6

Competitive Oligarchy with High Growth, 2001–04

The sacking of Prime Minister Viktor Yushchenko in April 2001 came as no shock. His departure seemed unfair as his government had done more for Ukraine than any other government, but at this stage Ukrainians were pessimistic and cynical. The surprise was that his government accomplished so much and survived for so long.

Ukraine's economy was finally taking off. In August 2003 I noted: "Anybody who comes to Kyiv is impressed by the frantic construction of big buildings in the city and the swift development of restaurants and shops, while its green beauty remains. With each visit to Ukraine, I am struck by the discussion being more open, intellectual and interesting."[1] The economic dynamism was stunning, especially in the three biggest cities: the capital, Dnipropetrovsk, and Donetsk.

Yushchenko was succeeded by Anatoliy Kinakh, who continued Yushchenko's reform policies at a more leisurely pace. The government continued to function far better than before the Yushchenko interlude, not least because society demanded more. The ensuing government led by Viktor Yanukovych maintained a focus on economic growth.

Intellectual and political liberation accompanied the novel economic boom. The old regime seemed too obsolete to last, and Leonid Kuchma was no longer without competition. For the first time, a strong center-right opposition organized around the two foremost leaders, Yushchenko and Yuliya Tymoshenko. Their first goal was opposition victory in the parliamentary elections scheduled for March 2002, and their ultimate aim

1. From my notes from a trip to Kyiv, August 19–22, 2003.

was victory in the presidential elections in October–November 2004. The strengthening of political parties in parliament laid the foundation for a full democracy. Yet Ukraine was at best semidemocratic (Freedom House 2008). The old regime was digging in its heels, gradually reducing the freedom of the media.

The oligarchs ruled. The greatest symbol of their might was the privileged privatization by Ukraine's two richest men, Rinat Akhmetov and Victor Pinchuk, of Kryvorizhstal, the country's largest steelworks. In July 2004 a real estate company put up posters on Shevchenko Avenue in central Kyiv, advertising a gated community with beautiful mansions on the outskirts of the city. The posters read: "The Rebirth of Aristocracy."

The Kinakh Government

Kinakh replaced Yushchenko as prime minister and was confirmed by parliament on May 29, 2001. He was a highly educated and intelligent man who had become chairman of the Ukrainian Union of Industrialists and Entrepreneurs after Kuchma. Kinakh had been deputy prime minister for industry a couple of times in Kuchma's world of musical chairs. He was a moderate reformer, though representing the old red directors he advocated some protectionism. Among the centrists, he was one of the most liberal, and he was not a businessman. Kinakh was the ultimate consensus seeker, and his main weakness was extreme caution.

His appointment was unexpected but ideal for Kuchma. First, he was a placeholder. The central theme of all political discussions was who would be the next president. Kinakh was too soft to be Kuchma's candidate and he did not represent any oligarchic clan. Second, as in 1997, Kuchma again needed a completely loyal prime minister. Kinakh still belonged to the Pustovoitenko's Popular Democratic Party, which was a leftover of Kuchma loyalists without more profitable connections. Third, in spite of his protestations, Kuchma appreciated Yushchenko's economic reforms and did not want them reversed.

Kinakh fulfilled his job description perfectly, following the Hippocratic oath: Do no harm! He maintained Yushchenko's strict fiscal policy and did not reverse any reforms. He continued promulgating acts Yushchenko initiated, notably the budget code and the land code. The important customs code was also adopted. Yushchenko had started the long-desired judicial reform with a new criminal code, and Kinakh followed up with a law on the court system and a program for the adaptation of Ukrainian legislation to EU legislation. Together, the Yushchenko and Kinakh cabinets promulgated more reform legislation than Ukraine had seen before. Yet the legislative speed slowed down under Kinakh.

Yushchenko had departed with only Yuriy Yekhanurov and his closest personal aides, and Kuchma had sacked Borys Tarasiuk and Tymoshenko earlier. The rest of Yushchenko's government stayed on. Yushchenko in turn had inherited most ministers from Valeriy Pustovoitenko. The government remained the high church of civil service, even if the odd big businessman intruded from time to time. A characteristic example is Ihor Mitiukov, who stayed as minister of finance from 1997 until 2001.

As expected, in due course Kuchma sacked Kinakh, citing his usual complaint about all his prime ministers: not pursuing enough reforms. This time, however, Kuchma's real purpose was evident. It was November 16, 2002, eight months after the parliamentary elections of 2002, a suitable time to choose a candidate for the presidential elections in October 2004. Yanukovych was elected with a slight majority of only 234 votes, only eight more than necessary (Wilson 2005, 83).

The absence of any policy reversal under Kinakh was the litmus test of the success of Yushchenko's reforms: They had proven irreversible. They had transformed the oligarchs from rent seekers to producers, and the producers needed a functioning market economy, although they did not mind tax privileges and some protectionism.

Organization of a Strong Center-Right Opposition

For years Ukraine had no organized center-right opposition of significance. Leading liberal or center-right politicians preferred to work within Kuchma's sphere rather than organize outright opposition. This was true of many prominent ministers, Yushchenko, Viktor Pynzenyk, Yekhanurov, Tarasiuk, Yuriy Kostenko (Rukh leader and minister of environment, 1995–98), and Serhiy Holovatiy. As a group, they had been too weak and individually sufficiently satisfied with cooptation by Kuchma. In 2001 the preconditions changed because the Kuchma regime had acquired three unforgivable flaws.

First, Kuchma had alienated Yushchenko, although the parliament formally sacked him.[2] Yushchenko and his associates remained ambiguous in their attitude toward the president. They did not enter the movement Ukraine without Kuchma, which Tymoshenko considered a betrayal, because she had joined it immediately after her sacking in January 2001. The

2. In his unique fashion of reconciliation, Kuchma himself went to Yushchenko's home the very evening of his ouster and commiserated with him. They drank, and Kuchma took out the guitar and sang melancholic songs. (Personal information from one of the few who attended this extraordinary event.)

Yushchenko group had many well-known leaders, including many former ministers, and numerous seats in parliament.

Second, the Mykola Melnychenko tapes had shown Kuchma's regime to be lawless and morally unacceptable. When media oligarch Viktor Medvedchuk took over from Volodymyr Lytvyn as Kuchma's chief of staff in June 2002, he imposed Soviet-style *temnyky* (theme papers) to instruct journalists what to write about and what to ignore (Prytula 2006, 106–107).

Third, several big Ukrainian businessmen had fallen out with Kuchma and his establishment. These businessmen were not necessarily more virtuous than the oligarchs, but they maintained substantial wealth. The Kuchma regime was sufficiently mild not to destroy them, but it did subject them to tax inspection and legal harassment. Most such businessmen made up with the regime, but four stood out as new opposition hardliners: Petro Poroshenko (nicknamed "chocolate bunny," as he was Ukraine's chocolate king), Yevhen Chervonenko (Ukraine's largest trucker and owner of a drinks company), David Zhvania, and Mykola Martynenko (both primarily engaged in nuclear power). These men were not billionaires, but each was worth a few hundreds of millions of dollars.

In 2001 a large number of right-wing and centrist forces founded the Our Ukraine bloc, which gathered together all the Rukh factions, other right-center party factions, and independents who supported Yushchenko. It was formed in opposition to Kuchma and its self-evident leader and future presidential candidate was Yushchenko. The formation of this bloc involved a great rethinking among the center-right, which was tired of losing. At long last, these forces were coming together rather than underlining their differences.

Yushchenko emphasized universal values, such as faith, family, clean government, and a liberal market economy, and he displayed his achievements as prime minister, notably the elimination of wage and pension arrears. Our Ukraine tried to reach out to the east and big businessmen, welcoming recent defectors from the Kuchma camp. Personally, Yushchenko was prepared to talk to everybody, including Akhmetov and Pinchuk, with only Medvedchuk being his absolute enemy. Yushchenko was determined to create a moderate image and move to the political and geographic center. Therefore he downplayed cultural and linguistic nationalism and excluded extreme nationalists.

Formally, Our Ukraine was an electoral bloc that included seven or eight small parties. It attracted many prominent personalities and enjoyed broad support in western and central Ukraine, especially among Kyiv's intelligentsia, while its attempts to appeal to the east largely failed. Thanks to its newly recruited businessmen, it had substantial financial backing. Its main weakness was media support, but strangely the government gave Poroshenko a license to establish his small cable television Channel 5.

Tymoshenko stayed outside Our Ukraine. She had her old *Batkivshchyna* (Fatherland) Party, which was a one-woman party without much ideology. Her first deputy was Oleksandr Turchinov, who had always been by her side but lacked popular appeal. No one else in her party was prominent. Nor did anybody pay much attention to her party program because only Tymoshenko herself mattered.

After she was sacked from the government in January 2001, Tymoshenko defined her party through staunch opposition to Kuchma. Her message was to fight against corruption and for democracy. Tymoshenko's original electoral base was Dnipropetrovsk in eastern Ukraine. She learned Ukrainian only in the late 1990s after becoming a politician, but even so, she swiftly turned around, nurturing western Ukraine and accepting hard right-wing nationalists, such as the UNA-UNSO (Ukrainian National Assembly and the Ukrainian National Self-Defense Force), whom Our Ukraine did not admit. Her politics, though subdued, appeared social democratic and populist. Together with the socialists, Tymoshenko formed the backbone of the Ukraine without Kuchma movement. As that action faded in March 2001, she renamed her movement the Front for National Salvation, making the ouster of Kuchma and his oligarchic circle in favor of democracy her goal. Eventually it became the Bloc of Yuliya Tymoshenko, suitably abbreviated BYuT to allude to her beauty.

In October 2001 Tymoshenko called for the creation of a broad political alliance that would link her front, the socialists, and Yushchenko's new Our Ukraine bloc. She claimed that this coalition would win the parliamentary elections in March 2002 (Karatnytcky 2006). Yet the Communist Party remained the largest party in parliament. It opposed Kuchma and the oligarchs but disliked Yushchenko and the national democrats more, so the opposition to Kuchma could not unite.

The March 2002 Parliamentary Elections

On March 31, 2002, the parliamentary elections took place as scheduled. The electoral system was the same as in 1998. In one single round, half the 450 seats were allocated through proportional party list elections and half through single-mandate majority elections. The politicians had learned their lesson from the first semiproportional elections in 1998 and ganged up in larger electoral blocs.

The center-right opposition united around Yushchenko and Tymoshenko, respectively. Similarly, most of the Kuchma oligarchs had merged into one electoral bloc called For a United Ukraine. Only Medvedchuk's social democrats ran as an independent oligarchic party because it was the best organized party, claiming 300,000 members, though the party paid the membership dues. On the left, the communists, socialists, and progressive socialists persisted as three independent parties.

The ruling group employed a large number of Russian political consultants before these elections. Their favorite trick this time was to set up

Table 6.1 Results of election to the Supreme Rada, March 31, 2002

Party	**List votes** (percent)	**Seats**[a]
Total Left opposition[b]	34.1	87
Communist	20.0	65
Socialist	6.9	22
Total Center/government[b]	28.2	148
For a United Ukraine	11.8	121
Social Democrats (United)	6.3	27
Total Right opposition[b]	31.4	134
Viktor Yushchenko's Our Ukraine	23.6	112
Bloc of Yuliya Tymoshenko	7.3	22
Deputies from other parties and independents		80
Against all	2.5	0
Total	100[c]	449
Voter turnout (percent)	69.3	

a. Seats won in list vote plus seats won by party members and party-endorsed independents in direct vote.

b. List votes include parties that failed to clear the 3 percent threshold (and did not win seats in the parliament).

c. Total includes invalid ballots, not counted as votes.

Source: Central Election Commission of Ukraine, www.cvk.gov.ua (accessed on July 2, 2008).

a dozen fake parties, labeled political twins, that were confusingly similar to the existing opposition parties. They were funded by businessmen close to the regime and given substantial television time.

The election results varied greatly between the proportional part and the single-mandate constituencies. In the proportional part, the four opposition parties (Our Ukraine, the Communist Party, the Socialist Party, and BYuT) won a landslide by no less than 58 percent of the votes cast against 18 percent for the two government parties. On the right, Our Ukraine became the biggest party with 23.6 percent, while BYuT received no more than 7.3 percent (table 6.1).

Our Ukraine had successfully mobilized the whole potential national democratic vote of one-quarter of the electorate. Could it proceed beyond this limit set by Vyacheslav Chornovil in the 1991 presidential election? Tymoshenko succeeded in her electoral makeover and won most of her votes in the radical nationalist western regions. On the left, communist support, which had been steady in the 1990s, fell significantly from 25 to 20 percent, while the socialists maintained their support at 6.9 percent.

For a United Ukraine received a paltry 11.8 percent, admittedly more than twice as much as Pustovoitenko's Popular Democratic Party had obtained in 1998 but still miserable. Medvedchuk's well-financed and superbly organized social democrats gained no more than 6.3 percent of the votes, even though he had spent large amounts and possessed Ukraine's

Table 6.2 Composition of the Supreme Rada, 2002 and 2004

Faction	List votes (percent)	Total seats (March 31, 2002)	Total seats (January 15, 2004)
Opposition	57.7	221	200
Our Ukraine	23.6	112	102
Communist Party	20.0	65	59
Bloc of Yuliya Tymoshenko	7.3	22	19
Socialist Party	6.9	22	20
Propresidential	18.0	148	229
For a United Ukraine	11.8	121[a]	
Party of Regions[b]			67
Labour Ukraine			42
Democratic Initiatives			18
People's Power			22
Agrarian Party			14
People's Democratic Party			16
People's Choice			14
Social Democratic Party (United)	6.3	27	36
Deputies from other parties and independents	21.8	80	20
Total	100[d]	449[c]	449[c]

a. Split after elections.
b. Joined by European Choice in November 2003.
c. One seat remained vacant.
d. Total includes invalid ballots, not counted as votes.

Source: Karatnycky (2006, 35).

strongest party organization. Much of those votes were captured in Transcarpathia with administrative resources, that is, fraud.

The political twin parties were surprisingly successful. Together they received no less than 13.5 percent of the votes, most of which would otherwise have gone to the opposition, but none of them entered parliament through the proportional elections (Wilson 2005, 65–67). As expected, the number of parties that passed the 4 percent hurdle declined—from eight in 1998 to six in 2002, and the share of the votes that did not result in representation shrunk from 34 to 24 percent.

But most of the individually elected seats went to oligarchic representatives. Altogether the opposition received 221 seats, while the government obtained 148 seats. In addition, 80 independents were up for grabs (table 6.2). It had proven cheaper and easier to buy individual seats than party list seats.

An independent exit poll indicated that some vote manipulation and fraud took place, but it was relatively limited, changing the results of the major parties by 0.5 to 1.5 percentage points, which amounted to a few percent of the total vote (Wilson 2005, 67). The speed with which the exit poll was announced might have prevented greater fraud by the government.

The social composition of the new parliament was quite extraordinary. Tymoshenko told me in October 2002 that no less than 300 of the 450 deputies were millionaires. Most of Ukraine's significant businessmen were deputies, and they were found in all parties, including the Communist Party. Their share had doubled from one-third after the 1998 elections to two-thirds. Ukraine's parliament had become a club of millionaires, as the US Senate was known under President Ulysses Grant, when the United States was at the height of its oligarchic era (Steele 2004). In these terms, the oligarchy seemed stronger than ever, but it was badly split and faced a strong and well-organized opposition.

An intricate situation had arisen. For Tymoshenko and Oleksandr Moroz, the situation was evident: The four opposition parties had to unite and form a government in opposition to Kuchma. For the presidential administration, the diagnosis was equally evident: It had to buy or bully the votes needed to maintain control over the parliament. Nobody was more skilled or better endowed at this art than Medvedchuk, and he acted fast and effectively.

Yushchenko, by contrast, faced a dilemma. He could try to mend fences with Kuchma or stay in opposition, but to him cooperation with the communists was precluded because he had nothing in common with them. These parliamentary elections were merely a test run for him. His focus was the presidential elections in October 2004. Consequently, he took a one-month holiday in Europe, Tymoshenko bitterly lamented. Conversely, the communists felt closer to the eastern oligarchs than to the western Ukrainian national democrats in Our Ukraine, so they made no attempt to oust the government. Tymoshenko and Moroz jumped in fury.[3]

Neither Kuchma nor the oligarchs were prepared to give up without a fight. Kuchma reacted to the poor election results by appointing Medvedchuk, his chief of staff, replacing Volodymyr Lytvyn, who was an intelligent intriguer playing politics like chess. Medvedchuk was a heavyweight. A lawyer by training, he was one of the big oligarchs and their leading politician. His big shortcoming as a politician was that his character was all too obvious, making it impossible for him to gain popularity.

Medvedchuk single-mindedly focused on two tasks. One was to persuade businessmen in parliament to join the regime. Since most of them were multimillionaires, they were not easily bribed, so the regime intimidated them instead. Most major businessmen in the opposition endured

3. Interviews with Tymoshenko, Moroz, Yushchenko, and several of Our Ukraine's leaders in October 2002.

raids by the tax police and arrests of their top managers for purported economic crimes, while parliamentary immunity of the deputies was respected. One after another, they gave in. After all, they were in politics for the sake of money. But several became so infuriated that they formed the backbone of holdouts, supporting Yushchenko.

Medvedchuk's second task was to subdue the already obedient media. The leading oligarchs owned most media outlets, and Medvedchuk himself controlled the three dominant television channels, which he had degraded to tabloid status. The same was true of nearly all daily newspapers. Disobedient independent newspapers were sometimes sued for libel and slapped with prohibitive fines, forcing them into bankruptcy. The State Tax Administration was the main means of repression. It inspected no less than 260 media outlets in 2002, adding insult to injury by complaining about their poor tax morals (Prytula 2006, Åslund 2003b).

After the parliamentary elections, two presidential candidates were evident. On the right, Yushchenko had proven to have much broader popular appeal than Tymoshenko, who still suffered from her prior status of an oligarch. Still young at 41, she decided to wait. On the left, the communists had gained three times more support than the socialists, so communist leader Petro Symonenko no longer saw any reason to yield to Moroz. Yet Moroz, never a shrinking flower, remembered Symonenko's poor second-round result in 1999 and insisted on being a third opposition candidate.

After the oligarchs had reassured themselves of their hold on parliament, they happily subdivided themselves into nine clan factions as was their habit. The three most powerful oligarchic factions each had around 40 deputies: Regions of Ukraine (controlled by Akhmetov of Donetsk), Labor Ukraine (Pinchuk of Dnipropetrovsk), and the Social Democrats (Surkis and Medvedchuk of Kyiv and Transcarpathia). The six other oligarchic factions had 14 to 20 deputies each.

The regime received a severe warning that it was likely to lose the presidential elections 17 months later, but it survived for the time being. The opposition had consolidated into four big electoral blocs or parties, while the regime was split into nine factions. As before, the parliament had 13 party factions. The stage was set for a monumental presidential election in October 2004.

The Yanukovych Government

Kuchma and the oligarchs also mobilized before the parliamentary and presidential elections. Their central question was who would become their presidential candidate. Several names were mentioned, but only two seemed plausible, Serhiy Tyhypko and Viktor Yanukovych.

Tyhypko had quite a good reputation. Until 1997, he had been one of the partners in Privat Group of Dnipropetrovsk, one of Ukraine's largest corporate groups involved in banking, metallurgy, mining, oil refining, and retail. When Tyhypko replaced Pynzenyk as deputy prime minister for economic reform in the Lazarenko government, he sold his share in Privat Group, showing an uncommon sense of avoiding conflict of interests. He had served in various governments, including as minister of economy in the Yushchenko government, and maintained good relations with most people. Tyhypko was sophisticated and a smooth talker. He was Pinchuk's foremost politician and the leader of his Labor Ukraine faction in parliament. His electoral drawback was that he was wealthy and elitist.

Yanukovych was quite another kettle of fish. He looked like the big and heavy apparatchik he was, but he was also a self-made man. Yanukovych was born into a poor working-class family in a mining village. His mother died when he was two, and he was left to grow up in youth gangs. The excellent investigative *Ukrainska Pravda* found out that he had been sentenced to prison twice in his youth for violent crimes, assault, and robbery and served jail time, but his records had been deleted. His nickname in prison was *kham* (boor). When he was out of jail, he worked as a laborer. But thanks to good connections, he got a new start. In the 1990s he advanced within the regional state administration in Donetsk, becoming the forceful governor of Donetsk oblast from 1997 until 2002. He befriended Rinat Akhmetov, Ukraine's richest businessman and the head of the Donetsk clan, and they rose together (Wilson 2005, 7–8, 12–13). While a conversation with Tyhypko was delightful, Yanukovych was an archetypical boss who hardly conversed but gave orders, and his authority bred popularity. Especially in eastern Ukraine, where many men had served jail time, the argument ran that jail service had made him a real man.

At the time, the three politically leading oligarchs were Akhmetov (Donetsk), Pinchuk (Dnipropetrovsk), and Medvedchuk (Kyiv and Transcarpathia). None of the members of Medvedchuk's group was electable—Surkis and Medvedchuk had tried repeatedly and failed miserably—so Medvedchuk had no candidate. Therefore, the competition was between Tyhypko and Yanukovych. Westerners rooted for the pleasant Tyhypko, but Yanukovych enjoyed support from Akhmetov and the Donetsk clan, which was richer and stronger in parliament than the other oligarchic clans. Finally, Yanukovych had the knack of a professional, popular politician. While Tyhypko's popularity rating did not rise from the low single digits, Yanukovych's popularity surged. When Kuchma made Yanukovych prime minister on November 21, 2002, he provisionally anointed him the presidential candidate.

The competitive Tyhypko did not give up. Yushchenko had built his authority as chairman of the National Bank of Ukraine (NBU). That position was occupied by Yushchenko's long-time first deputy Volodymyr

Stelmakh, a loyal civil servant with no particular qualifications for that job. One week after Yanukovych's appointment as prime minister, the parliament—contrary to the idea of central bank independence—tried to oust Stelmakh, but the first attempt failed. However, Tyhypko supporters maintained pressure on the nice, not very combative Stelmakh, and he resigned. On December 17 Tyhypko became chairman of the NBU. Although he was more qualified than Stelmakh, his maneuvers left a bad taste.

Yanukovych formed a new type of government. Since 1991, approximately the same group of civil servants had played musical chairs with government portfolios. Most of them had become reasonably competent over time, but they also grew older and less interested in reform, and many had become quite corrupt. Yanukovych undertook the first (nearly) complete change of ministers since independence. His new ministers were big new businessmen who had made large fortunes in their early thirties, mainly from the east but also from Kyiv. Most were parliamentarians and this was the first parliamentary coalition, formed by nine centrist, oligarchic factions. The new ministers loved to decide and hated to obey or compromise. Some of them wanted to do good, though most of them were more interested in doing well. Somewhat unexpected, the Yanukovych government proved dynamic in its legislation, mobilizing a legislative majority mostly to its right.

A stalwart was First Deputy Prime Minister and Minister of Finance Mykola Azarov, who had built the repressive State Tax Administration. He authored Yanukovych's most important reform, a tax reform, which was adopted on May 22, 2003. Its purpose was to liberalize and simplify the tax system. It had two major components. First, the previous progressive income tax peaking at 40 percent was replaced with a flat income tax of 13 percent starting in January 2004. Ukraine followed the example of Russia, which had introduced such a flat income tax in 2001 resulting in higher revenues from the personal income tax (Åslund 2007b). When I met him in March 2003, Azarov advocated a flat income tax of 20 percent, while the right-wing opposition wanted a progressive tax with two rates, 20 and 30 percent, but as in Russia sheer political momentum carried the day.

A second tax reform was a reduction of the corporate profit tax from 30 to 25 percent. In addition, some remaining loopholes in the value-added tax (VAT) were abolished, but the free economic zones that primarily benefited Donetsk businessmen were maintained. A new law on the registration of enterprises and entrepreneurs was also adopted, which eased the bureaucratic burden and arbitrariness on business.

The Yanukovych government legislated a new progressive three-pillar pension system on July 9, 2003, introducing mandatory private pension savings in line with the World Bank (1994) best practice. But no follow-up legislation was enacted, leaving the pension reform unimplemented.

Yanukovych had a rather liberal minister of justice, Oleksandr Lavrynovych, who originated from Rukh. He continued the judicial reform, adopting a criminal-procedural code and a civil-procedural code as well as a law legalizing private arbitration courts.

In other cases, different parts of the government promulgated contradictory laws. Ukraine had long needed a civil code with modern corporate legislation. The Yanukovych government sensibly adopted a civil code on January 16, 2003, but in a weird compromise it enacted a contradictory economic code on the same day. Both codes covered the same ground, but the economic code entitled the state to interfere in private corporate contracts. Ukrainian judges were given a free hand to choose which code to apply, facilitating lucrative bids from competing businessmen. This legal situation was absurd, but it persists (OECD 2004, EBA 2004).

Yanukovych's government did not reverse Yushchenko's reforms because its industrialists desired economic growth. As a strong minister of finance, Azarov maintained the fiscal balance until the presidential election campaign posed more pressing demands. Most disappointed was Minister of Economy Valeriy Khoroshkovskiy, who at 34 was one of the youngest ministers but a successful businessman in banking and retail trade. His liberal urge was to take Ukraine into the World Trade Organization (WTO), but his endeavor found little sympathy among his industrialist colleagues. Liberal trade legislation came to a halt.

A dominant concern of exporters in Ukraine was to recover their VAT refunds after export. By law, exporters were entitled to receive a refund of the 20 percent VAT on their exports from the state, but hardly anybody did. As a result, VAT functioned as a 20 percent penalty tax on exports. The International Monetary Fund (IMF) tried to sort out the VAT problems. Originally, one authority (e.g., the State Tax Administration) received VAT payments while another (e.g., the Customs Committee) was supposed to pay refunds, but the latter refused to do so because they had not received any funds for this purpose. Moreover, the government budgeted too little money for VAT refunds or crudely sequestered such funds. The government complained that widespread exemptions from VAT led to tax fraud, since many did not pay this tax but illegally claimed refunds. In particular, VAT was not paid on imports through Ukraine's 20 free economic zones, depriving the state of large tax revenues. Similarly, agriculture and much of the energy sector were exempt from VAT. The main cause, however, was that Ukrainian officials did not give businessmen money unless they were paid a commission. A system had developed where a central group of state officials demanded, and usually received, 20 to 30 percent of the VAT refunds in commission through a private intermediary (Åslund 2003a, EBA 2004).

When the weather conspired against agriculture in 2003, Yanukovych reacted in the old Soviet fashion, unleashing a major antimarket drive. He threatened grain traders with arrest because of price gouging and ordered regional governors to control grain trade and prices and the police to check grain transportation. The marketization of the countryside suffered a serious setback.

Controversial Privatization of Kryvorizhstal

Privatization of large enterprises proceeded slowly. Hardly any privatizations were open, and the main beneficiaries were usually big Ukrainian businessmen with good political connections. Although disadvantaged, Russian businessmen also knew how to please the authorities, while Western businessmen were lost.

By and large, state enterprises had been declining. They could cut costs and undertake purely defensive restructuring, but they were unable to develop new production or expand. As a consequence of privatization, the big Ukrainian businessmen successfully turned around neglected Soviet behemoths, and the Ukrainian capitalists grew stronger, more productive, and more multifaceted.

One privatization caught the public's imagination. On June 14, 2004, Ukraine's two richest oligarchs, Pinchuk and Akhmetov, bought Kryvorizhstal steelworks together. This privatization became a cause célèbre as the Russian loans-for-shares privatizations had in 1995 before Yeltin's reelection (Freeland 2000).

The reasons for the controversy were many. This was Ukraine's largest and most modern steelworks, considered the jewel in the crown, and it was the only state-owned steel mill left. Other metallurgical factories had already been revived so it was no longer seen as a white elephant. Akhmetov and Pinchuk were the richest oligarchs and the bulwark of the Kuchma regime. They usually competed with each other, but in this case they colluded. Several competitors had expressed interest, ranging from the Industrial Union of Donbas to Europe's Arcelor and Russia's Evraz group. The conditions for the tender were highly protectionist: "Only two of the six companies, both Ukrainian, which submitted tenders could meet the requirement of having produced at least one million tons of coke and two million tons of rolled steel for the last three years, two of them profitably, inside Ukraine" (Kuzio 2004).

The price was the highest paid for any Ukrainian company at $800 million, and it was in cash. Pinchuk argued that this was twice as much as had been paid for the privatization of all other Ukrainian steelworks. Yet at that time Kryvorizhstal might have caught a price of $3 billion in an open tender. Akhmetov and Pinchuk insisted that it was vital for Ukraine's future that Kryvorizhstal remain Ukrainian, because it was the backbone of the country's steel industry. Without it, Ukraine's steel industry would be parceled out among global giants, such as Arcelor, Mittal, and Russian steel corporations.

By Ukrainian privatization standards, the privatization was not all too shocking, but powerful competitors existed, and the conditions were more transparent than in any other major privatization, which facilitated criticism. Most important, this blatant underpricing occurred four-and-a-half months before the epic presidential elections, of which it became one of the main themes.

Economic Boom

The year 2004 was a strange time in Ukraine. The air held a tantalizing sense of the end of an era, a *fin de siècle*, but the elite was not worried but joyful. They seemed caught in hubris, thinking that they could get away with anything. The oligarchs made money as never before, and the economy developed at an extraordinary speed. Ukraine's growth hit 12 percent in 2004, the highest in the country's modern history (figure 5.5).

An underlying cause of this boom was the rise in international steel prices. Steel accounted for close to 40 percent of Ukraine's exports. In 2004 Ukraine's exports skyrocketed by 41 percent, as its volume and value surged (figure 6.1). Imports could not keep up in this race, and Ukraine achieved a large current account surplus of 7 percent of GDP in 2004, although it suffered from rising prices of imported oil (figure 6.2).

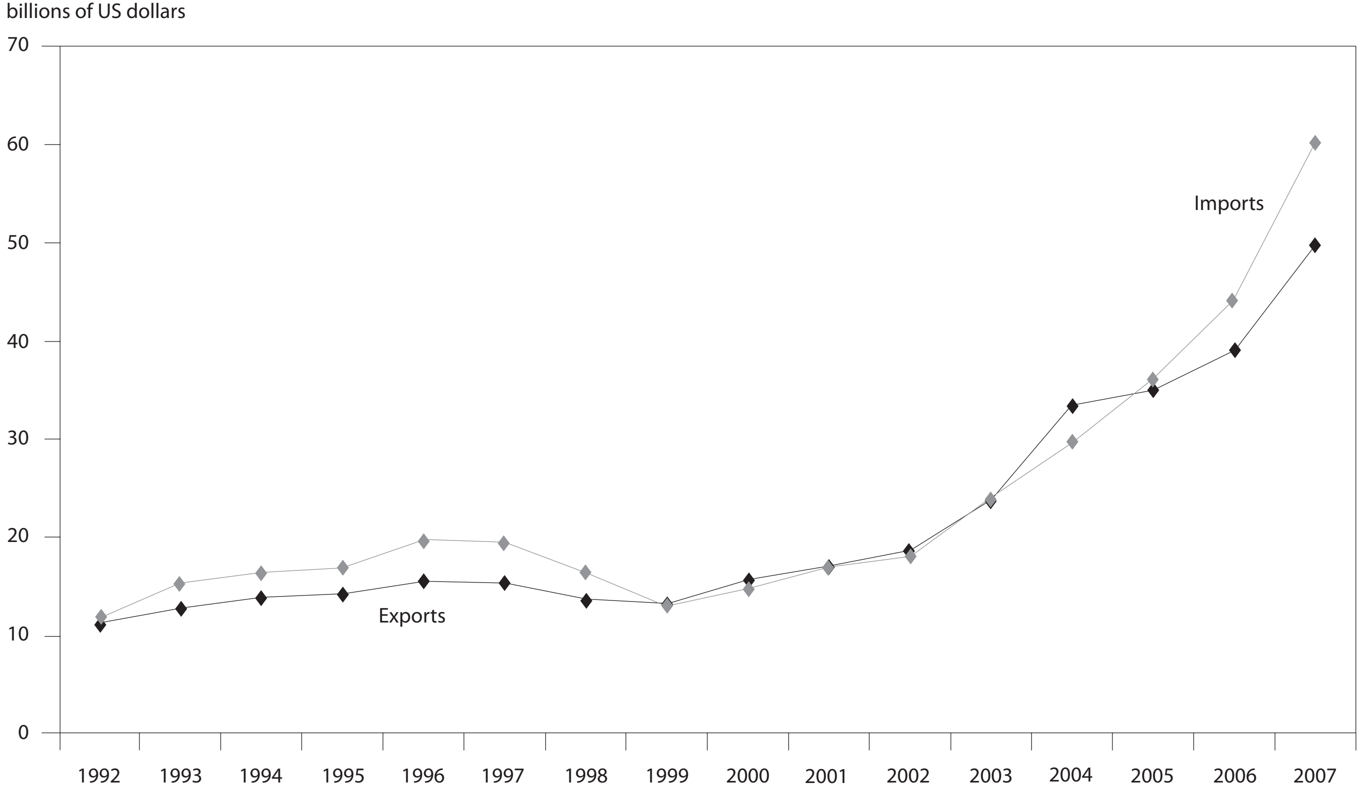
Ukraine's gross fixed investment had held up well at around 20 percent of GDP in the downturn (a normal European level) and started surging in 2003, reaching the respectable level of 27 percent of GDP in 2007 (figure 6.3).

Ukraine's workers had suffered from wage arrears, low wages, and underemployment rather than unemployment, which never became very high, though no appropriate survey measures were available before 1998. In the breakthrough year of 2000, unemployment was 11.6 percent. It fell to a reasonable level of 7.2 percent in 2005 (figure 6.4).

The long-depressed real wages started an impressive recovery of between 15 and 20 percent a year, peaking at an incredible 24 percent in 2004, the year of the Orange Revolution (figure 6.5).

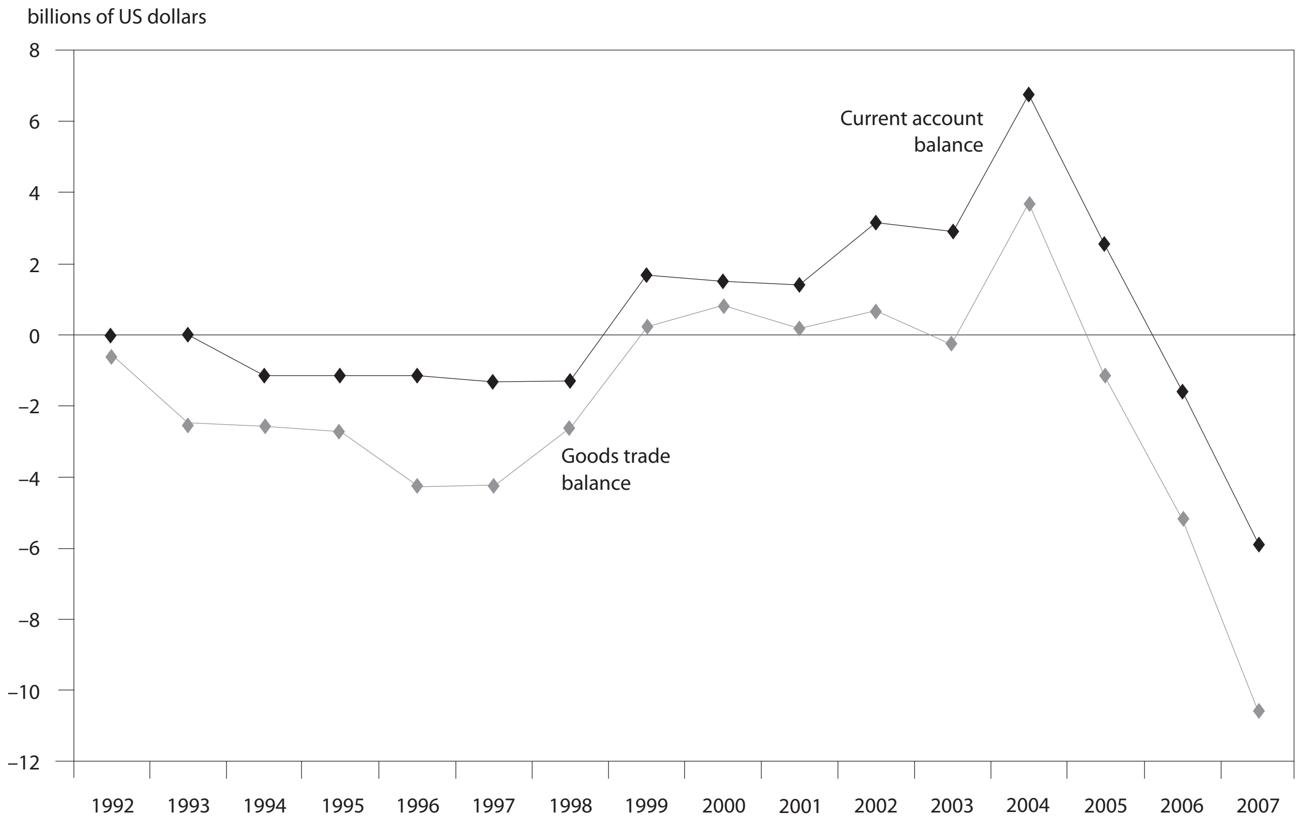
This picture is full of irony. In most regards, Ukraine's economic development had never looked better than in 2004. In his famous book, *The Old Regime and the French Revolution*, Alexis de Tocqueville (1955 [1856], 176) noted that the French Revolution did not occur when things were getting worse but when they were improving. Likewise the Orange Revolution took place in the midst of an unprecedented economic boom. As in de Tocqueville's France, public concern was not the economic efficiency of the old system but its lingering injustices: "There was nothing new in these delinquencies on the part of the administration; what was new was the indignation they aroused" (178).

Figure 6.1 Ukraine's exports and imports of goods, 1992–2007



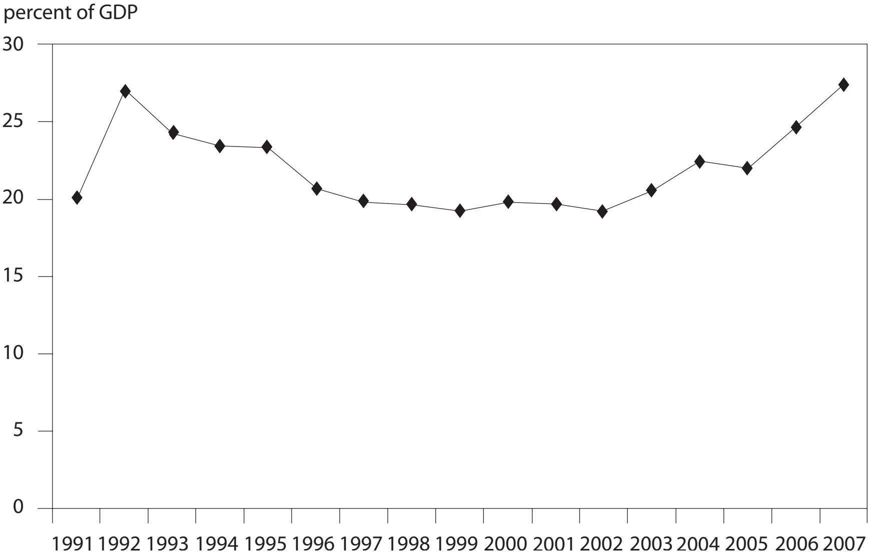
Source: European Bank for Reconstruction and Development online database, www.ebrd.com (accessed on July 1, 2008).

Figure 6.2 Ukraine's trade and current account balances, 1992–2007



Source: European Bank for Reconstruction and Development online database, www.ebrd.com (accessed on July 1, 2008).

Figure 6.3 Ukraine's gross fixed investment, 1991–2007



Note: Gross fixed capital formation at prices and purchasing power parities of current year.

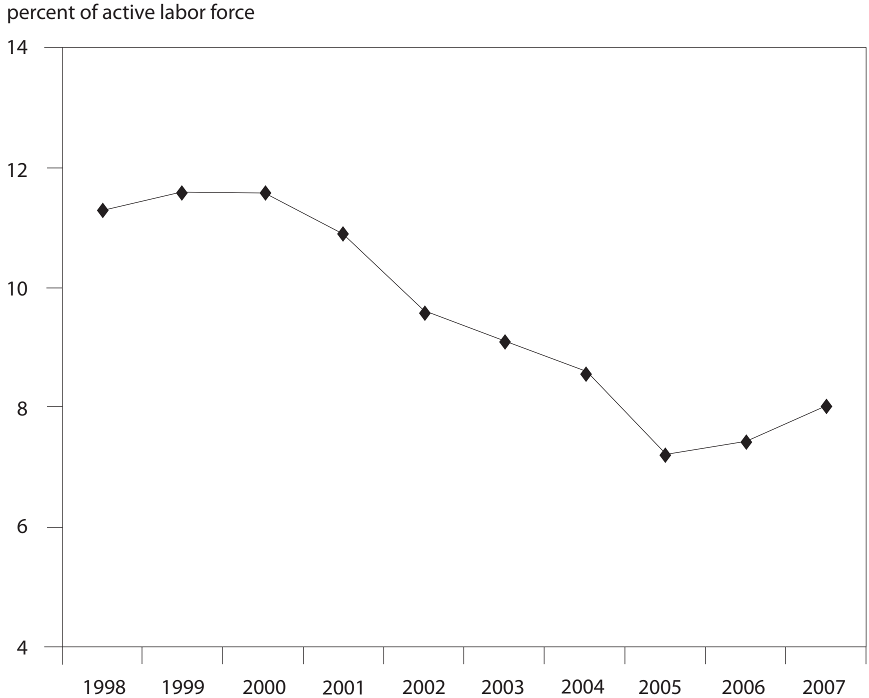
Source: UN Economic Commission for Europe online database, www.unece.org (accessed on July 1, 2008).

The Ukrainians also acted in line with modernization theory (Lipset 1959). High economic growth and rising welfare convinced them that the political system was obsolete. A Marxist would say that the economic base had outgrown the political superstructure, and rising welfare undoubtedly enhanced the self-confidence of the surging middle class (Åslund 2006).

But were the statistics credible? Two caveats exist. First, VAT fraud in exports was rampant, and it skyrocketed in 2004, when Yanukovych's tax people decided to make a killing before the deluge. As a consequence, exports were substantially exaggerated that very year, which would also have overstated GDP. The two ensuing governments made several alternative assessments. The largest claim was 5 percent of GDP, but 2 to 3 percent of GDP is more likely, which would have been substantial but still not changed the overall picture of 2004 having been Ukraine's finest boom year.

A second statistical query is whether the sudden rise in growth rates reflected a gradual incorporation of the large unregistered economy into the official economy, but that was hardly the case. The Ukrainian Ministry of Statistics has been very conservative and inert, not revising its numbers much and using surveys and samples less than most statistical authorities. A careful study by Iryna Mel'ota and Paul Gregory (2001) found that the undetected shadow economy, revealed through statistical discrepancy, would raise the real Ukrainian GDP by as little as 12 percent in 1999. The popular perception, however, is that the unregistered economy is much larger.

Figure 6.4 Unemployment in Ukraine, 1998–2007



Note: 2007 statistics as of July 2007.

Sources: UN Economic Commission for Europe online database, www.unece.org (accessed on August 16, 2007); Statistics Committee of Ukraine, www.ukrstat.gov.ua (accessed on August 16, 2007).

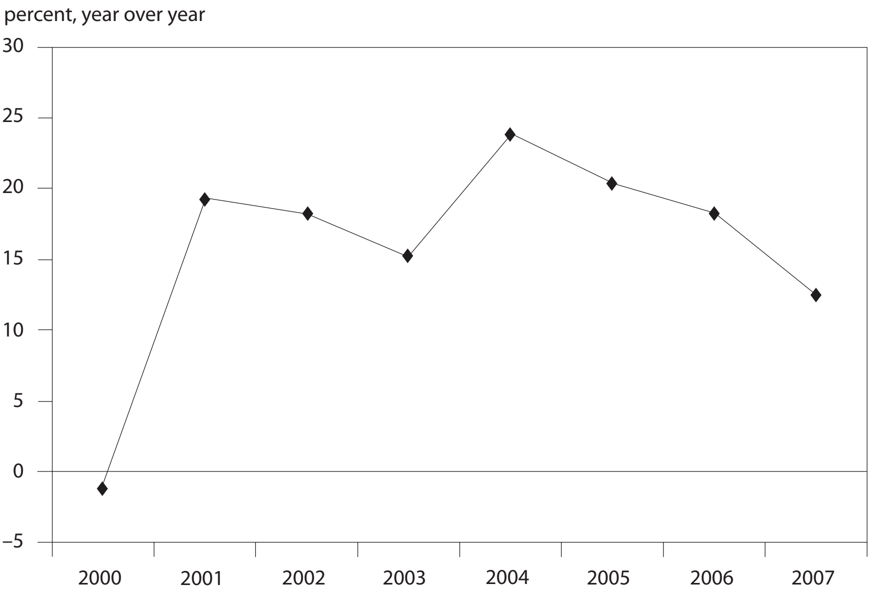
Moreover, Yanukovych let the budget deficit explode in 2004, delivering a massive fiscal stimulus that boosted GDP. Economic growth in 2004 was great, but a significant part of the recorded growth might have taken place in 2005.

Putin's Policy on Ukraine: Gas Trade, Common Economic Space, and the Tuzla Incident

On December 31, 1999, Boris Yeltsin anointed Vladimir Putin president of Russia. Initially, Putin paid little attention to the former Soviet republics, but gradually his interest was aroused.[4] His foremost interest was

4. The main sources of this section are Stern (2005), Wagstyl and Warner (2006), and Åslund (2007b).

Figure 6.5 Real wages of Ukraine's population, 2000–2007



Source: Statistics Committee of Ukraine, www.ukrstat.gov.ua (accessed on July 28, 2008).

Gazprom, and he looked at Ukraine through its prism. His second policy focus was the Ukrainian presidential elections in October 2004. Third, he wanted to rope in Ukraine through the Common Economic Space. Finally, a strange border incident occurred in October 2003 on the unpopulated islet of Tuzla on the Kerch Strait.

In the spring of 2001, Putin carefully plotted the ouster of the Gazprom management, where the Russian government was majority owner. Former Prime Minister Viktor Chernomyrdin was chairman of Gazprom's supervisory board and the guardian angel of Gazprom CEO Rem Vyakhirev. In order to sack Vyakhirev, Putin first dismissed Chernomyrdin as chairman of its supervisory board and then sent him off as ambassador to Ukraine in May 2001. Days afterward, Putin personally ousted Vyakhirev at a meeting in the Kremlin. He appointed two of his closest collaborators to run Gazprom: His first deputy chief of staff Dmitri Medvedev became chairman of the supervisory board, and his former assistant Aleksei Miller was appointed CEO.

The change of Gazprom management was important also for Ukraine. The key issue for Ukraine was the gas trade regime—the usage of an intermediary trading company, the length of contracts, the system of pricing, and payment in barter or cash. In practice, little changed. Itera lost out to a new intermediary trading company, Eural Trans Gaz, which was established in December 2002, but the trading conditions remained as before.

In late July 2004 Kuchma and Putin met in Yalta and replaced Eural Trans Gaz with another intermediary, RosUkrEnergo. They oversaw the signing of its contracts with Gazprom and Naftohaz Ukrainy for gas deliveries to and through Ukraine. RosUkrEnergo was better formalized than Eural Trans Gaz. It was registered in Zug, Switzerland, and half-owned by Gazprombank. The other half was owned by Centragas Holding, a company whose Ukrainian owners remained a secret, but it was managed by Austria's Raiffeisen International Bank.

A coordination committee for RosUkrEnergo was appointed, which included Yuriy Boiko, Ukraine's deputy minister of energy and chairman of Naftohaz Ukrainy, and his deputy, Ihor Voronin, although the Ukrainian government and Naftohaz Ukrainy had no official ownership in RosUkrEnergo. In a blatant conflict of interests, these two Ukrainian officials represented a private trading company. The renewed trading system did not clean up the gas trade (Global Witness 2006, 51–52; Milov and Nemtsov 2008).

In return, Putin did not push for higher gas prices with Ukraine, and international oil price rises took off only in 2004. His dominant interest in this trade appears to have been to skim off profits and direct them to his men in the Kremlin. As before, the Russian officials concerned were happy to share their gains with their Ukrainian counterparts to facilitate their personal enrichment.

In early 2003 Putin turned his eyes on Ukraine because of the upcoming presidential elections. Russia had repeatedly tried to rope in Ukraine with attractive trade arrangements, but Ukraine was a hard flirt, and the Russian-dominated Commonwealth of Independent States (CIS) had a bad habit of setting up a new organization rather than solving the dysfunction of existing bodies.

True to style, Putin came up with a new scheme, the Common Economic Space (CES).[5] It was specifically designed to attract Ukraine. Therefore, it was not bilateral but multilateral, but without the Central Asian countries, which were of little interest to Ukraine, and it was exclusively economic.

On February 23, 2003, the CES was launched with great fanfare in Moscow, with a common declaration by the presidents of Russia, Ukraine, Kazakhstan, and Belarus. By September 2003 they concluded an agreement as planned, and all four parliaments ratified it. The CES was designed to be a customs union as well as a currency union, coordinating the four countries' entry into the WTO, which all four had been negotiating for years. However, as Russia's prior attempt at a customs union showed, it was not going to work because Russia insisted on dictating its own import tariffs on the other members, who naturally resisted. The spectacular collapse of the ruble zone in 1993 and the lasting double-digit

5. An overall source on the CES is Bukkvoll (2004).

inflation indicated that a currency union was premature. Any attempt at coordinating WTO accession was likely to delay entry for all countries concerned.

Even within Yanukovych's government, the CES was immensely controversial. Three major members of his cabinet protested publicly against the CES, namely Minister for Foreign Affairs Kostyatyn Gryshchenko, Minister of Economy Valeriy Khoroshkovskiy, and Minister of Justice Oleksandr Lavrynovich.[6] The minister responsible for foreign trade, Khoroshkovskiy, soon resigned. Kuchma accepted the CES with hesitation, as did Yanukovych, who was anxious to obtain Moscow's support for his presidential candidacy. The only enthusiastic supporter of the CES in the Yanukovych cabinet was First Deputy Prime Minister Mykola Azarov, who was considered most pro-Russian.

Thus, both economically and politically, this scheme looked even less viable than previous Russian ideas, and it was to be a drain on time, energy, and policymaking capacity. In September 2003, thanks to having gone along with the CES, Ukraine resolved many of its numerous trade conflicts with Russia as at the conclusion of the Russian-Ukrainian Treaty on Friendship, Cooperation and Partnership in May 1997. These trade disputes usually amounted to Russia prohibiting particularly successful Ukrainian export items, typically agricultural goods or steel. Ukraine, however, subscribed only to the free trade part of the CES, and then Putin was not interested. The scheme slowly died after the Orange Revolution.

On October 22, 2003, a Russian-Ukrainian conflict of a new type erupted without warning. Russian emergency troops unexpectedly stormed the uninhabited islet of Tuzla on the Kerch Strait. The border between Russia and Ukraine had never been regulated on these waters, and Tuzla was disputed territory. Surprisingly, Prime Minister Yanukovych vehemently protested against the Russian border violation, and without delay both Ukraine and Russia started substantial troop movements to the area. After a few days of excited public exchanges, the Russian troops withdrew, and the dispute died down. Apparently, Ukraine had responded with sufficient force to persuade the Kremlin to interrupt its surprise action.

NATO and the European Union's European Neighborhood Policy

After the Melnychenko tapes started being released in November 2000, the West began treating Kuchma as a pariah. As a consequence, and contrary to his desires, Kuchma's multivector policy collapsed into a single

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6. Tom Warner and Stefan Wagstyl, "Ukraine Ministers Seek to Change Treaty," *Financial Times*, September 16, 2003.

Russia/CIS policy. Kuchma did whatever he could to break his isolation from the West, but nobody listened to him.

Kuchma courted the North Atlantic Treaty Organization (NATO) by all possible means, and Ukraine participated in all NATO cooperation that was offered and in all peacekeeping operations in former Yugoslavia. Most spectacularly, in May 2002, Kuchma announced that Ukraine's ultimate goal was to join NATO (Pifer 2004), but nobody seemed to take him seriously. He even gate-crashed the November 2002 NATO summit in Prague, despite NATO having made clear that it did not invite him (Wilson 2005, 60).When the United States contemplated invading Iraq in 2003, Ukraine became one of the original members of the coalition of the willing, sending no less than 1,700 troops to Iraq.

In 2003 the long-slumbering European Union finally took a new initiative toward Ukraine. The irony was that Russia desired to tie Ukraine closer to itself, while Ukraine resisted. The European Union, by contrast, wanted to keep Ukraine at arm's distance, but Ukraine aspired to get much closer to it.

For years, the European Union had been so preoccupied with the Central and Eastern European countries designated to become EU members that it had no time for other countries. However, by 2003, it was clear that eight former Central and Eastern European countries would become EU members on May 1, 2004 (Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary, and Slovenia), with Bulgaria and Romania following on January 1, 2007. The EU bureaucracy had freed up time and capacity to look further, raising the question of how to regulate EU relationships with other adjacent countries.

In March 2003 the European Commission published a conceptual document, "Wider Europe Neighborhood: A New Framework for Relations with Our Eastern and Southern Neighbors" (Commission of the European Communities 2003).[7] It outlined the principles for a new European Neighborhood Policy (ENP). This policy was designed for both North African and Middle Eastern countries (Algeria, Morocco, Tunisia, Libya, Egypt, Jordan, the Palestinian Authority, Israel, and Lebanon) and the western CIS countries (Russia, Belarus, Ukraine, and Moldova). It was an attempt to structure and standardize the EU approach to friendly neighbors, offering them more market access and interaction but also making clear that they were not welcome to become members. In October 2003 the highest EU body, the European Council, endorsed the ENP and asked the European Commission to formalize initial action plans with the individual countries.

7. This discussion of the ENP is based on Milcher, Slay, and Collins (2007). See also De Souza et al. (2005), CEPS (2006), and Sushko (2006). The ENP strategy is developed in Commission of the European Communities (2004).

The initial reaction from Ukraine (and Moldova) was highly negative. According to the EU founding treaty, the 1957 Treaty of Rome, all European countries are entitled to apply for membership of the European Union, and by any definition Ukraine is European. Thus Ukrainian diplomats interpreted the ENP primarily as an alternative to membership designed to keep Ukraine out of the European Union. They were insulted to be treated the same as North African and Middle Eastern countries, which were certainly not European. However, as Russia and Belarus excluded themselves from the ENP, Ukraine and Moldova forged ahead as the frontrunners within the CIS, which appeared more palatable to Ukraine.[8]

The European Union had opened a door, but the political relationship between the European Union and Ukraine was bad because of EU protestations against Ukraine's democratic flaws. Little progress could be made until Ukraine took a determined step toward democracy, but that was just about to happen.

8. Russia refused to be called a neighbor and excluded itself. The European Union kept Belarus outside because of its frozen relations with the European Union. Armenia, Azerbaijan, and Georgia, by contrast, were upset to have been left out. They asked to be included in the ENP, which the European Union accepted.