

Prepared for the congress

Investment in Ukraine. Challenges and opportunities

Hotel Polonia Palace, Warsaw,
8th-9th November 2004

Investment environment in Ukraine

Vladimir Dubrovskiy



CASE Ukraine

www.case-ukraine.com.ua

Formal and informal impediments to entrepreneurship and investments in Ukraine: the main peculiarities and the ways of coping with them

The political-economic causes for persistence of the "bad institutions" in Ukraine: can we predict the changes, and promote the improvements?

Evolution of the political-economic system: where Ukraine is going?



Peculiarities of investment climate

Institutions:

“Soft” rule of law

The *nachal'niks* versus bureaucrats

Vague property rights

Making things done:

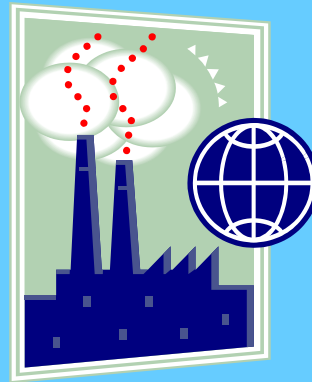
Blat networks of interpersonal exchange
with favors

“Soft” rule of law

The “pales of law” can be...

...loose

...tight: so hard to keep within the law!



... and SOFT: no way to
fully keep within the law!

but

“There is only a block of concrete that really means “NO ROAD”.
The rest of prohibitions mean just “TOLL ROAD”

For your competitors too

“Soft” rule of law

Karamsin, 19th century Russian historian

“The severity of the Russian laws is alleviated only by discretion in their enforcement” “... just this disorder makes life in Russia possible”

Gertzen, 19th century Russian social thinker

Authoritarian modernization: law contradicts to practices

~~The law applies to all~~

Everybody is a lawbreaker

“Laws are written for the fools”

Because they are applied at the discretion of a *nachal'nik*

“Who are the boss, we or the law?”

personal vlast' of NACHAL'NIKS

EXTORTION under
enforcement of the law

**Preconditions for
extortion**

Nachal'niks: not the bureaucrats!

Bureaucracy (by Weber)

Highly-paid professional public servants facilitating rational processes of control.

Implements legislation in a strictly formal (**impersonal**) way

Operates under constant public scrutiny and political oversight

No decision-making power
Clear separation of “powers” from branches of State

Strictly controlled and separated from business

Administrative power in Ukraine

Poorly-paid and dependent upon administrative rents (in money or barter)

Relies upon **discretionary** power and vague and arbitrary informal rules

Controls politicians rather than vice versa. Tries to control mass-media to avoid public scrutiny

Possesses the political power to magnify ambiguity and non-transparency in legislation

Uncontrolled and mostly affiliated with business

Blat networks



Authoritarian modernization,
especially under Communists : law contradicts to practices



Normal economic activities were considered illegal



Ledeneva,
1998

No contract enforcement was officially available



Reputation-based informal networks of interpersonal mutual exchange with “favors of access” (*blat*)

Emerge to facilitate the illegal transactions of all kinds

Litwak,
1991 (!)



Weak rule of law

while

“One has to deserve a right to pay a bribe”

Vague property rights

Right to use the object WITHIN THE LAW

Under a “soft” rule of law



Real value of an asset depends on the position of its owner within the informal networks of *blat*

Political economy



The “vicious triangle” of legislation-*corruption*-discretion

Rent seeking, *overappropriation*, and “*arbiter*-client” relations

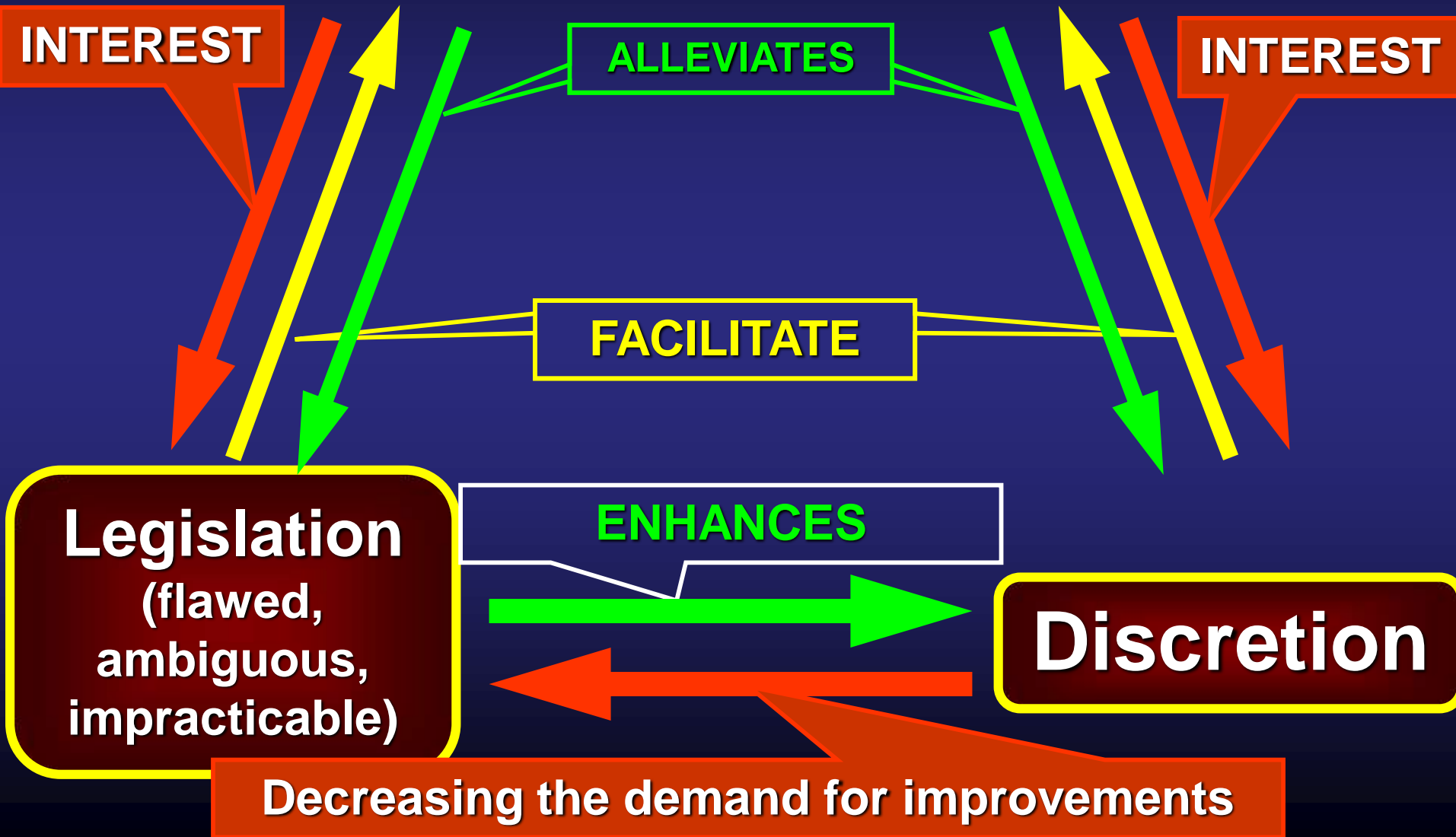
“*Zero-sum perception*” and the problem of legitimacy of entrepreneurship

“*State capture*” by corrupt networks

Evolution of the rent-seeking society of Ukraine

The *Orange revolution* and its immediate consequences

Corruption



Rent seeking vs. profit seeking

Profit seeking

Creation of the value **voluntary**
apprised by **competitive** market

↓
A **positive-sum** game (“cooking a pie”)
increases the public wealth

↓
Players can establish certain **efficient**
institutions, primarily, the **property**
rights by a **voluntary** agreement

Sonin (2003), Hoff and Stiglitz
(2002, 2004), Polishchuk and
Savvateev (2002):

Rent seeking

Appropriation of already existing value,
e.g. created by others

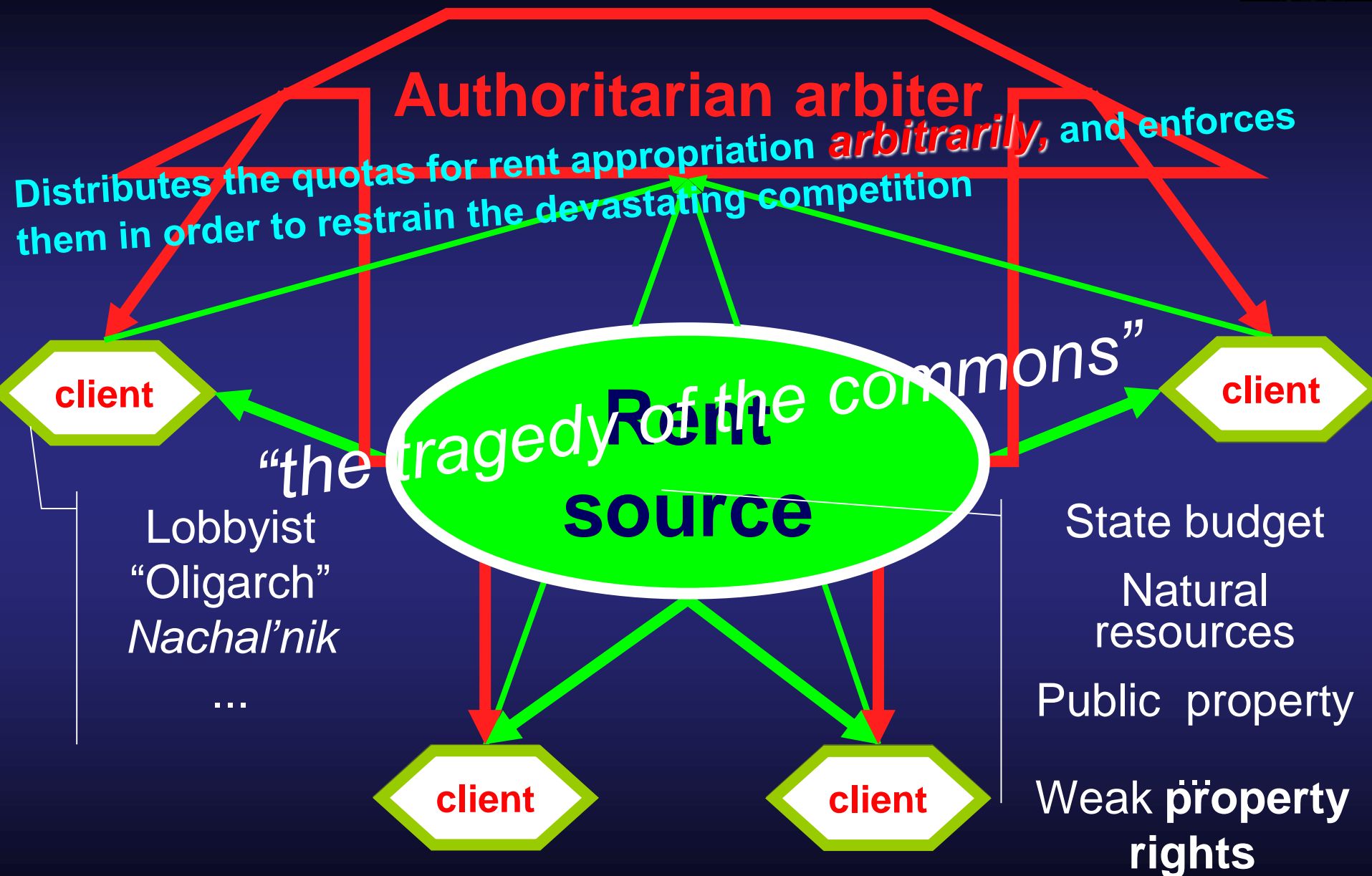
↓
A **zero-** or **negative-sum** game
 (“cutting a pie”) usually **decreases** the
public wealth

↓
In many cases players fail to establish
the efficient institutions.

↓
A **coercive force is required** to arrange
appropriation while preventing the
overappropriation

↓
**Rent seeking requires FORCED coordination and
control that can only be arranged by
AUTHORITARIAN POWER**

The “arbiter-clients” model



... but instead extorts the rent himself, or trades it for loyalty



An arbiter:

In effect, “owns” a source of rent \Rightarrow Has an incentive to extract the rent (share the players’ rents)

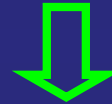


Looks as “captured” with vested interests

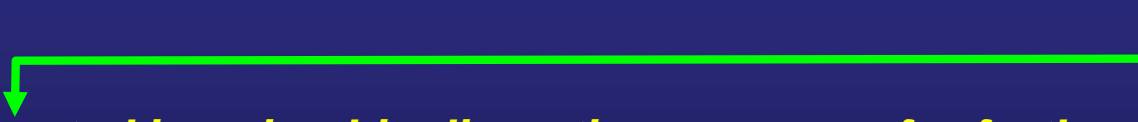


Crowds out and suppresses any other ways of preventing the overappropriation

Asymmetry: The players can motivate their arbiter with a “carrot”, but not threaten to him \Rightarrow **irresponsibility**



players are clients of their arbiter



Interested in using his discretionary power for further weakening the clients’ residual rights of control

Arbiters: $\begin{cases} \text{Rent-maximizing} & \equiv \text{authoritarian, plutocratic} \\ \text{Power-maximizing} & \equiv \text{totalitarian} \end{cases}$

Arbiters and clients form a hierarchy

Why do the people hate entrepreneurs?

Any kind of market exchange is being perceived as a sort of

«**zero-sum game**»

Inherited to a traditional
society

A “zero-sum” perception

Business incomes are not being distinguished by their origin

Business and wealth of ANY kind is illegitimate

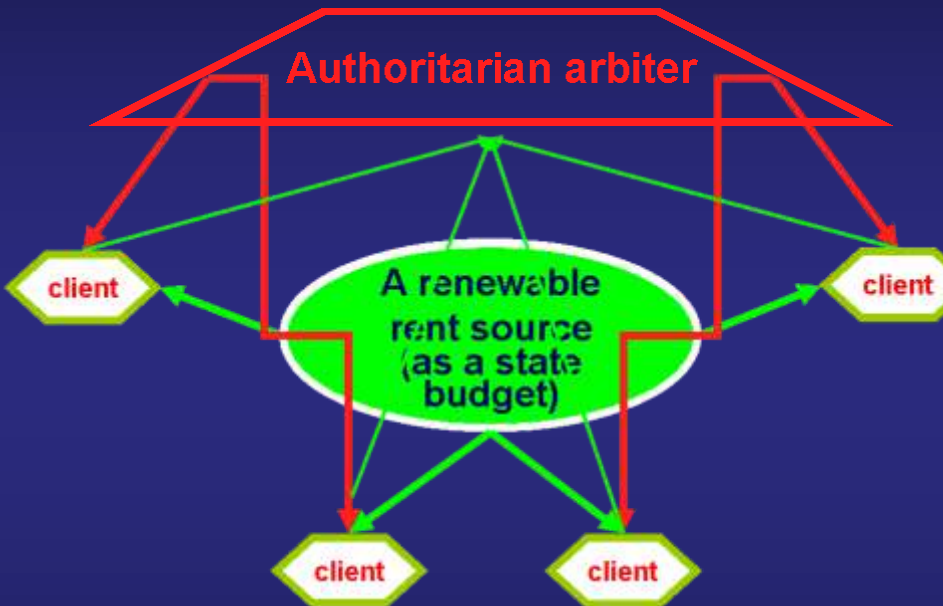
Weak property rights

“fairness” of business
is unrewarded

The rent seeking DOES dominate!

Effects of authoritarian rule

Rent seeking sector

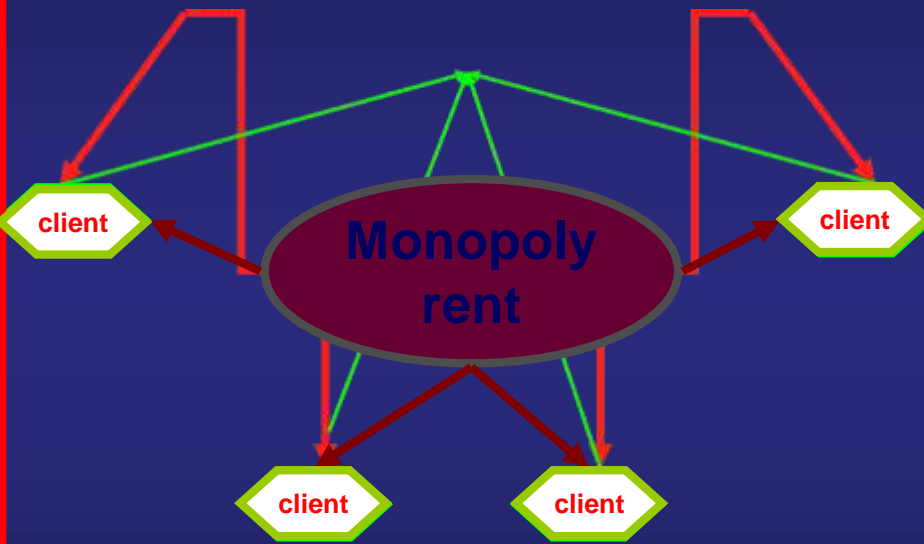


Increase in the social wealth

Firms earn their incomes mostly as **rents** depending primarily on the arbiter's discretion

Profit seeking
(competitive) sector

"A "zero-sum" perception



Decrease in the social wealth

Paternalism (clietneilism) and corruption

Evolution:

The rent seeking is costly for a society

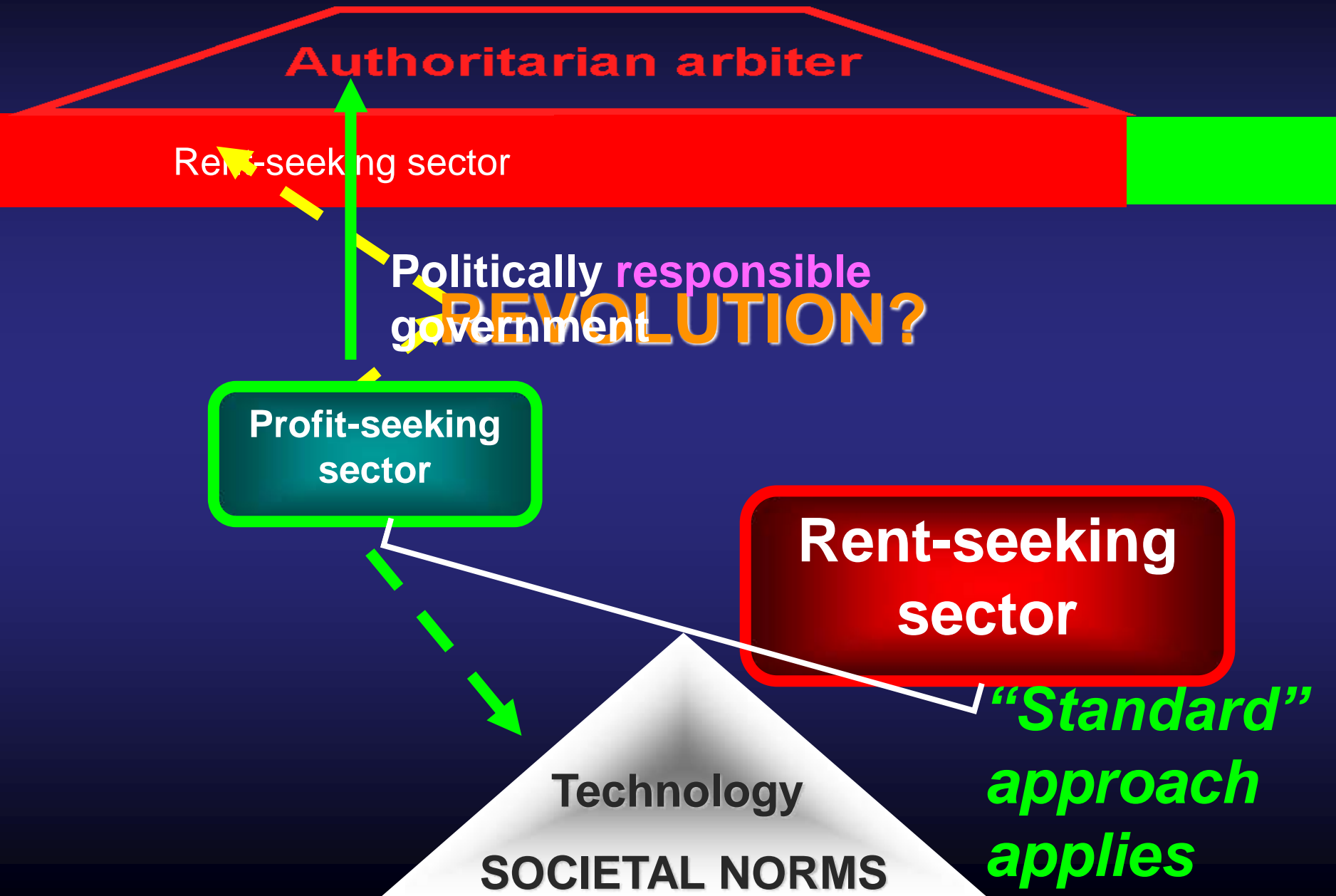
It takes certain **cost** of an arbiter to **coordinate and control** the rent seekers

Size of the rent-seeking sector is determined by the balance between amount of rents available for an arbiter and his costs of control and coordination of the rent seekers

The rent seeking contracts

With **exhausting of the available rents**, and **complicating of control and coordination**

Transition from a rent-seeking society: *Evolution* and *REvolution*?



Depletion of the rent sources

Market imbalances

Financial instability

Cheap energy and credit

Subsidies and government contracts

Close collaboration of business and officials based on *blat*

«intermediate winners»

Sources of Rent
1988 - 1994

Overappropriation of state budget and enterprises' fixed assets

“Overappropriation” of creditors' trust

Sources of Rent
1995 – 2000???



Orange Revolution

November, 2004

As a result of the revolution:

Public is not passive anymore, it became a “principal” of the politicians

BAGs and their arbiters are not the only players anymore

Political market emerges

Executive power officials have lesser impact on the legislature

Politicians appeal to the broad groups of population

while

Public consciousness is still immature:

- does not properly distinguish profits from rents
- supports redistributive activities (as “re-privatization”)
- supports “coordination and control” (e.g. price regulation)



**Threat of populism and paternalism
towards large groups of population**

Revolution of the politicians

Political capital

A “zero-sum” perception

POPULISM

**Financial-
industrial groups**

Destruction of the rent-seeking opportunities

Political parties

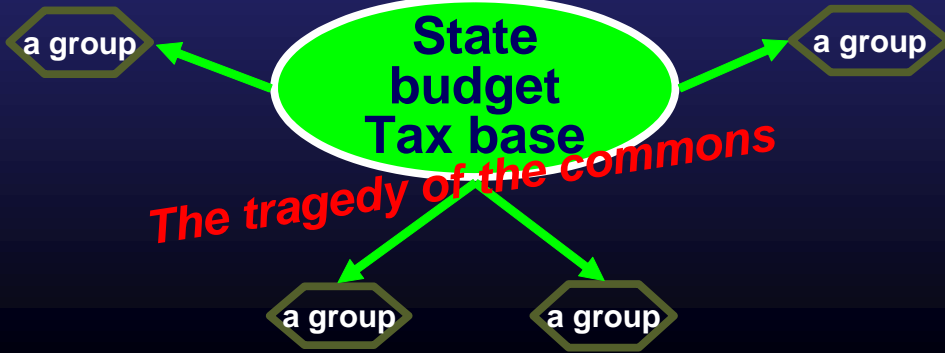
Working for the competitors

An “arbiter” for the
large groups

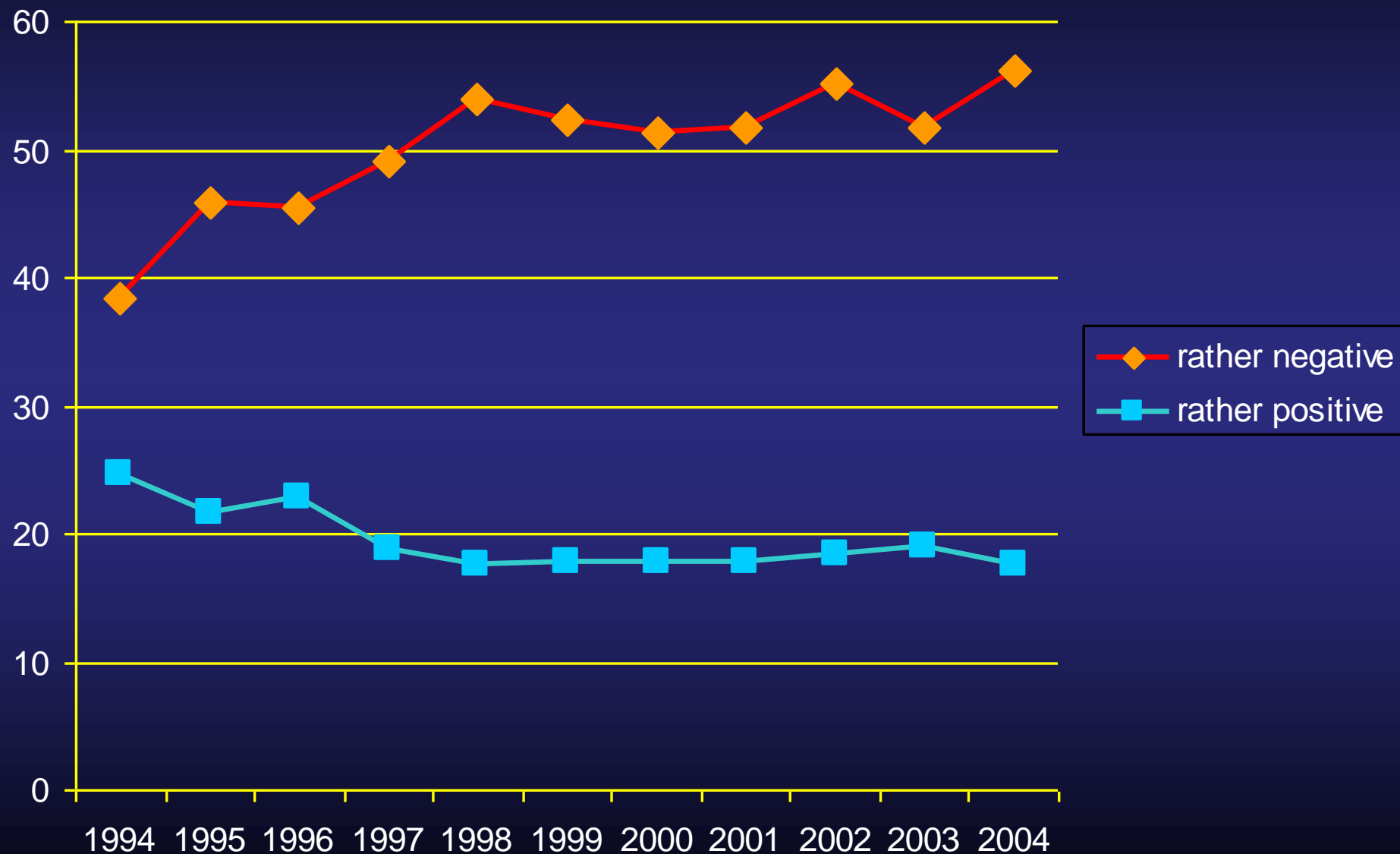
State
budget
Tax base

The tragedy of the commons

**Demand for the
UNIVERSAL rules of
the game**

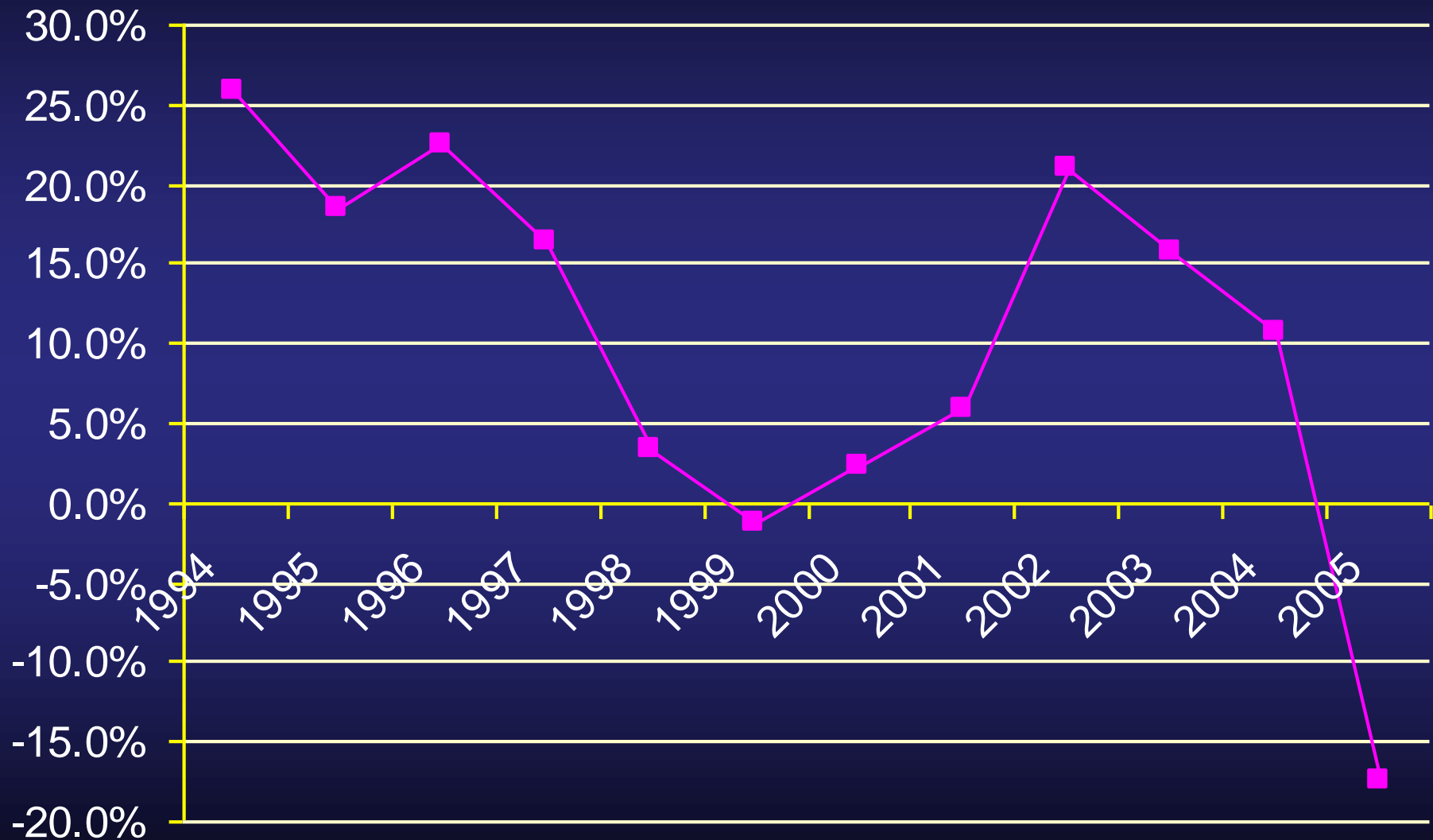


People's attitude to the privatization of large-scale enterprises



source: National Academy's Institute of Sociology's surveys (Panina, 2005)

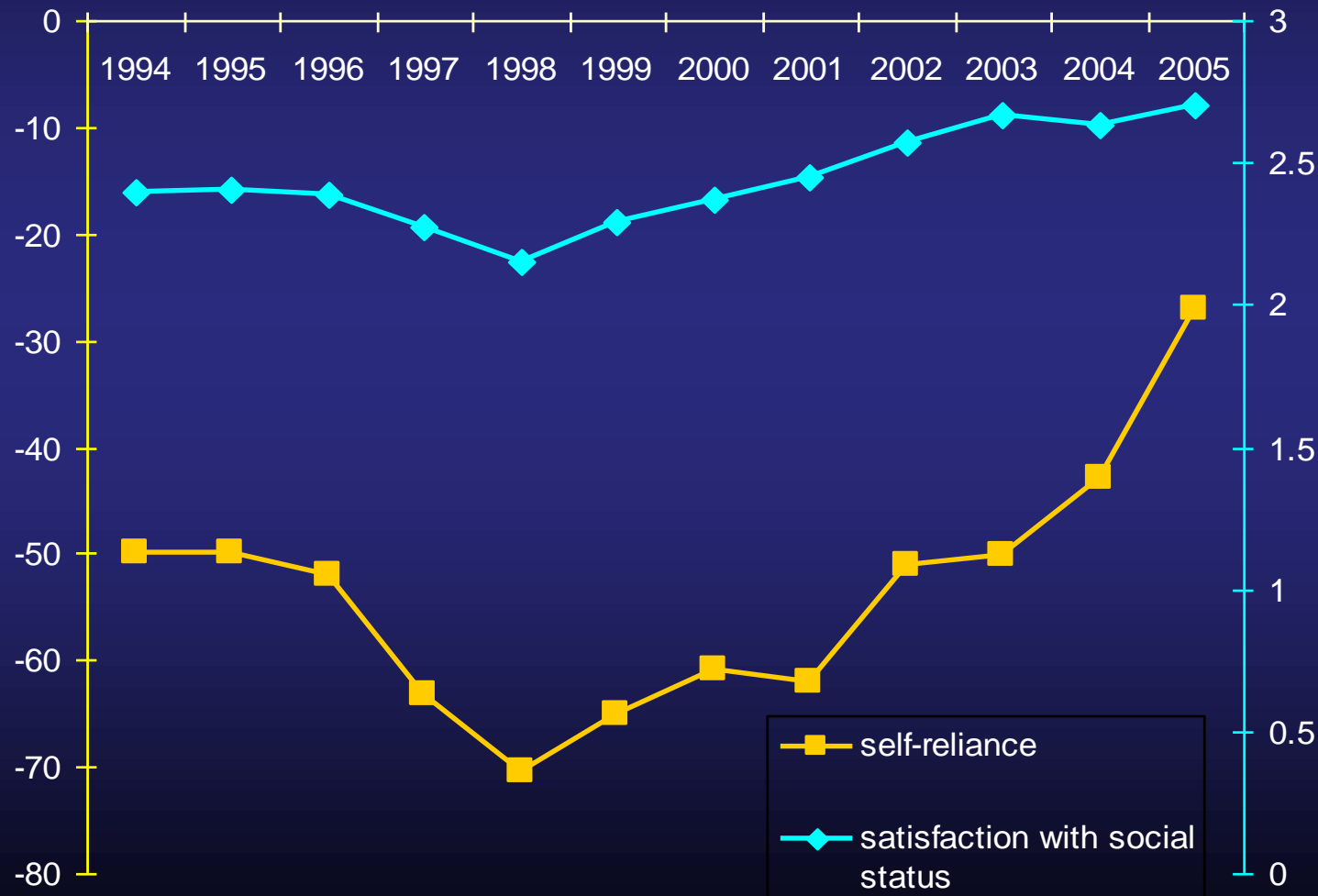
Balance of attitudes to land privatization



source: National Academy's Institute of Sociology's surveys (Panina, 2005)

SATISFACTION with own SOCIAL STATUS (score of

maximum 5, right axis), **and SELF-RELIANCE** (percentage of respondents agreed that their life success depends on themselves, net of the percentage of respondents agreed that it is determined mostly by the external conditions – left axis).



source: National Academy's Institute of Sociology's survey (Panina, 2005)

***Thanks for
your attention!***