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Growth Potential of the Ukrainian Economy – Is the "Miracle" Meant to Last?

> "Optimists are those who have no idea of how our economy really functions"[1]
> "… just try to go to a Kiev market, in order to sell meat." – "You will not be able to do it." – "That's correct. Or try to open a newspaper stand, not even in the city centre, let's say on the left bank. It will be burnt within five days."[2]

The macroeconomic figures of the past four years combine to a very positive picture. GDP grew at an annual rate of 9.4 % in 2003 and even of 12.3 %[3] during the first half of 2004. In 2004 the Government needed to update its forecast for annual industrial output growth from 4.5 % to 14 %. Investment is increasing, inflation remains moderate. The Government's budget execution recorded a surplus. Exports are increasing (by 27 % in 2003) and despite a simultaneous import growth the current account remains positive. A construction boom can be observed, which has in turn boosted manufacturing. In addition, rising real wages have lifted private consumption, reflected in strong trade sector growth. In 2003 foreign direct investment inflow has doubled in respect to 2002. On the basis of these figures Government institutions and investment banks use an enthusiastic language praising the "Ukrainian Miracle".

But how does it fit together with the miracle that "in 2003 the population of Ukraine lived even worse than the previous year.

1 A Ukrainian entrepreneur, cited in Möllers et al.
2 From an interview with a Ukrainian Parliamentarian. In 2004 the stand would maybe not be burnt, but closed by more subtle means (md).
3 State Statistics Committee of Ukraine.

A feeling of apathy and pessimism exists among almost all social groups. The average income is lower than the means that allow to survive. Four of five persons expect their financial position for the next years to be bad or very bad, the percentage of persons calling themselves 'poor' increased in respect to the previous year."?[4]

This paper puts Ukraine's current positive macro-economic figures into perspective with the overall economic performance since independence. The incomplete transformation, the state of the business environment, and the country's deeper socio-economic structure will let me conclude that the growth potential of Ukraine is limited, if profound structural changes do not occur. Only an entrepreneurial economy based on fair and even competition and underpinned by a stable regulatory framework will allow Ukraine to fully use its potential and create the basis for long-term growth and prosperity.

Economic Performance and Reform Efforts

Although in 1991 Ukraine's well-educated workforce, abundant natural resources and large industrial infrastructure promised excellent prospects, the country stands out as having had one of the longest and deepest recessions of all transition countries. In 1999 the Ukrainian economy was at 40,8 % of its 1990 level, and during four growth years it reached 49,4 % (2003) – in figures, the economy was three-quarters the size of Hungary's even though Ukraine's population is five times larger. Even at purchasing power parity exchange rates, Ukraine's GDP ranks well below that of its central European neighbours and Russia. Health and

4 International labour organization: poll 2003, quoted by Radio Svoboda, Ukrainian Service, Jan. 17th.

educational institutions and infrastructure are in dire straits and underfunded. Sickness from preventable causes is rising, life expectancy is falling, and the population is shrinking, reflecting the deterioration in economic and social conditions and emigration. Ukrainians have to live on less than half the income they had a few years ago and perhaps up to 75 % of families are below the poverty line. The inequality between the poorest and the richest is one of the highest in region. Capital flight estimated to be between 20 and 50 billion USD has taken place. The reference point for the present positive figures, most of them relative and not absolute values, was therefore very low.

Why has Ukraine not been able to take advantage of its potential and could not match the successful developments concerning wealth and democracy in the Central European transition countries? "While initial conditions are critical for explaining the output decline at the start of transition, decisive and sustained reforms are important for recovery of growth"[5]. No doubt, the environment in CIS countries was more difficult, due to greater economic distortions at the outset of transition. And Ukraine, in its "quadruple transition of marketization, democratisation, state-, and nation-building" (T. Kuzio in R. Kravchuk) faced a particularly difficult task. Starting conditions were much worse than what the enthusiastic nationalists wanted to see in 1991: An economic system closely tied to other Soviet republics on political and not economical criteria was disintegrating. Capital was technologically outdated and too intensive in energy and material to be efficient, and the dependence on Russian oil and gas was soon to be felt. The military sector made up over a third of the industry at a time of declining demand for military production, whereas consumer goods lacked competitiveness. There was no real banking system, no contemporary management know-

5 World Bank World Development Report 1996: From Plan to Market, cited in: World Bank 2002.

how or knowledge of markets, and the skills of many professionals were not in demand (Halushka).

The difficulty and costs of reform were underestimated. The post-Soviet Ukrainian government lacked the skills needed to fulfil its new role in a market economy (Nanivska), as this was an absolutely different task than the management of a country-sized production line as "a colonial type of administration … the Government of the Ukrainian SSR being a branch office of that in Moscow" (Hawrylyshyn). The Soviet-style government machine proved unable to cope with the new challenges of transformation, substantively (what to do) and managerially (how to make it happen). While the President and the government have articulated a medium-term economic reform policy, the reality of policy implementation bore little resemblance to that vision. Ukraine has mainly reacted in a "fire-fighting" manner to upcoming problems. The "Faustian bargain" (R. Kravchuk) of the nationalist intelligentsia with the communist nomenclature secured independence at the expense of political and economical reforms and resulted in a subsequent oscillation between piece-meal reforms, half-measures, and the temptation to return to direct administrative controls; it failed to produce clear "rules of the game". A powerful industrial lobby was able to "capture the state" and impose its narrow private interests (Hellman et al.). The resulting market distortions lead to considerable social cost.

Three reform pushes can be identified in Ukraine (Vincentz) from the time of Kuchma's accession in 1994, but they were inconsistently implemented. It was only the regional economic crisis of 1998 that forced the government to accept greater co-operation with international lenders; this co-operation resulted in some reforms. As a result of ten years' half-hearted efforts a substantial amount of state property has been privatised, most markets for goods and services are now liberalised, and inflation could be stabilised. But Ukraine failed to complete some of the more difficult tasks of the transition to a market economy.

Privatisation without Market Discipline

Privatisation should put hard budget constraints on enterprises of the inherited structure and create incentives for production and innovation, rather than asset stripping and rent seeking[6]. Privatisation must be part of an overall strategy for creating a competitive environment and improving corporate governance. If privatisation is not accompanied by restructuring, if it does not lead to the abolition of direct or indirect state subsidies, and if new market entrants are not allowed to compete with the privatised companies, it will not contribute to the creation of an efficient market economy (Akimova 2001). The ideal privatisation strategy appears to be the transfer of assets to strategic investors through open, fair, and transparent methods. "Small enterprises should be quickly privatized through competitive auctions, medium-size enterprises through case-by-case methods, with a majority share sold to outsiders. Very large enterprises should be sold only when a clear strategic investor is identified" (World Bank 2002). On the other hand, rapid privatisation to insiders or through voucher privatisation can even lower the quality of corporate governance. Precisely these two latter privatisation methods prevailed in Ukraine. The often non-transparent schemes resulted in former communist directors becoming de facto feudal lords (Halushka), but lacking capital, know-how and market experience to cope with a competitive environment and the required internal restructuring. The expected change of behaviour did not occur and "effective owners" whose interests coincide with that of the enterprise are largely absent. Often the owners' personal interest is maximised *at the expense* of the interests of the enter-

6 Asset stripping: acquire a company and sell its assets individually at a profit. Rent-seeking: unproductive profit-seeking activity that often occurs at the expense of the general interest, by means of lobbying for privileges from the state, e. g. monopolist situations.

prise. Most of the privatised enterprises are not easily restructured; their ownership is too diffuse. And, in some cases, the government retains a share part, permitting it to block restructuring that would be needed to draw in new technologies, streamline existing capacity, and improve cost, quality and competitiveness. As a result, the enterprises continue to suffer from a lack of investment capital.

In recent years, privatisation was mostly done with fiscal benefits in mind, although it should rather have investment character with investment obligations (Heyets). A few financial-political groups, the "privatisation grandmasters, the President's loyal businessmen and politicians", dominated this process.[7] Western investors have not been attracted by the high prices demanded for the minority ownership stakes on offer and played a marginal role in the country's privatisation process, unlike in other east European economies. The Ukrainian side may also have "feared that Westerners impose rules based on economic rationality that may threaten their position" (Van Zon).

The enterprises inherited from communist times, whether privatised or not, were often spared the exposure to market reality: subsidies continued to be granted through the budget or by indirect means, such as tax and social security arrears, cheap energy, or debt arrears to the banking sector. Mutual arrears, barter and shadow economic activity constituted another means of avoiding market discipline. Uneven competition and price distortion are the result, the link between firm efficiency and financial results is cut, and no adaptation of enterprises to market conditions takes place. Under these conditions markets do not assume their information function; this leads to an enormous misallocation of resources and perverted incentives for enterprises (Vincentz). A systematic connection can be found between state subsidies to loss-making enterprises "to maintain jobs, produc-

7 The Ukrainian, 1/2004: "Grosmejsters'ka" privatizacijna gra".

tive potential and know-how", lack of restructuring of these enterprises, and "tunnelling" of funds into private hands – the hands of those who are able to ensure the continuing flow of the state subsidies that keep the company alive (World Bank).

Sector Performance

Longer-term growth of the different sectors is far from being secured. Some indications on sector developments (EIU): The *metallurgy* industry, accounting for 37 % of exports, has benefited from high prices on external markets. But sector growth stagnates, technology is obsolete and consumes too much energy, and labour productivity is low, reflecting the absence of industrial restructuring. The *manufacturing* sector accounts for more than 70 % of total industrial production and has been the driving force behind Ukraine's economic recovery. Yet official data do not take into consideration the extent to which the government subsidizes unviable enterprises. Steel and energy-related industries gain prominence at the expense of higher value-added sectors. The share of machine building in total industrial output has fallen from around 30 % at independence to below 10 %, deteriorating the country's export structure. Increased *arms export* became the fastest growing source of foreign exchange, as the enterprises of the military-industrial complex are the only high value added enterprises capable of attaining world market level. The *agricultural* infrastructure is in a bad state, productive assets are outdated, management is ineffective, and labour productivity low – Ukraine has moved from being a net grain exporter to a net importer. The *coal mining* industry has suffered a sharp decline and has the world's highest workers' death rate, owing to obsolete equipment and ineffective safety standards. Only the Donbass region's strong coal lobby prevented the mines from being shut down. The *food-processing* sector, which has recovered strongly in recent years, still accounts for less than 15 % of total industrial production. The *tourism* infrastructure is underdeveloped, even in traditional tourist areas. The situation of the Ukrainian *energy sector* "must be called catastrophic" (Pleines) due to a lack of reforms. The introduction of market relations encounters much resistance, and it comes as no surprise that most oligarchs made their fortunes in the energy sector. Old technology leads to inefficiency, accidents and ecological consequences; and sustainable improvement due to investments is not in sight.

Foreign Trade and Inclusion into the World Economy

The development of foreign trade reflects in many ways the lack of reform in the domestic economy, the performance of the external sector being a good indicator for the progress of market reform in the whole economy (Quaisser). Ukraine has enjoyed only limited success in diversifying away from the industries – steel, chemicals, shipbuilding, coal, machine-tools and weaponry – that relied heavily on government subsidies and became even less viable when the traditional export markets collapsed after 1991. These traditional sectors of Ukraine's Soviet-era industrial base do not provide a solid foundation for sustainable export growth, given their obsolete capital stock, excessive energy intensity, and inability to adjust to changes in international markets. But Ukrainian exporters face difficulties in penetrating non-traditional markets with anything other than low value-added primary and semi-finished products. Ukraine still sends over one-third of all exports to members of the FSU and only around 15 % to EU states. (By contrast, Poland now exports nearly 70 % to EU markets and only 3 % to Russia.) This is mainly the reflection of Ukraine's lack of competitiveness outside the former Soviet Union. The Ukrainian leadership adopted a policy of developing these traditional basic industries at the expense of other sectors – despite its rhetoric of preserving the "scientific potential" of Ukrainian industry (Halushka). Foreign trade has become one of the favoured areas for rent-seeking, corruption and tax evasion, as it is one of the rare opportunities to obtain money in the form of convertible cash (Quaisser). The prevalence of short-term interests is bound to produce future problems: the narrow export base makes the country vulnerable not only to world price trends but also to protectionist measures abroad and to anti-dumping charges. „There exist no raw material tigers."[8]

The prospects of cheap, domestically priced energy and free access to a big market, which could be the result of closer ties to Russia within the Unified Economic Space, exert some attraction. However, political agreements and mutual import quotas resulting from preferential treatment will not substitute the need for enterprises to become competitive (Quaisser).

Further strong increase in both consumption- and investment-related imports could again lead to annual merchandise trade deficits, which could be avoided since 1998. As FDI contributed very little to balance the current account during a decade, a persistent Ukrainian deficit had to be financed mainly with official credits. The government's considerable debt-service difficulties already forced it to restructure almost 3 billion USD in commercial and Paris Club debts between 2000 and 2002. In order to prevent a further crisis related to foreign exchange, a better export sector will be needed and more foreign direct investment (IEDPK 2002; EIU).

> The inclusion of Ukraine in the world economy has been one-sided, ephemeral and asymmetrical. There was only internationalization of trade and not of productive structures. (Van Zon)

8 Biznes, No 19 (538), May 2003 "Kuda rastem ?"

Hampered Entrepreneurial Dynamics

The entry and growth of new firms, particularly of small and medium enterprises, in generating economic growth and employment, is of great significance. Labour productivity is more than 100 % higher in new firms than in the old ones. This is due to greater efficiency in sales, exports, investment, and employment creation. There exists an inverse correlation of the firm's size and net employment growth (Konings; LICOS 2002).

In Ukraine there are only 100,000 registered small private firms (Halushka)[9] and their share in total output and employment is very low. The inclusion of private individual entrepreneurs gives a figure of entrepreneurial potential that comes close to that of western countries (Institute of Competitive Society, 2003[10]). But most SME are active in trade and services, and only very few in manufacturing.

The business environment is shaped by the quality of governance; it is measured by the effectiveness of the State in providing the institutional infrastructure corresponding to the standards of a well-functioning market economy (Akimova 2002). In Ukraine, SME have to function in an environment with many barriers for development. Although legislation improved in recent years, many of the positive developments in the Ukrainian business environment suffered subsequent setbacks. Poor co-ordination of legislative acts and undermining of legislation due to frequent amendments nullifies much of the progress made (Thiel). Even if it has improved slightly in recent years, the investment climate is

9 As a comparison, there are 300,000 in Switzerland having a seven times smaller population.

10 This study's statement that official data is not reliable for employment in the SME sector, share of SME in the total number of jobs and SME share in GDP, is credible and no figures will be given here.

still "challenging for the entrepreneur"[11]. Firms rate the high real overall tax burden, "comparable to a 70 % rate in the West" (Van Zon), and unstable tax legislation as main impediment[12] (Kipen'). Other major difficulties include inconsistencies in the economic policies, an excessively bureaucratic administration with licensing and registration procedures open to abuse, legal uncertainty and a weak judicial system, the inability to enforce property rights, and absence of suitable credit and financial mechanisms (Yacoub et al.) – a long list that "only inadequately describes the daily labour of Sisyphus faced by the entrepreneurs" (Hoffmann et al.). Anticompetitive practices, corruption, and unwarranted state interference in business activities have increased (IFC 2003). Control visits by 26 state institutions (fire brigade, tax inspectors, etc.) authorized to perform inspections and fine entrepreneurs for any infringement of the agency's rules (Van Zon) have become even more frequent. Entrepreneurs complain about lack of transparency in the procedures and in the controller's expectations. Consumer protection policy has transformed into a system for forcing businesses to give bribes. SME are not consulted for new policy measures and oftentimes not even informed about change of regulations, to which they must correspond. It comes as no surprise that Ukrainian entrepreneurs instinctively equate the concept "policy" with "interference" (Möllers et al.). Enterprises connected to bureaucracy and politics receive preferential treatment. Lack of a strong and independent judiciary able to enforce commercial agreements makes it difficult for productive companies to appeal against such inequalities of competition.

The Ukrainian government adopted several SME assistance programs during the last 10 years. But this support policy didn't have a noteworthy effect on the sector due to lack of funding for

11 The politically correct expression was used in an investment guide of the American Embassy in Kyiv.

12 E. g. in 1998 there were 365 changes in the VAT legislation – as I had been told in Kyiv by a horrified accountancy apprentice.

implementation, non-compliance with SME priority needs, ambiguity of the measures, and lack of implementation control. Other administrative organs disregard the existing SME support policy, and general fiscal policy permanently conflicts with it. The *actually implemented state policy regarding SME* was not the result of these programs, but formed in the confrontation of the business community and the administrative system. Major policy achievements stimulating quantitative growth and strengthening the sector (simplified taxation methods, some deregulation) were the fruit of demands and pressure of the entrepreneurs, who are gradually beginning to better understand their rights and interests (ICS 2003).

Effective implementation of a small business development policy is directly related to reform of the administrative system that creates all major barriers today, as it is still based on the intervention method of economy regulation. Although the system gave in to the pressure towards liberalization in the early stages of applying regulatory policy, with time it developed bureaucratic ways to impede liberal policy. The administrative system has become "the roof" that replaces legitimate mechanisms for protection of property rights and participates in the regulation and distribution of revenues generated by small businesses. The system and individual officials are motivated to directly interfere with operations of independent businesses.

The Shadow Economy

The shadow economy, "economic activity, which involves the creation of added value not embraced by official statistics and not included to the taxation base"[13], comprises different phenom-

13 Ukraine develops strategy for reducing shadow economy, International Centre for Policy Studies newsletter #79 September 25, 2000.

ena, including a certain criminal layer of illicit activity. But most shadow activity consists of ordinary people meeting their needs. "The decision to stay in the shadow is not considered immoral. The state itself is immoral, because it does not keep up with its public obligations. And in an immoral state there is no place for honest business."[14] This is not only due to high tax rates, but also due to a lack of confidence in the state in its use of tax money and return on payments. With up to 60 % of the economy working in the shadow economy, private initiative seems to be far ahead of the regulatory framework.

It is true that a shadow economy exists in every country, but if it becomes too big, it blocks further economic development. Although for a large part of the population the shadow economy has become a means of survival that helped to avoid social shocks related to Ukraine's economic crisis, its negative results – the loss of Government budget revenues and low impact and inappropriateness of economic policy – outweigh the positive ones. The vicious cycle of informalization, lower tax revenue and further increase of tax rates on a shrinking tax base has to be inversed.

Not only SME are closely connected to the shadow economy; the Ukrainian political elite itself can realize its interests by the help of shadow income.[15] The state bureaucracy appears not to be very interested in combating the shadow economy, because of the profits from bribes. So there is a peculiar symbiosis between the state and the shadow economy (Van Zon). "Will people who have grown in the shadow be able to fight it?"[16]. A certain potential exists from lowered tax rates, such as the ones that came into effect in 2004.[17]

14 *Ibid.*
15 The Ukrainian, 2004.
16 Biznes, 22 (541) 2003.
17 Reduction in the corporate profit tax from 30 % to 25 %, and the introduction of 13 % flat rate on income tax, from Jan. 1st.

The shadow economy can frighten away foreign investors, as it makes it impossible to grasp the development tendencies of the economy and make projections for the future.

The Ability to Attract Foreign Direct Investment

The inflow of FDI is a valuable source of capital and new technology, and usually accompanied by know-how that leads to better labour productivity and economic performance. It is estimated that 75 % of Ukrainian fixed assets will be over 20 years old by 2010 and the urgent need for modernisation is evident – foreign investors could actively step in (Setan).

The size of FDI in a country can be used as an indicator for the progress and the nature of the privatisation process, as well as for the quality of the country's business environment and investment climate, as it reflects the confidence in the country's economy. Since independence, Ukraine received very little FDI, in comparison to Central Europe and CIS countries rich in natural resources. Ukraine has not been able to take advantage of its low-cost, well-educated work force.

In shaping the measures that will further improve the business environment, account should be taken of the fact that developments depend primarily on local investments. Special treatment for foreigners can therefore not be justified (OECD). Major amendments of Ukraine's FDI legislation have been enacted during the past few years and constitute a shift form an ineffective system of specific incentives to a system of non-discriminatory legal conditions for all investors. Ukraine has also signed a host of bilateral investment treaties that supersede the Ukrainian Foreign Investment Law. But while foreign investment regulation appears to be compatible with that in other Eastern European countries, the implementing institutions in Ukraine are rated as being ineffective (Ögütçü; OECD). Many barriers for local entrepreneurs also affect foreign investors. Foreign investors complain about unclear rules and lack of transparency in administrative decisions, lack of unified procedures, the difficulty to obtain licences and permits in due time, non-acceptance of international ISO norms, smuggled and copied merchandise, non-acceptance of international arbitrage courts' rulings, etc. The "defence of the State's interest" occurs often at the expense of fair trials.[18] Even though customs taxes were lowered, many invisible barriers to trade still exist, and import tariffs change frequently. Several joint-venture disasters and continued non-transparent privatisations equally undermined investors' confidence.

The Ukrainian government has repeatedly launched political initiatives in order to attract more FDI. In 2003 another new administrative body was created to assist foreign investment, which led a commentator to the statement, that "the Ukrainian government violates the basic law of the investment climate: less bureaucrats, more investment. Experience shows that support can be extremely costly for the supported".[19] Yet, obtaining support of government institutions seems to be a key requirement for economic success of FDI in Ukraine.

Foreign investment has recently started to rise and doubled in 2003 in respect to 2002 from 0.75 to 1.25 billion EUR, but a large part of this could be Ukrainian or Russian capital flowing back from off-shore locations[20]. FDI has generally been directed to the sectors that produce the fastest returns, such as food and agro-processing and domestic wholesale trade. However, other sectors are slowly catching up, which suggests the arrival of some investors with longer time horizons (EIU 2004).

There is still mistrust between foreign investors, local private interests and the administration. Short-term greed is assumed to be the prime motive of the foreigner; this perception does little to

18 Kontrakty, 24, 2003.
19 Biznes, 28 (547), 2003: "Nesite vashy denezhki".
20 Biznes, 47 (566), 2003.

discourage the predatory tendencies of some officials in Ukraine (Seton). The potentially positive role of foreign capital as a creator of new jobs and tax revenue, provider of opportunities for local suppliers, and of general prosperity for a region or city, does not seem to be recognized by many local authorities.[21] Up to now Ukraine has not yet experienced enough foreign investment to know and to trust what it can really do for the country. The Polish experience has shown that foreign companies do not "milk" the country, but rather keep reinvesting profits and develop a pool of local management talent (McKinsey Global Institute, 1999). Ukraine needs FDI that brings experience of self-discipline rather than experience of avoiding or evading discipline (Seton).

Today Ukraine certainly presents many opportunities for foreign investors able to combine local expertise with the international practices, and use a hands-on approach in developing the market. Understanding of the country and a careful risk-tolerant program of development will be indispensable.

Unexpectedly High Growth Rates since 2000

Too little is known about the sources and driving forces of the current economic growth in Ukraine to be able to identify the determining variables with certainty. Some of the factors that contributed to four years of growth are the following (Dabrowski):

- The 40 % real currency depreciation seen in 1998–1999 sparked widespread import substitution and boosted the international

21 President Kuchma stated at a conference in 2003 that "one of the main indicators of the evaluation of the regional governors' work will be the state of the attraction of foreign investment" (Biznes, 24 (543), 2003). A rating system for regions will be created to gauge the regions' performance in this respect (Delovaya Stolitsa, 16, 2004).

competitiveness of otherwise uncompetitive industrial sectors. (In spite of the later real appreciation of the Hryvnia, growth continues.)

- The export sector began to benefit from strong demand in leading markets such as Russia, and benefited from high prices for metal on the international market. But this kind of economic recovery heavily relied on manufacturing sectors that add low value, or that are even value-subtracting. (Despite a deteriorating situation in the international markets for metal products, growth has continued.)
- Many years of output decline have left significant production capacities unused. In these circumstances initial catching up growth can be relatively easy, but is short-lived if not supported by new investments.
- Parts of the informal sector are returning into the legal sphere. This must be welcomed, but this kind of growth has a purely statistical character and will not last for a longer time.
- In 2000 the later ousted cabinet led by Viktor Yushchenko began to insist on cash payments for budgetary obligations and energy purchases. This helped to reduce the barter schemes and payment arrears that distorted the economy; corporate tax privileges have been reduced.
- Some (although limited) progress in privatisation, deregulation, and restructuring and a change in the economic behaviour seems to have taken place, notably in the enterprises producing consumer goods, exposed to market competition and not being large enough to rely on effective rent-seeking.

But there are voices that see the positive figures more as a as a result of inter-enterprise arrears, energy tariffs that cover only 63 % of the actual price, wage arrears and state debt towards exporters for VAT reimbursement.[22] In 2003, a year of growth, the Government could not avoid a further increase of the external

22 Biznes, No 19 (538), May 2003 “Kuda rastem ?”

debt.[23] And in general the validity of all figures should be regarded sceptically, as “half the growth occurs in the grey economy and the other half goes, wherever the Government sends it: for some sectors it is easy to decide in a cabinet room about the ‘necessary’ indicators. E.g. it can be observed that the investment rate falls sharply whenever money must be made available for an election campaign”.[24]

What is clear is that reform is the only factor that can really be influenced by policy makers.

Market and Institutions

If the advantages of economic reform and the creation of a liberal business environment are so obvious, why do countries “in a no man’s land between centrally planned and market economies” not adopt them? The view of a *transition from plan to market* appears to be superficial to adequately describe the past and present developments in Ukraine.

In Ukraine market forces were turned loose in the institutional vacuum left by a receding state that lacked the means to regulate the emerging market economy. Yet, the market alone does not resolve problems. It needs an institutional environment that ensures competition and induces the entrepreneur to an innovative behaviour (Buravoy). The most important element in transition is *institutionalisation* (R. Kravchuk). In Ukraine liberalisation and privatisation did not lead to functioning market institutions. Instead of the emergence of a new incentive structure, a kleptomaniac process spread (Van Zon). The anticipated economic, social and political transformation, supposed to create effective own-

23 Kontrakty, 2004.

24 www.ukraina.ru, Oct. 30th 2002.

ers, did not take place. The invisible hand did not form, as private and general interest remain disconnected. Under these conditions the market cannot develop its creative potential.

Even though Ukrainian organizations, rules and actions appear very similar to corresponding elements in Western countries, they can have very different meanings and roles (CASE 2003). Ukraine's transition must in many regards rather be described as façade modernization: democracy, market economy and "reform simulation" are a mere Potemkin exterior. Reforms peeled off the outer layer of a deeper-lying socio-economic structure. Consequently, the formal structures and policies of the Ukrainian state do not necessarily reflect existing informal institutions that developed from the institutional and cultural legacy of the hidden reality of communist times. These informal institutions that contain e.g. a deep-rooted culture of paternalism and patronage, or the reliance on personal networks, could sponge up the new concepts and formal institutions (Fisun). In Ukraine institutional change led to "a parasitic economic structure contained in a semi-feudal bureaucratic context" (Van Zon), whose mechanisms differ significantly from a functioning market economy. In this situation economic change cannot be measured with the usual macro-economic indicators (Dubrovskiy et al.).

I consider Ukraine's "neo-feudal post-communist socio-economic structure" as the hardware that economic theory and political decisions try to influence, and describe its features by opposing it to an ideal-type of a market economy, or "entrepreneur's economy" (Taranuha).

Western market economy (Ideal-type)	"Neo-feudal post-soviet economy"[25]
Social aspects	
Large elite recruitment, generalized option for social upwards movement.	Insider "club" of owners and decision makers, dependent on close ties to the state and not interested in further reforms: "Oligarchic cartel pluralism".
Fortunes are based on value creation.	Fortunes have been made by appropriation of assets by insider privatisation or by tunnelling. Personal clientelistic relationships with the leader play crucial role in amassing personal wealth or in the rise and decline of members of the elite.
Authority and income through skills and merits.	Authority through status and position.
Profit-maximising enterprise, where economic rationality primes. Interactive management (incl. voice option).	Enterprise as top-down system, where hierarchical rationality primes. Hozjain and subjugated. Hierarchy stifles creativity and initiatives coming from below
Generalized trust; trust in institutions; entrepreneurial networks.	Clan structure trust; general mistrust; "survival networks".
"Civilised entrepreneurship", voluntary submission under the law, leading to "indirect utilitarism".	Entrepreneurship developed from soviet rule-avoiding behaviour in the legal loopholes of transition; Speculative character (redistribution, not production); psychologically everything is allowed; "parasitic innovativeness".
Economic aspects	
Firms compete by maximising customer satisfaction through innovation and cost reduction. Facilitated entry and enforced exit of companies.	"Politico-economic groups" headed by powerful businessmen use their per sonal connections with the authorities in order to gain lucrative contracts and political influence.

25 Extension of the modelling of Van Zon, including some elements from Buravoy.

	Oligopolistic markets split between rent-seeking clans. Protected enterprises produce according to objectives unrelated to market signals. Barriers for new enterprises.
Mass of market data; transparent information; unified accountancy norms and analytic reporting system; insider benefit forbidden.	Lack of transparency; formalistic non-transparent accountancy; Economic calculation impossible (moreover for the large shadow economy); insider benefit is the norm.
Stability allows for longer-term calculation and planning at individual and company level. Enterprises can specialize.	Primacy of short-term action, short-term interests and short-term investment amortization. Enterprises must diversify to minimize risks.
Historically grown institutional framework protecting contracting and property rights and inducing to the combination of "morality" and business.	Lack of an adequate institutional framework with strong mechanisms of corporate governance, rules to protect minority shareholders, rules against insider deals and conflict of interest, etc.
Favourable level-playing business environment for investors, including SME and FDI. SME are the economy's major actors and are well represented in the political system.	Legal uncertainty, "rule by uncertainty", unequal competition, state extortion. SME play a marginal role and are cut from the political system. Different rules in different sectors and regions.
Private entrepreneurship and privatisation as a means to attain economic efficiency.	Private property and privatisation aim rent-seeking and wealth hoarding of a few.
No difference between the treatment of foreign and local capital.	Crowding out of foreign capital that cannot function according to Ukrainian rules.
Government and administration	
Politics create framework conditions in dialogue with the economy.	Identity of capital and political power. Primacy of politics over the economy. Special interests capture the State and block further reforms.

State is market-facilitating. Impartial state as guarantor of rights. Mutual rights and obligations state – citizen. Weberian bureaucracy with rules ensuring equal treatment.	State is rent-seeking. State with "privatised" interest. Unchecked self-reproducing and expanding predatory bureaucracies, with internal corruption predatory chain. Public functions as a legitimate means for personal enrichment. Rules are instrumentalized for bureaucracy and state-capturing vested interest.
The State's budget input/output circle (taxes – services) functions. Striving for a taxation system with a maximum economic efficiency. Large shadow economy	High nominal taxes, low real state income. Low state output and enforcement capacity.
Rule of law. Impartial judiciary system.	Weak governance. Power is more important than law. Mores are more important than law. Weak judiciary system. Feeble position of the creditor[26] due to low enforcement capacity.
Private property with stable property rights.	Property rights are certain only for state administrative organs. State unable to enforce secure property and contracting rights. "Roofs" outside or within the state.

The identification of a "neo-feudal post-soviet economy" implies some consequences:

- Ukraine is no longer in a transition from plan to market. The task that the country faces must be called the reforming of the socio-economic system that came into existence during transition, in order to create another economic system capable of ensuring sustainable growth and improvement of the

26 Burakowskij.

country's living standard. It will definitely not be an easy task to develop the momentum to change this socio-economic structure. Yet, "a minimum critical mass of reforms needs to be in place before economic reforms have the desired effects on performance. Below this threshold, it is possible that additional reforms could have a negative impact on output" (Word Bank 2002).

- Given these structures (which seem not to be transitional, but rather stable) the country's present potential for performance can hardly be judged by that of a market economy. A true market economy has a superior growth potential due to much more widely spread economic resources that create accelerators and multipliers (self-reinforcing investment and consumer demand). Yet it should be noted that the "neo-feudal" economy does have a certain growth potential that can lead to the well-being of a widened elite and can be observed by the change in the heart of major cities.
- The effect of a policy decision may differ or even be radically opposed to its (noble) intention, formal appearance, and superficial interpretation, due to the appropriation of the measure by the societal structures and the interrelatedness of the components of the socio-economic system. Only the outcome of a policy should be judged, the yardstick being whether it leads towards a market economy or, on the contrary, further strengthens the "neo-feudal" systemic elements. Examples: Consumer protection policy, FDI support institutions.
- Advice to policy makers that ignores the *systemic nature* of the "neo-feudalist" structure, and isolated policy measures, are likely to fail to bring about the expected results. Western counselors who do not grasp the specificities of this structure risk speaking a language unable to produce a correct diagnosis. It is not sufficient to change the wording of a law if other mechanisms intervene at the level of interpretation, execution, and enforcement of the legislature.

Conclusion: Preconditions for Sustainable Growth

In many regards Ukraine's economy seems to be in a better state then 10 years ago, given the macro-economic stability, some successful liberalisation and privatisation, and the present growth rates. But for years little investment has occurred, and the economy dwelled on the old infrastructure. This time will come to an end. The continuation of the present growth process should not be seen in any way as inevitable or automatic, and must not lead to false conclusions: major reform steps still lie ahead.

Ukraine shows an extreme discrepancy between its potential in terms of physical and human capital and its actual performance. Although the country was ranked in 1997 as second in the world in the relation of the number of new patents to GDP, the actual share of intellectual and high-tech products in its total export volume is negligible (CASE 2003). Only the orientation toward skill-intensive production can make use of the country's human resource potential (Heyets; Babanin et al.).

Privatisation was not able to live up to initial expectations. Today the creation of a level-playing business environment, "a menu of policy, regulatory and institutional factors that provide incentives sufficiently robust to induce the private sector to invest in socially desirable projects"[27] has become a key requirement. Despite the improvements seen over the past years, Ukraine is still far from corresponding to the model of a functioning market economy. The country's economic institutions are considered to be some of the most unreformed and distorted among transition countries (CASE 2003). Economic and social development is blocked by a set of parasitic mechanisms at all levels of the economy that prevent profitable and productive value-added economic activities to emerge (Van Zon). Only a truly competi-

27 Weingast 1992, cited on the World Bank poverty reduction internet subsite.

tive environment will generate incentives for production and innovation and provide the dynamic actors with the resources needed for development[28]. This requires eliminating multiple means of support to old enterprises and a consequent enforcement of bankruptcy laws. Instead, fiscal policy could redirect support toward worker training and severance payments. On the other hand, Ukraine has to learn to build on existing societal forces instead of fighting them: the new sector must evolve from a passive receptacle for absorbing resources into an active competitor that attracts the most qualified workers. According to the World Bank new enterprises must reach a threshold of around 40 % in their contribution to employment, in order to become an engine of growth (World Bank 2002).

Making a society more entrepreneurial is a multidimensional task that must bring a wide range of public, private and non-governmental actors to work together. Mechanisms for interaction between the State and SME are needed that lead to the formulation of an effective policy, in line with the sector's actual needs (ICS 2003).

The failure to implement strategies of encouragement (policies that encourage entry of new enterprises) and discipline (policies that put hard budget constraints on the old large enterprises) results in a flow of resources in a direction opposite to the needs of a long-term growth environment.

Ukraine will have to develop its own model of success (Hal'chins'kiy), but some principles will help to build the right model: Fair competition (IEDPK 2003) without special privileges, a stable and transparent legal, political and macro-economic environment, execution of the law, and minimal interference into business by the state administration, form a business environment that fosters creativity and allows the country to use its potential for prosperity. Removing the numerous means by which

28 There is a statistical correlation between the strength of competition in a country and its average revenue (Vagliasindi).

the federal and local governments can interfere with the markets to extract economic rent will also lead to a reduction of corruption (McKinsey).

Ukraine needs to secure long-term growth, for even if it will attain a high 5,5 % annual GDP growth, it takes 20 years to reach the level of 1990.[29] Without growth, the country will not have the resources needed to provide basic public goods such as legal and judicial systems, secure property rights, basic infrastructure, and education, health, and social safety nets. Only if reforms are introduced in a consistent fashion, the Ukrainian economy will be able to grow in a sustainable way, for the benefice of its entire population.

Annexe – Selected indicators[30]

	1999	2000	2001	2002	2003
Real GDP growth (%)	–0.2	5.9	9.2	4.8 b	9.4
Consumer price inflation (av; %)	22.7	28.2	12.0	0.8	5.2
Population (m)	49.5	49.0	48.2	47.8	47.5
Exports of goods (US$ m)	13,189	15,722	17,091	18,669	23,739
Imports of goods (US$ m)	–12,945	–14,943	–16,893	–17,959	–24,008
Current-account balance (US$ m)	1,658	1,481	1,402	3,174	2,891
Foreign-exchange reserves excl gold (US$ m)	1,046	1,353	2,955	4,241	6,731
Total external debt (US$ bn)	14.0	12.2	12.8	13.6	14.6
Debt-service ratio, paid (%)	16.3	18.6	10.6	13.8	11.4

29 Biznes, No 19 (538), May 2003 “Kuda rastem ?”
30 EIU 2004.

Principal exports 2003	% of total	Principal imports 2003	% of total
on-precious metals	36.8	Fuel & energy, incl ores	36.2
Machinery & equipment	15.8	Machinery & equipment	24.9
Fuel & energy, incl ores	14.3	Food, beverages & agricultural products	9.4
Food, beverages & agricultural products	11.8	Chemicals	7.7
Chemicals	8.4	Industrial products	5.6

Main destinations of exports 2002	% of total	Main origins of imports 2002	% of total
Russia	17.1	Russia	35.2
Italy	6.6	Turkmenistan	10.5
Turkey	4.4	Germany	9.2
Germany	4.0	Poland	3.0
China	2.8	US	2.6

Average monthly wages, Oct 2003 (US$)	
Ukraine	93.5
Russia	187.6
Romania	207.3
Poland	594.3

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