off of funds from enterprise bank accounts (*Kartoteka* 2), which should be authorized by a court or a notary. Ensuring the right to use funds on these accounts freely. June 2000.

Gradually reducing and unifying customs tariffs and fines. September 2000.	Adopting the CMU resolution on reducing the ceiling rates of import duty and abolishing the minimal customs value. December 2000.
Converting a portion of government securities owned by the Bank of Russia into liquid market instruments. November 2000.	Implementing long-term restructuring of T-bills arrears owned by the NBU, and implementing joint measures aimed at increasing gold and currency reserves. June 2000.
Improving the budget legislation. December 2000.	Introducing hard budget constraints. September 2000. Adopting legal regulation on external debt management, setting a ban on use of external loans for budgetary expenditures. December 2000.
Improving the system of payments. January 2001.	
	Including all funds of budgetary organizations into the special fund, with control over its expenditures by the State Treasury. June 2000.
	Overcoming the arrears crisis. June 2000. Arranging for open auctions for sales of the right to claim for overdue arrears (over 2 years) of Ukrainian entities, along with compensating for the state budget expenditures for repayment of credit guarantees and liabilities issued by the CMU. December 2000.
	Attracting domestic hard currency loans from citizens (payable to bearer) and legal entities through their registration as securities. December 2000.
Structural Policy, State Property Management	
Composing inventory of state assets and liabilities. September 2000.	Introducing new methods of survey of state property and new standards for expert evaluation of real estate, movable property and intangible assets. April 2000.
Adopting legal regulations on nationalization of property. October 2000.	
Improving the procedures of corporatization of federal unitary enterprises. October 2000.	Drafting and implementing a program for restructuring of state-owned enterprises. 2000-2004. Preparing enterprises for privatization, expanding the privatization base, selling the major share holdings in liquid enterprises to industrial investors. June 2000.

Compiling a single register of Russia's real estate abroad. December 2000.	
Improving the legal framework for management of state property abroad. July 2001.	Adopting legal regulation on management of state-owned enterprises and state corporate rights. December 2000.
	Introducing individual approach to privatization of strategic enterprises, including power-engineering enterprises and open joint-stock company "Ukrtelecom." June 2000.
	Implementing new procedures and mechanisms for bankruptcy and resumption of enterprise solvency. June 2000.
Innovative Economic Development	
Setting guidelines for the government's mid-term and long-term policy in research and technology. September 2000.	Developing the system of regional centers for research and technology and of regional centers for high technology transfers. 2000-2004.
Setting guidelines for economic application of results of scientific and technological activities financed from the federal budget. December 2000.	Concentrating resources on fundamental and applied research related to Ukraine's scientific, technological and manufacturing potentials, which may promote the entry of Ukrainian goods into the world markets. June 2000.
Improving legal regulation on intellectual property protection. October 2000-June 2001.	Harmonizing Ukrainian regulation on patents, copyrights and related rights with international practices. 2000-2004.
Developing procedures for inventory and evaluation of intellectual property items. July 2001.	Gradually introducing economic transactions with intellectual property items and intellectual products. December 2000.
	Developing and implementing new information technologies. September 2000.
Natural Monopoly Reform	
	Improving legislation on competition, along with increasing the effectiveness of state regulation of natural monopolies. December 2000.
	Eliminating privileges granted to selected categories of consumers for paying for energy supply. June 2000.

Gas Sector	
Developing new methodology for natural gas pricing. November 2000.	
Introducing separate financial accounting of expenditures on transportation and sales of gas for gas distributing organizations. November 2000.	
Changing the manner gas price-making through separating tariffs for transportation and marketing services provided by gas distributing organizations. November 2000.	
Approving the Concept of gas market development. November 2000.	Establishing transparent, competitive and efficient energy markets. Introducing auction sales of oil, gas, and coal extracted in Ukraine. June 2000.
Creating conditions for development of independent gas extracting and sales entities. December 2000.	
Developing operational rules for wholesale of natural gas. January 2001.	
Establishing uniform two-tier tariffs for gas transportation via trunks and distribution pipelines. April 2001.	
Improving anti-monopoly control mechanisms on the domestic wholesale gas market. May 2001.	Diversifying the sources of gas and oil supply to Ukraine. 2000-2001.
Electric Energy Sector	
Drafting the guidelines for development and functioning of electric energy wholesale market. December 2000.	Reforming the wholesale energy market. June 2000. Drafting the Concept of strategic development of fuel energy sector up to 2030. September 2000.
Developing mechanisms for financial and institutional separation of natural monopolists and potentially competitive enterprises in the electric energy sector. January 2001.	
Developing the environment conducive to establishment of independent energy producers and sellers. June 2001.	Revising the National energy program up to 2010. September 2000.
Establishing anti-monopoly regulation procedures for energy sector. June 2001.	Developing transparent, competitive, and efficient energy markets. June 2000.

	Establishing market mechanisms for energy pricing. Eliminating cross-subsidies to households through transfer of these expenses to industrial consumers; shifting to market setting of tariffs. December 2000.
	Accelerating the construction of the priority energy facilities, including Khmelnytskiy and Rivne Nuclear Power Stations and Dnistrovska Hydro Power Station. June 2000.
	Implementing measures to increase the safety of nuclear blocks at the power stations. Drafting the Concept of government research and technology program of nuclear and radiation safety up to 2010. December 2000.
	Drafting the CMU resolution "On additional measures for implementation of the Complex program of energy conservation." June 2000.
Railway Transport and Communications Sector	
Approving the Concept of structural reform of railway transport. October 2000.	Drafting the presidential decree "On National commission for transport and communications." December 2000.
Drafting the Concept of further liberalization of telecommunications market. November 2000.	
Streamlining state regulation of railway transport tariffs. November 2000.	
Introducing separate accounting of receipts, expenses, assets, and liabilities by type of activity for communications enterprises. December 2000.	Reducing the number of shipments with overdue term of storage kept in sea ports and railway stations due to confiscation and sale. December 2000.
Designing legal framework for reform of federal railway transport. December 2000-January 2001.	
Streamlining the rules for granting of privileges to persons using the railway transport services. January 2001.	
Improving the mechanisms for regulation of prices (tariffs) for communication services. May 2001.	Eliminating cross-subsidies granted to individuals for tariffs for transport and communication services through transfer of these expenses to industrial consumers. December 2000.

Separating the management from regulatory functions in the railway sector. July 2001.	
Separating freight transport companies, long-haul passenger transport companies and suburban passenger transport companies. July 2001.	
Dividing assets and facilities of railway transport into monopolistic and competitive. October 2001.	
	Involving foreign and domestic investors into construction of roads in Ukraine (under concession terms). December 2000.
Fuel and Energy Sector Development	
Reducing the list of organizations exempted from restrictions on provision of fuel energy resources. September 2000.	
Guaranteeing non-discriminatory access of oil producers to trunk oil pipelines. November 2000. Creating competitive environment in the oil sector. December 2000.	Establishing transparent, competitive and efficient energy markets. Introducing sales of oil, condensed gas and coal extracted in Ukraine through auctions. June 2000.
Undertaking expert analysis of investment programs implemented by regulated organizations in the fuel and energy sector. January 2001.	
Agricultural Sector Development	
Streamlining the allocations of subsidies at the federal and regional levels. Developing cooperative financial organizations. September 2000.	Introducing mortgaged credits, with the use of land as collateral. December 2000.
Developing private farming. November 2000.	Finalizing the transfer of collective agricultural enterprises into private ownership. June 2000. Promoting development of private land plots and increasing their marketability. December 2000.
Streamlining the regulation on land and land property rights. June 2001.	Finalizing the land reform. June 2000.
	Ensuring the sale of foods, material and technical resources for agricultural complex, and removing bans on free movement of goods. December 2000.

	Introducing the mechanism for enabling commodity exchange contracts for provision of agricultural products, material and technical resources. June 2000.
	Developing social insurance system for agricultural producers, based on private land and property ownership. December 2000.
Land and Real Estate Market Development	
Adopting legal regulation on land management procedures. September 2000.	Drafting the law “On property transactions”, and revising the law “On property”. September 2000.
Designing the procedure for transfer to owners of buildings and enterprises of land plots, on which such buildings are physically located. January 2001.	Drafting the Law “On purchase and sales of land plots”. (Three months following adoption of the new Land Code).
Establishing new management principles for state and municipal real estate. February-October 2001.	
Amending the legislation to enable the uniform real estate property rights. February 2001.	
Separating the land property rights at federal, regional, and municipal levels. February 2001.	
Designing a uniform system of registration of integrated real assets based on the state land cadaster. March 2001.	Drafting the law “On state registration of property rights“. September 2000. Drafting the law “On state land cadaster”. (Three months following the adoption of the new Land Code).
Guaranteeing the real estate rights. October 2001.	
Foreign Economic Policy	
Implementing the effective legislation on dispute resolution; granting licenses, distributing quotas, introducing qualitative export and import restrictions, introducing procedures for implementation of export subsidies and other forms of encouragement of export production. December 2000.	Increasing the flow of Ukrainian goods into EU markets through increase in quotas and elimination of trade barriers. December 2000.
	Carrying out bilateral consultations and negotiations with 25 WTO member countries on entry of Ukrainian goods into their markets. December 2000.

	Preventing anti-dumping procedures against Ukrainian exports. Ongoing.
	Developing and implementing the Ukrainian version of European classification system. 2000-2003.
	Developing and exporting the Ukrainian high technology products, increasing the production and further integration into a common European scientific and technological space. 2000-2004.
	Developing extensive system for sales of goods and services abroad. December 2000.

The Program to Bring Activities out of the Shadow Economy Is on the Agenda

Edward Novoseletsky

1. Introduction

In spring 2000, on the initiative of the President of Ukraine and mandate of the Cabinet of Ministers, the Ministry of Economy with the assistance of a number of research organizations and NGOs started the detailed elaboration of the Program. The task of the Program was to develop a comprehensive strategy for shifting economic activities away from the shadow economy to the official sector. The Harvard/CASE team assisted the Ministry in this endeavor. Several iterations of the Program have been developed. In this chapter a tentative draft is presented. This draft was discussed by the Cabinet of Ministers in August 2000 and was sent back to the Ministry with instructions for some amendments and extensions. A new draft will be finished by the end of 2000.

The development of the Program of "De-Shadowization"[1] testifies to the Ukrainian government's recognition of both the importance of the unsolved problem of unofficial economic activities, and their significant impact upon the efficiency of enterprises and economic growth.

2. Why does a shadow economy trouble society?

Any economy, regardless of its orientation, faces the problem of shadow production. It is often emphasized the negative impacts of the shadow economy on society and national economy, however, there are also some favorable effects. For instance, in Ukraine, the

[1] The term "de-shadowization" defines the efforts carried out to legalize economic activities (bring them out of the shadow).

shadow economy has enabled a large portion of labor force survive the economic crisis during the 1990s. From the point of view of a particular household, the shadow activity is often a necessary (and in many cases, the only) way to survive. But from the point of view of social welfare, the shadow activity embodies a number of interrelated problems:

- Unpaid taxes lead to insufficient budget revenues and an unreasonably high tax burden put on the official activities.
- Insufficient public finances require the cuts in expenditures and lead to delays in wages and pensions.
- Sectors such as health care, science and culture, armed forces and law enforcement, and others face insufficient financing.

Thus, the government fails to perform its principal function of fair redistribution of national income.

Also, the increase in non-official activities points to the inefficiency of governmental policies and the inadequacy of laws. It stimulates corruption and other illegal activities at all levels, from local to national. Moreover, the related increase in tax evasion undermines the confidence in government, in its role as an indispensable institution of democratic society as a whole, and in the effectiveness of the tax system in particular. These processes, in turn, may lead to social and political instabilities.

The inclusion of the shadow sector into economic analysis will result in significant changes of the values of many important economic indicators, such as GDP, indices of industry and market development and of households' behavior. Thus, the results of analyses of the unofficial part of economy may significantly improve the economic information and thereby increase the efficiency of decision-making of businesses and governments.

3. What is the shadow economy?

There was a lot of debate about definition of the shadow economic activity while developing the program draft by the working group. Ukrainian and foreign experts define the shadow economy in many different ways. Some propose including criminal income in the shadow economy, while others insist on the inclusion of agricultural subsidiary plot production. Obviously these two activities (criminal activity and natural farm production) are important but their nature is substantially different from the "proper" shadow activity. For instance, the income from the subsidiary plot production should be accounted for by the measures of total economic output and employment, but it would not affect the tax base, nor it would contribute to budget revenues. Criminal income shows that it is necessary to revise a number of types of allowable economic activities, but primarily it highlights the need to improve law enforcement.

Given these issues, the participants of the working group defined shadow activity as the economic activity that, from the point of view of national accounts, creates marketable value and is not included, either fully or partially, in the tax base. It is an outcome of tax evasion by individuals and enterprises whose income derives from some legitimate economic activity.

4. The scope of shadow economy in Ukraine

The experience of global economic development shows that each country faces the problem of tax evasion. It is the scope of tax evasion that defines the extent to which it hinders sustainable economic development. To define the scope of shadow economy, economists have developed various methodologies. Each methodology produces its own estimates, and in most cases the estimates differ substantially. The official statistics give relatively low estimates of the shadow economy in Ukraine: 5.2 percent of official GDP in Ukraine in 1994 and 12.3 percent in 1995. According to a monetary approach (estimation of the share of national currency in shadow sphere), the shadow GDP in 1995 accounted for 47 percent of the official one. The Electric Power Consumption Method (based on the assumption of a fixed interrelation between energy consumption and industrial output), applied by the World Bank experts, showed that, between 1990 and 1994, the unofficial sector in Ukraine's economy increased from 18 percent to 92 percent of the official GDP. It should be noted that since 1993-94, when the methodology for national accounting was revised, the official Ukraine's GDP has been including the estimates of shadow activity that accounts for 15-20 percent of the total GDP.[2]

Each methodology has its own advantages and disadvantages. It is difficult to select the most appropriate methodology for Ukraine. One way to study the shadow economy, is to re-assess the main macroeconomic aggregates, such as household consumption, investment, and foreign trade, by including in these figures estimates of shadow activities. These estimates can be produced based on consumption, investment, employment and income

[2] A detailed description of the methodologies of estimating shadow economy, their results, and relevant references can be found in Edward Novoseletsky. 1999. "The Shadow Economy in Ukraine". A Master's Thesis in Economics, under the supervision of Professor Janusz Szyrmer. Kyiv-Mohyla Academy: EERC.

surveys. Based on this approach, an analysis of incomes and expenditures of Ukrainian households was used to assess shadow economy in Ukraine in 1995-98.[3] The results of this analysis are presented in Table 1. They suggest that annual consumption of Ukrainian households exceeded their official income by about 40 percent.

Table 1

Estimated Difference Between Incomes and Expenditures of Households in Ukraine, Q2-1995 – Q2-1998

Period	Incomes*	Expenditures**	Difference	
	UAH billions	UAH billions	UAH billions	% of official GDP
1995 Q2	5.3	10.6	5.3	53.3
Q3	7.3	16.9	9.6	62.9
Q4	8.5	14.3	5.8	27.0
1996 Q1	9.1	14.9	5.8	34.1
Q2	9.9	15.1	5.2	27.8
Q3	10.9	24.2	13.3	64.0
Q4	10.8	18.0	7.2	29.1
1997 Q1	10.8	18.1	7.3	38.5
Q2	11.1	18.3	7.2	34.0
Q3	12.6	27.4	14.8	58.2
Q4	12.4	20.8	8.4	30.2
1998 Q1	11.6	20.0	8.4	40.3
Q2	11.7	20.6	8.8	36.9

Notes: *official data; **estimation based on direct surveys and the Harvard/CASE model.

Sources: State Statistics Committee of Ukraine and Harvard/CASE calculations.

Table 2 presents another set of figures, produced by the same method, that assess the losses of the state's consolidated budget caused by the shadow sector. The table provides estimates of the proportions of the shadow value added that could have covered the budget deficit, if the shadow activities were shifted to the official sector. If the government were successful in converting a third of shadow activities into official activities, the budget deficit would vanish.

The results of a September–October 1999 survey of Ukrainian households revealed that, on average, actual household expenditures exceeded their official (taxable) income by 63 percent.[4]

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[3] This methodology was developed by the Harvard/CASE Ukraine Project's team in 1996/97. Currently a large project based on this methodology is carried out in Ukraine by the Ukrainian-European Policy and Legal Advice Center, jointly with Institute of Sociology of the Ukrainian Academy of Sciences and the Harvard/CASE experts.

[4] This survey was conducted within a joint research by the Institute of Sociology of the Ukrainian Academy of Sciences and the Harvard/CASE Ukraine Project.

Interestingly, this number coincides with the results of the earlier research for the corresponding periods (the third quarters of 1995-1998, see Table 1). This implies that the consumption financed from the shadow (non-taxed) income may account for about two-thirds of the total consumption of Ukrainian households.

5. Reasons for the shadow economy existence

The conflict of interests between those generating income while producing goods and providing services and those redistributing the income while regulating the production process is inherent to any economy. While enterprises seek to maximize profits and create value, the government is extracting a certain fraction of these profits in order to provide people with goods and services that the market is unable to provide efficiently, if at all, such as various social programs, health, education, and national security. Producers may lose their interest in paying taxes, if the government fails to provide people with the goods and services that it is expected to deliver. Wage and pension arrears are examples of such a failure.

Table 2

Budget Losses Caused by Shadow Economy in Ukraine, Q2-1995 – Q2-1998

Period	Tax revenues to the consolidated budget, UAH millions	Loses of tax revenues		Budget balance, UAH millions	Share of shadow economy (%) sufficient to cover the budget deficit**
		UAH millions	USD millions*		
	1	2	3	4	5
1995 Q2	4,659	2,484	1,461	-586	26.4
Q3	5,724	3,602	2,029	-1,015	26.9
Q4	7,047	1,905	1,055	-1,773	73.2
1996 Q1	6,505	2,215	1,156	-1,141	55.2
Q2	6,242	1,737	970	-779	45.3
Q3	7,437	4,758	2,770	-587	11.9
Q4	9,959	2,900	1,574	-1,109	32.1
1997 Q1	6,541	2,516	1,389	-1,047	41.1
Q2	8,797	2,989	1,634	-1,177	39.7
Q3	10,320	6,001	3,235	-2,475	37.5
Q4	11,233	3,393	1,800	-1,498	37.8
1998 Q1	7,678	3,092	1,534	-1,367	44.0
Q2	8,723	3,219	1,586	-798	22.4

Notes: *current official exchange rates (quarter averages) were used; **the share of shadow economy sufficient to cover the budget deficit is calculated as a ratio of budget deficit (column 5) to losses of tax revenues as a result of shadow activities (column 3).

Sources: Harvard/CASE Ukraine Project and UEPLAC.

Also, the tax payers may not be interested in paying taxes when (1) the government fails to secure orderly tax payment procedures, (2) the costs incurred in the processes of meeting tax liabilities are unreasonably high, or (3) the income subject to taxation is ridiculously small. Many entrepreneurs single out an excessive number of taxes, unstable legislation and high tax rates as the main reasons for tax evasion.[5] Minimum monthly non-taxable income in Ukraine is still UAH 17 (or less than three US dollars). Poor tax policy and regulatory environment are among the major reasons to work in the shadow economy. Moreover, huge shadow sector put additional pressure on those who operate legally to remain in the official sector.

6. Concept of the Government Program for bringing the Ukrainian economy out of the shadow

The strategic goal of the Program is to develop a complex of measures allowing to get enterprises out of the shadow. The core of the government actions is the establishment of an economic environment in which the benefits of operating legally would exceed the benefits from working in the shadow economy. This would stimulate a shift of the activities to the official sector. The following measures were listed in the Program:

- Reduction in tax pressure, decriminalization of non-payments of small amounts of taxes
- Abolishment of tax privileges
- Alteration of the structure of the taxation system, shifting more tax burden from production to consumption, and general simplification of the tax system
- Simplification of the accounting and reporting systems of business entities
- Simplification of the registration process of business entities
- Restriction of the powers and regulation of state control bodies in order to reduce their interference into business activity
- Improvement in transparency of public administration entities and other budget sector organizations

[5] For example, an IFC survey of about 900 Ukrainian small enterprises (see Max Yacoub and Bohdan Senchuk. 2000. “The State of Small Business in Ukraine.” Kyiv: International Financial Corporation: Business Development Project in Ukraine), which was conducted in 1999, revealed that the taxation system remained the biggest problem for SMEs (85% of respondents), followed by the unstable legislation and imperfect legislation (respectively 48% and 37% of respondents).

- Development of the banking sector, financial markets and market institutions
- Creation of incentives for labor to leave the shadow sector
- Prevention of misappropriation of public funds
- Improvement of the system of payments between economic entities
- Imposition of stricter sanctions against illegal activity, and
- Assurance of permanent research of the shadow economy by the research and government structures

The de-shadowization concept is fully consistent with the Government's Program, "Reforms for Welfare,"[6] and as such is an important step toward establishing the market, socially oriented economy and democratic society. Development and implementation of measures according to this concept will ensure the establishment of transparent and efficient economic activity, increase the tax revenues and consolidate the market and social institutions. However, this will not happen overnight. Even with the absence of any kind of serious impediments in implementing this program, its first positive results cannot be expected very soon (not earlier than after one or two years).

[6] See "Government Program: 'Reforms for Welfare'" in this volume.

1997 Program for Economic Growth in Ukraine

Edited by David Snelbecker

In the fall of 1996, the Government of Ukraine under the leadership of then Vice Prime Minister Viktor Pynzenyk, designed a comprehensive reform program called "Economic Growth – 1997", and introduced it in the Parliament. Although this package was not accepted by the Parliament, several important proposed measures were adopted, such as elimination of the Chornobyl tax and simplification of licensing requirements. Furthermore, the work on drafting this reform program set a "standard" for reform efforts that each subsequent government has referred to in its activities.[1] The following chapte presents a description of reform proposals from the package as it was prepared in the fall of 1996. This chapter is an edited version of a document produced by the Harvard/CASE Ukrainian Project team in November 1996, describing the planned proposed reforms as of that date.

In 1996, Ukraine entered a new historical phase. Independence and statehood were cemented by the signing of the Constitution, and by the introduction of a full-fledged national currency – the hryvnia. Substantial progress was made toward macroeconomic stability. With a budget deficit greatly reduced, inflation kept at a low level (the monthly rate in September 1996 was 2 percent), and a moderately stable exchange rate for over a year, Ukraine is laying the foundations for a healthy market economy. There are already

[1] See also "Government Program: Reforms for Welfare" and "The Social and Economic Policy Programs of the Russian Federation, with a Comparison to Ukraine" in this volume.

signs of improvement. Exports are growing fast. Privatization of small enterprises is almost finished, while that of large enterprises has made a significant progress.

The program's objectives:

- To stimulate dynamic, sustained growth and improve living standards
- To promote a shift in economic activities from the shadow economy to the formal sector
- To solve the problem of arrears while maintaining monetary and fiscal stability

A new package of radical reforms is necessary in order to reverse several years of falling production and bring about a rapid growth of investment and output. To make this possible, broad-based policies must curtail financial arrears and create incentives for enterprises to move from the shadow into official economy. Policies must achieve these ends without threatening macroeconomic stability. Conditions for sustained growth of income and welfare of Ukrainian families must be created.

These reforms will create solid foundations for a full-fledged market economy and definitively abolish old Soviet-era laws, policies, and institutions. They will require a great deal of effort and sacrifice. Unnecessary regulations and restrictions on the business sector must be removed and the excessive tax load, which currently straightjackets the economy, must be reduced. At the same time, strong budget discipline must be imposed. Clear social and economic policy priorities must be defined and rigorously followed. Painful budget cuts will become unavoidable.

General principles

Economic reforms must radically restructure the government sphere while protecting the government's top priorities of health, education, pensions, and social protection to the indigent and the disabled. Reforms must guarantee basic freedoms for economic activity, ensure labor mobility, and create the institutions of a market economy. Private property rights and business contracts must be enforced. All sectors of the economy must be opened up, streamlined, and liberated from harmful governmental interventions. For reforms to succeed, policies must be credible and predictable, the currency and the exchange rate must be stable, budget constraints must be hard, financial accountability must be enforced, and the economy must be open fo foreign trade and foreign investment.

Proposed reforms

During the coming months, the introduction of a comprehensive economic reform package is planned. It will address six main issues:

1. Fiscal/budget policy and administration
2. Regulatory reform
3. Social policy
4. Monetary/financial policy and banking
5. Enterprise restructuring, privatization, and industrial policies
6. Public policy and relationships with international institutions

The principal elements of the reform package are outlined below.

Fiscal policy requires, first of all, low, stable taxes that build confidence among businesses and create incentives for risk-taking. A comprehensive tax reform is being prepared. Its most important task will be to reduce the Pension Fund tax and reduce or completely eliminate other payroll taxes, including the Chernobyl Fund tax, the Social Insurance Fund tax, and the Employment Fund tax, as well as many smaller taxes earmarked for various funds. On the expenditure side, we propose to reduce subsidies to industries and enterprises, and expand financing government deficit through well designed, prudent bond issues on domestic and foreign markets.

Budget-sphere and budget-sector reform should result in transparency, formalization, and control of budget formulation and implementation. Ministries, local governments, and other spending authorities must have clear agreements with the Ministry of Finance and the Cabinet of Ministries on how much money they receive, when, and for what purposes. Financial control should be implemented through reporting all expenditures of the spending agencies to the Ministry of Finance on a monthly basis, broken down by item and spending unit. Budget-sphere sectors should be reformed. Cuts in spending will be necessary, especially on programs that are not in the Government's priority areas. The health and education sectors must be restructured and partially privatized.

Liberalization and regulatory reform will curtail existing obstacles to doing business in Ukraine. The role of government should be to facilitate, not suffocate business. The most important steps will include the elimination of all non-essential regulations, licenses, restrictions and fees on the activities of private business; elimination of the *propyska* system (registration and regulations of the population mobility) and the freedom of firms to employ and lay-off workers. Moreover, the Government should adopt reasonable policies towards rapidly developing shadow economy. According to some estimates, as much as a half of the economy operates unofficially, causing substantial losses of state revenues. In order to bring shadow activities into the official economy, the Government's strategy should be to establish a comprehensive macroeconomic level strategy. The objectives of this policy should not be limited to the tax base changes, but should also take into consideration many other issues, such as improvement of conditions for small business participation in the economy.

In the sphere of social policy, the old-age pension system will be radically reformed. In 1997, it will move from an entirely pay-as-you-go system to a two-tiered system. It will provide a minimum state pension and sponsor a newly-funded pension program, whereby workers and employers will contribute 5 percent of wages each into individualized pension account. Initially, individualized accounts will likely be opened only at the State Savings Bank and invested into Treasury bills. Eventually, private pension funds will develop within a properly regulated environment. They will also manage individualized accounts.Pension contributions will be allowed to be invested into private equities as well as into Treasury bills. Other areas of social policy will be reformed so that they better target those most in need of support, rather than making payments to broad categories of people regardless of need.

In the area of monetary policy, the National Bank of Ukraine and the Government will continue measures to secure low inflation in Ukraine. A draft Law on the National Bank that will ensure independent administration of the National Bank of Ukraine will be submitted to the Parliament. During 1997, an accelerated shift of the Ukrainian banking system to the world accounting standards with increased participation of foreign banks will lead to formation of a solid commercial banks industry. Agreements reached with the international financial organizations will allow Ukraine to make a commitment to a particular foreign exchange rate regime. This will provide further confidence in the hryvnia and the reform process as a whole. Successful development of a strong treasury bonds market in Ukraine will provide a new tool of domestic non-inflationary budget deficit financing (45 percent of budget deficit was financed with T-bills in 1996 in contrast to 6 percent in 1995). The

Government is determined to foster development of financial markets, with equal attention provided to governmental, and corporate equities.

The privatization process in Ukraine will accelerate to promote broad microeconomic restructuring of enterprises, halt production decline, and finally initiate economic growth. Domestic and foreign private investors will be able to invest their money in all branches of the Ukrainian economy, including agricultural and agro-business industry. The completion of mass privatization in 1997 will open the stage for a cash privatization program. The Government is determined to remove administrative impediments for privatization to achieve a real break-through in transformation of the large enterprises' ownership. In addition, different methods of cash privatization are planned to further the reform process.

The overall level of foreign direct investment (FDI) in Ukraine remains very low. An open-door policy towards FDI will be one of the pillars of the new stage of economic reform. The tax, regulatory and government sector reforms under consideration will be designed to create an environment conducive to investments regardless of their origin. Institutional reforms, aimed at securing property rights, developing workable rules for corporate governance and creating the necessary market economy infrastructure, will also serve the goals of attracting and retaining FDI into Ukraine. The government should undertake further steps towards the liberalization of the financial market and to secure non-residents' access to the T-bills market. Creating a positive economic and legal climate for foreign investors will result in an infusion of substantial foreign capital into the Ukrainian economy.

The above mentioned reforms will involve undertaking certain political risks, and lead to significant transformation of the government finances. The first few months of this reform will be crucial for its success. During this period it will be necessary to mobilize substantial internal and international resources to deal with potential short-term budgetary revenue shortfall, foreign debt repayments, and increased social obligations (increased unemployment payments and other transfer payments).

Ludwig von Mises: An Anti-Socialist Prophet

Janusz Szyrmer

Without calculation, economic activity is impossible. Since under socialism economic calculation is impossible, under socialism there can be no economic activity in our sense of the word. In small and insignificant things rational action might still persist. In the absence of criteria of rationality, production could not be consciously economical.

For some time [after the socialism is in place] possibly the accumulated tradition would preserve the art of economic administration from complete disintegration. Men would preserve the old processes not because they were rational, but because they were sanctified by tradition. In the meantime, however, […] the general decline of "economic thought" comes. […]

In a socialist community there will be thousands of establishments, but a minority of these will produce goods ready for use. The majority will produce capital goods and semimanufactures. […] The economic administration will have no real sense of direction. It will have no means of ascertaining whether a given piece of work is really necessary. How would it discover which of two processes was the more satisfactory?

Under a system based upon private ownership of the means of production, the scale of values is the outcome of the actions of every independent member of society. Everyone plays a two-fold part […] first as a consumer, and second as a producer. As a consumer he establishes the valuation of goods ready for consumption. As a producer he guides production-goods into those uses in which they yield the highest product. […]. Interplay of these two processes ensures that economic principle is observed in both consumption and production. […]

At first sight, the above statements do not seem to be extraordinary. Most of us, having experienced the real socialism, would agree with their essence. However, we can be shocked not by the content, but rather by who was the author of these words and when they were written. These words belong to Ludwig Von Mises and are included in his paper titled “Die Gemeinwirtschaft” published in 1922.

Mises (1881-1973) without doubt can be considered now as one of the greatest prophets in economics. Almost a century ago he expressed the views for which there were no place within social science, where "liberal" leaders and thinkers such as Marx, Stalin, Roosevelt and Perron dominated. Etatism in different colors and shades dominated the thoughts and actions of policymakers and scholars both in the East and in the West. Starting with war communism in the *Bolshevik* Russia and "success" of Stalin’s economic plans (*piatiletku w tri goda*)[1] through Roosevelt’s “New Deal”, Mao’s cultural revolution, “British socialism,” and Sweden’s welfare state, various types of government intervention, protection, and control became omnipresent throughout the world. The names of such economists as Oskar Lange, John Keynes, or Paul Samuelson are world-known. On the contrary, we rarely come across in newspapers and other mass media the names of scholars from the Austrian school, of which Mises was one of the most outstanding representatives. Maybe that is the reason why his writings are fascinating. They impress us with their expressiveness and sharp images that the author draws for his readers.

These are the real "memories from the future," said one of the students from the University of Pennsylvania who knew communist Eastern Europe very well. Mises could not take advantage of his own experience since the above words were written when no real socialism had existed yet, and the first state building a society of social justice had yet to implement the new ideas (the first Soviet five-year plan, or *pyatiletka*, began in 1928). Solid knowledge, general erudition, and common sense led the scholar to the above theses. Mises believed that socialism is not feasible (in the long-run), since it is inefficient.

One can believe that socialism could work rather well in case of the so called stationary economy, i.e., such economy within which all the operations are constantly repeated and nothing ever changes. If we assume that the socialist system of production were based upon the last state of the system of economic freedom which it superseded, and that no changes were to take place in the future, we could indeed conceive a rational and economic socialism. But only in theory. A stationary economy can never exist. Things are continually changing. […] All

[1] Rus.: (fulfilling) the five-year plan in three years.

economic changes would involve operations the value of which could neither be predicted beforehand nor ascertained after they had taken place. Everything would be a leap in the dark. Socialism is the renunciation of rational economy.

The essence of capitalism lies in individual activity at the individual's own risk. In such a system, the economic actors should constantly make decisions, the consequences of which (negative and positive) they will have to bear. Efficient allocation is allocation that directs assets to those producers who are capable of making the best use of these assets. Whether anyone likes it or not, capital goods cannot be allocated efficiently without competition, without banks (and bankers), stock exchanges (and brokers), real estate markets (and real estate agents), etc. Marx detested all of these and considered parasitic, because they do not produce while gaining (often huge) profits. Also, no efficient allocation is possible without continuously adjusting prices, wages, interest rates, and exchange rates.

Fortunately, Mises now is not a "voice of one crying in the wilderness." His thoughts are accepted by his many followers – not only in the post-Soviet economies, but also in such social democracy strongholds as Sweden or Canada. This should be a warning for diverse utopian-socialists, naïve populists, and primitive improvers who, despite the painful experience of the last eighty years, keep arguing that they will be able to solve severe social and economic problems through various state orders and decrees, administration, controls, and protection. Faith in the magic power of Robin Hoods and Janosiks, Stalins and Perrons, Lukashenkos and Zhyrinovskys has not vanished.

Let's turn again to Mises who, many years ago, warned against threats that would come from the manipulation of social justice.

The motive force of the whole process which gives rise to market prices is the ceaseless search of economic benefits […]: the entrepreneurs (including shareholders) are striving for profit, the landlords - for rent, the capitalists - for interest, and laborers - for wages. It is only the prospect of profits which directs production into those channels in which the demands of the consumer are best satisfied at least cost. If the prospect disappears the mechanism of the market loses its mainspring […]. The market is focal point of the capitalist order of society. It is the essence of capitalism. […] It cannot be "artificially" imitated under socialism.

The problem of economic calculation is of economic dynamics […] it arises in an economy which is perpetually subject to change, an economy which every day is confronted with new problems which have to be solved. Now in order to solve such problems it is above all necessary that capital should be withdrawn from particular lines of production, from particular undertakings and concerns, and should be applied in other lines of production, in other undertakings and concerns. This is *not a matter for the managers of joint stock companies, it is essentially a matter for the capitalists who buy and sell stocks, make loans and recover them, who speculate in all kinds of commodities. It is these operations of speculators, which create those conditions of the money market and stock exchanges. […] They create the data to which managers have to adjust their business and which therefore give direction to their trading operations. […]*

The capitalist attempts to strike a balance between his desire for profit and his estimate of the risk of loss. He must exercise foresight. If he does not do so, than he suffers losses - losses that bring it about that his disposition over the factors of production is transferred to the hands of others who know better how to make a better choice. The socialist state cannot leave to other hands that disposition over capital […] who would "simply" have the business of doing what capitalists and speculators do under capitalist conditions, the only difference being that the product of their foresight should not belong to them but to the community.

If the socialists attempt to belittle the significance of the problem of economic calculation in the socialist community on the ground that the forces of the market do not lead to ethically justifiable arrangements, they simply show that they do not understand the real nature of the problem […] *of ascertaining how the existing means of production can be used most efficiently* […]. *In order to solve this problem it is necessary that there should be economic calculation. And economic calculation can only take place by means of money prices established in the market for production goods in a society resting on private property in the means of production.*

Of course, this is a simplification. The reality is more complex. However, the details are not the most important here. It would be difficult to defend each single statement written by Mises. His praise for market and condemnation of centralized economic planning should not be interpreted in extreme ways. Not every government intervention is harmful. An unlimited discretion of business entities is not always good. What matters is his general concept. His works help explain why socialism was not of the kind its creators intended it to be. A simple logic of economic processes is sufficient to understand this. The problems related to the lack of economic thinking in the post-socialist economies remain a principal impediment to successful reforms and fast economic growth.

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