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Kuchma's Stagnation, 1996–99

By the summer of 1996 Leonid Kuchma's strategic outlook was clouded. He had introduced elementary market economic reform and the national currency, the hryvnia. Although he desired to pursue more privatization, his reformist endeavors had to a large extent been accomplished. After long and hard work, a Ukrainian constitution was finally adopted in June 1996. National integrity seemed safer. But Ukraine's foreign policy was not settled, and no great deed, such as membership of the European Union, was within reach. Kuchma started devoting a lot of time to foreign policy. Politically, he was at his peak, but he had no real vision or major goals to accomplish. His strategy seemed to have evaporated, and tactics took its place.

As so often happens with politicians who have enjoyed early success, Kuchma focused on his own political survival, which took five expressions, best summarized as standard divide and rule with limited policy ambitions. First, he checked the power and ambitions of his prime minister. Second, he devoted great efforts to both parliamentary and presidential elections. Third, he played different business and regional groupings against one another. Fourth, he also played different branches of law enforcement against each other. Fifth, the presidential administration increasingly disciplined and controlled media. These were tactics without strategy.

This period was not pretty. In 1996–97 Pavlo Lazarenko was prime minister but acted like a businessman. Deputy Prime Minister Viktor Pynzenyk undertook a brave but hopeless attempt at renewed economic reform for the sake of economic growth. Kuchma replaced Lazarenko with the passive bureaucrat Valeriy Pustovoitenko. Kuchma's main achievements lay in his foreign policy, notably the 1997 agreements with Russia.

The main boondoggle at this time was gas trade with Russia, which augured the rise of the oligarchs. Crime continued rising, which strengthened the political role of law enforcement. Worst of all, media freedom was reduced. The parliamentary elections of March 1998 largely mimicked the 1994 elections, though they were less free. Kuchma's reelection in October–November 1999 was designed on Yeltsin's reelection in Russia in July 1996. By 1999 Ukraine appeared to be stuck in an underreform trap.

As usual Kuchma attained his main goals. He survived the parliamentary elections of March 1998 and won the presidential elections of October 1999. The problem was that he hardly had any goals but power.

Lazarenko's Excesses

In September 1995, when Yevhen Marchuk was prime minister, Kuchma appointed Pavlo Lazarenko, a strong man from his home town, Dnipropetrovsk, first deputy prime minister responsible for energy. Yet, Lazarenko was never perceived as Kuchma's close ally but as an independent force. When he became first deputy prime minister, he was only 42. He was a bull of a man, and his eyes blinked nervously, giving him a rather frightful look. He was a crude, uneducated man who had spent his first 15 years of professional life on a collective farm.

Before entering government, Lazarenko made a fortune on the natural gas trade in the Dnipropetrovsk region, and he was considered the richest man in Ukraine. He was also regional representative of the president, in an egregious conflict of interests.

As first deputy prime minister, Lazarenko's primary task was to allocate gas quotas to private companies. He gave priority to two gas trading companies: Itera, which was connected with the management of Gazprom, and United Energy Systems of Ukraine (UESU), which was headed by his diminutive business partner from Dnipropetrovsk—Yuliya Tymoshenko, only 35 years old and nicknamed the gas princess—and which he partly owned himself (Global Witness 2006, 22).[1]

He also fought successfully for the right to supervise the environmental inspection. When I investigated why, I learned that environmental inspectors extorted the largest bribes because of Ukraine's exceedingly strict Soviet environmental standards, which had been established for show and were never supposed to be applied. Ukraine's inspectors used them to extort large bribes.

1. In November 1996 I had the honor of hosting Yuliya Tymoshenko at a seminar at the Carnegie Endowment for International Peace in Washington during her first trip to the United States. She made a strong impression on the audience and defended her business eminently, but she argued that complex barter schemes were necessary.

On May 27, 1996, Kuchma, complaining about the absence of economic reforms, fired Marchuk and nominated Lazarenko in his place. On July 10, the parliament approved Lazarenko's appointment. When he became prime minister, the humble Volga cars outside the cabinet of ministers building were replaced by large, expensive, black Mercedes Benz cars. The previously rudimentary security was beefed up, indicating that a major clan leader had moved in.

On July 16, 1996, just six days after Lazarenko became prime minister, someone tried to blow up his car in the middle of his convoy when he was heading to Kyiv airport to fly to Donetsk. Despite its sophistication, the attempt failed. Lazarenko came out roaring, accusing the Donetsk clan of trying to murder him, which made many suspect a setup. He instantly sacked about 50 state enterprise managers in Donetsk. On November 3 Yevhen Shcherban, a leading shady businessman and parliamentarian from Donetsk, was murdered at Donetsk airport. Ukrainians reckoned that organized crime had taken over government.

Lazarenko's year-long tenure as prime minister became the epitome of corruption. He acted without inhibition, reintroducing multiple regulations which facilitated the extortion of money from businesses. His dominant business remained gas trade, which he pursued through UESU, whose regional gas monopoly was greatly extended under Lazarenko's executive power (Lovei 1998a). As an offshore company, UESU was not subject to Ukrainian taxation.

Grain export was another lucrative business. Kuchma had liberalized grain exports, but nothing could stop Lazarenko. A Ukrainian minister told me that the prime minister had written on ordinary paper to all regional governors that they were entitled to prohibit grain exports from their oblasts if they considered it necessary. Although these letters had no legal status and contradicted Ukrainian law, all governors obeyed and blocked all grain exports. Lazarenko also issued statutes prohibiting the railways and ports to export grain. The state-controlled grain procurement agency Khlib Ukrainy purchased grain surpluses at low, regulated domestic prices and exported the grain at great profit.

Lazarenko considered the privatization of big enterprises too serious to be done by anybody but the prime minister. In a nontransparent fashion, big enterprises were privatized to favored purchasers. Needless to say, apart from privatization, Lazarenko stalled all reforms and some liberalization, while he allowed public expenditures and the budget deficit to grow sharply (figure 3.1). He made any kind of policy statement.

Lazarenko harbored great political ambitions. He set up his own party, *Hromada* (Ukrainian for community), in evident opposition to Kuchma, with Yuliya Tymoshenko as its leader. Ideologically, *Hromada* was another centrist business party that desired extensive state regulation to generate rents for its business owners.

As long as Lazarenko was prime minister, he was hyperactive and appeared to have taken over from Kuchma as Ukraine's top leader. He had certainly taken charge of economic policy. Nobody could understand their mutual relationship. They both hailed from Dnipropetrovsk and their paths had crossed before. On June 19, 1997, Kuchma surprised everybody by sacking the seemingly omnipotent Lazarenko purportedly for "health reasons." In addition, he complained that Lazarenko had failed to pursue tax reform and had done nothing to enact an anticorruption program.

Lazarenko went into direct opposition to Kuchma and mobilized for the March 1998 parliamentary elections. Kuchma's associates used all means to beat Lazarenko and *Hromada.* He was subsequently accused of corruption, and a tragicomedy began.

In December 1998 Swiss police arrested Lazarenko at the border, when he tried to enter the country with a Panamanian passport. They charged him with laundering millions of dollars through bank accounts in Switzerland. He was freed on $2.6 million bail.[2] But Lazarenko escaped bail and returned to Ukraine. On February 17, 1999, the Ukrainian parliament voted by a large majority to lift his parliamentary immunity,[3] and he left the country in haste. On February 20, 1999, he tried to enter the United States through John F. Kennedy airport in New York. A *New York Times* article reported, "Lazarenko held an expired diplomatic passport and a valid tourist visa. But he was detained after immigration officials interviewed him and concluded that he had not come to the country merely for a casual visit, as the rules governing visitor visas require. . . ."[4] His lawyers claimed that he applied for political asylum, and they fought successfully against his extradition to Switzerland.

Instead, Lazarenko was arrested for laundering $114 million in the United States and accused of unlawfully receiving over $200 million from various Ukrainian businesses as prime minister. He was eventually sentenced in California in 2006 to nine years in prison for money laundering, wire fraud, and transporting stolen goods. He was also fined $10 million.[5]

When Lazarenko left the country, *Hromada* split. His right-hand woman, Yuliya Tymoshenko, left the party and founded her own

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2. Timothy L. O'Brien, "A Palace Fit for a Fugitive and Ukraine's Ex-Premier," *New York Times*, September 1, 1999, available at www.nytimes.com (accessed on September 25, 2008).

3. Pavel Polityuk, "Ukrainian Parliament Votes 310–39 to Strip Lazarenko of Deputy's Immunity," *Ukrainian Weekly* LXVII, no. 8, February 21, 1999, available at www.ukrweekly.com (accessed on September 25, 2008).

4. Michael Wines, "Ex-Ukraine Premier, Accused of Corruption, Detained by U.S.," *New York Times*, February 23, 1999, available at www.nytimes.com (accessed on September 25, 2008).

5. Jesse McKinley, "Ukraine: 9 Years in U.S. Prison For Ex-Premier," *New York Times*, August 26, 2006; Global Witness (2006, 23).

Batkivshchyna (Fatherland) Party to distance herself from Lazarenko. She continued to lead the opposition against Kuchma, but her opposition was no longer irreconcilable as Lazarenko's had been. Meanwhile, she wound down her business and became a professional politician.

Lazarenko stands out as the greatest parasite in the history of independent Ukraine, and the only surprise is that he was so appropriately punished. I once asked socialist leader Oleksandr Moroz how that could have happened. Moroz answered: "Lazarenko made only one mistake: He did not share."

Pynzenyk's Abortive Program for Economic Growth

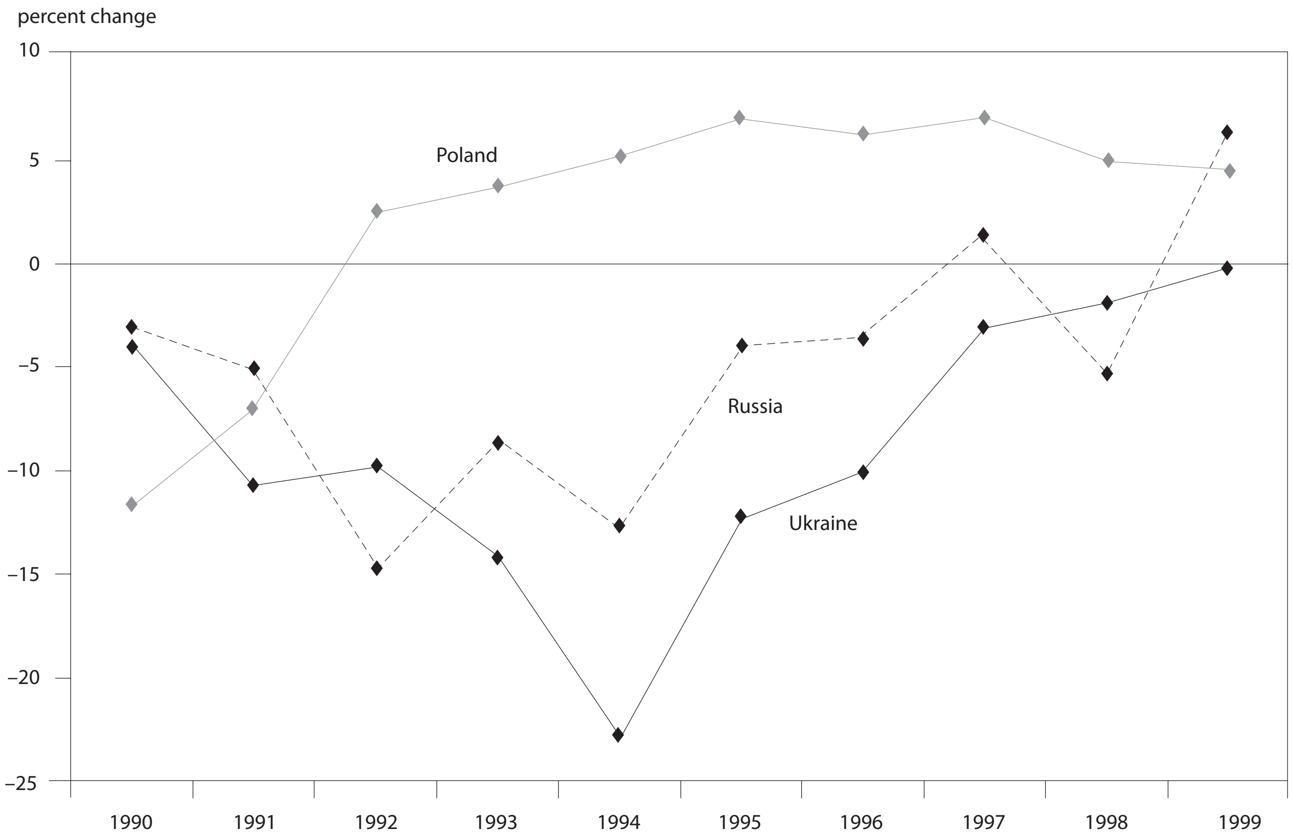
A basic market economy with financial sanity had been established, but economic growth remained elusive. In 1994, the year of confiscatory taxation and economic chaos, GDP plummeted by no less than 23 percent. Market economic transformation usually led to the closure of value-detracting production lacking real demand, which was reflected as a decline in official output. Therefore, a continuous fall in official GDP of 12 percent in 1995 could have been anticipated (figure 4.1).

In early 1996, however, it became evident that GDP would continue to contract by 10 percent. Lazarenko's regime had not abolished the market economy, but it had encumbered the economy with extraordinary red tape. The State Planning Committee had not reemerged, but numerous inspection agencies troubled and extorted productive business. At this time, the Polish economy was long booming with growth of 7 percent, and even the Russian economy was slowly approaching growth. Ukraine's persistent economic decline was truly shocking, but few leaders were concerned, with the exception of Viktor Pynzenyk, deputy prime minister, and Viktor Yushchenko, chairman of the National Bank of Ukraine (NBU).

The reasons for the absence of growth were all too evident: Government bureaucracy paralyzed the economy. Ukraine was mired in all conceivable and inconceivable inspections, which made entrepreneurial work just about impossible. In a pioneering work on corruption, Daniel Kaufmann (1997), the resident representative of the World Bank, found that in 1996 Ukrainian enterprise managers spent over one-third of their time with government officials, the highest in the world.

Tax inspections were outright comical. While visiting a modern Western factory in Kyiv I learned that they had seven to eight permanent tax inspectors on their premises throughout the year, who demanded office space and food. A vodka factory suffered even worse, hosting four inspectors round the clock. The resident representative of the International Monetary Fund (IMF) in Kyiv, Alexander Sundakov, explained it to me: In order to reduce the number of tax inspections, the government allowed

Figure 4.1 GDP growth, 1990–99



Source: European Bank for Reconstruction and Development online database, www.ebrd.com (accessed on September 16, 2008).

only one tax inspection a year, but its length was not specified. Ukraine had about 10,000 enterprises that paid significant taxes and 70,000 tax inspectors, which meant an average of 7 tax inspectors per taxpaying enterprise throughout the year.

Almost all prices had been liberalized in November 1994, but the powers of the Anti-Monopoly Committee to control monopolies had been reinforced, though its definition of monopolies was far too broad. Ukraine had four large champagne factories, and all Ukrainian champagne bottles had the same price because the Anti-Monopoly Committee regulated their prices. Every page of the menu at any restaurant was signed by both the accountant and the manager of the restaurant because the Anti-Monopoly Committee demanded it. Thus the committee was the reincarnation of the old Soviet State Price Committee, and its inspectors were as numerous as activist, extorting bribes whenever they could. Dozens of control agencies conducted similar harmful inspections. Little surprise that price stabilization had not brought about economic growth.

In the summer of 1996, desperate for the lack of concern among his colleagues, Pynzenyk initiated a reform program he called Economic Growth '97. He received overt support from President Kuchma and Prime Minister Lazarenko. Although this support was evidently not sincere, Pynzenyk went into battle. He organized dozens of Ukraine's best experts, who wrote a 134-page program for three years of reform.

Economic Growth '97 was Ukraine's most comprehensive and radical reform program to date, with detailed structural and social reforms. A large part of the program was fiscal. The tax system was supposed to be simplified with fewer and lower taxes, as well as fewer unjustified exemptions. Most of all, the high payroll tax would be cut. The treasury and payment systems would be reinforced to avoid arrears. Pynzenyk let his experts scrutinize the large social expenditures, which more often than not turned out to be pure Nomenklatura benefits. The poorest 20 percent of the Ukrainians received as little as 8 percent of all nonpension cash transfers in 1995, showing that Ukrainian social benefits were starkly regressive, giving more to the wealthy than the poor (Milanovic 1998, 113). For example, the widow of a colonel was entitled to four weeks of paid vacation at a nice resort in Crimea. The Pynzenyk package also called for a modern pension reform with part of the pension going into private accumulative savings accounts. The reform package prescribed substantial deregulation of business, especially of licensing, as well as the reduction of inspections. It advocated stricter regulation in one area, energy monopolies.

On October 15, 1996, Lazarenko presented the program to parliament. As was its habit, the parliament adopted the program itself but refuted the many draft laws that ensued. Pynzenyk realized that neither Kuchma nor Lazarenko supported him. Nor did his ministerial colleagues. Instead of giving up, Pynzenyk went on the offensive with a public relations campaign, but the parliamentarians were more interested in their own incomes than in their voters and turned down the package. Only minor changes to the value-added tax and the corporate profit tax were legislated. On April 2, 1997, Pynzenyk accepted *fait accompli* and resigned.

Although Pynzenyk failed miserably, he had formulated a strong, detailed reform agenda that became a fixture. He had become the country's leading economic reformer. Kuchma, who had done little to support his old brother-in-arms, used Pynzenyk's failure as an excuse to sack Lazarenko.

Serhiy Holovatiy, the high-profile reformist minister of justice from 1995 to 1997, experienced a similar fate. Soon after he became minister, he had Ukraine's first law on organized crime adopted, and in April 1997 he launched a program called Clean Hands, directed against corruption, not least among parliamentarian deputies. Within the elite, that was not a popular theme, and in September 1997 Kuchma sacked Holovatiy for his exuberant promotion of this program.[6]

Pustovoitenko: Passive Loyalist

On July 16, 1997, Kuchma replaced Lazarenko with Valeriy Pustovoitenko. Shockingly, a man with a seriously tainted reputation was succeeded by Ukraine's arguably greatest bureaucrat as prime minister, while corruption and bureaucracy were the country's two most severe ailments.[7] But Kuchma remained the political master.

Lazarenko was as colorful as Pustovoitenko was gray. Lazarenko was frightening; Pustovoitenko was boring. Yet both came from Dnipropetrovsk, where Pustovoitenko had been mayor, but his comparative advantage was absolute loyalty to Kuchma. After having appointed two strong prime ministers who had betrayed him to succeed him, Marchuk and Lazarenko, Kuchma desired a completely reliable prime minister. Moreover, Kuchma's goal was no longer reforms but to win the parliamentary elections in March 1998 and the presidential elections in October 1999, which was Pustovoitenko's task. Pustovoitenko returned to a government dominated by civil servants. He made no major changes, packing the government with older and grayer Soviet apparatchiki.

Once I had the misfortune to chair a dinner for Pustovoitenko with prominent international business leaders. This dinner should have been

6. Taras Kuzio, "Ukraine's Virtual Struggle against Corruption and Organized Crime," Radio Free Europe/Radio Liberty, Crime, Corruption, and Terrorism Watch, September 6, 2002, available at www.taraskuzio.net (accessed on October 2, 2008).

7. That day I decided to close down our Soros International Economic Advisory Group in Kyiv.

an opportunity for Ukraine's prime minister to promote his country. Instead, Pustovoitenko seemed absorbed by one salient idea: how to get out of this. He refused to talk to anybody but Yeltsin's amicable chief of staff, Yuri Petrov, who had been mayor of Sverdlovsk (now Yekaterinburg), a city confusingly similar to Dnipropetrovsk.

Kuchma's Foreign Policy

Kuchma loved foreign policy, and after he had settled crucial domestic concerns, he indulged himself in his favorite occupation. He traveled extensively, going on official visits to many countries that had had minimal contacts with Ukraine. In his election campaign, Kuchma had spoken about a multivector foreign policy, which others would call multipolar, with a desire to improve Ukraine's relations in all directions.

Ukraine's most important foreign partner was Russia, and two vital issues were outstanding: the division of the Black Sea Fleet and the status of its headquarters, Sevastopol, on Crimea. After Yeltsin's reelection in July 1996 and his prolonged treatment for a heart ailment in the fall of 1996, Yeltsin regained sufficient political and physical strength to return to his long-desired final settlement with Ukraine.

On May 28, 1997 the Ukrainian and Russian prime ministers signed three intergovernmental agreements on the division, basing, and cost of the Black Sea Fleet. By letting the prime ministers sign these controversial agreements, Yeltsin did not have to ask the Russian parliament for ratification. The fleet was finally divided, with Russia obtaining the lion's share. Formally, the fleet was divided in half, but Russia bought a large part of Ukraine's share. Ukraine leased the port facilities in Sevastopol to Russia for 20 years (until 2017) for $98 million a year. The lease could be prolonged for five more years by mutual consent. Sevastopol would remain the headquarters of the Russian Black Sea Fleet for at least 20 years. Ukraine's 1996 constitution allowed an exception for temporary presence of foreign bases on Ukrainian territory (Sherr 1997; Wolczuk 2002, 29–32, 36–38). Yet Crimea, Sevastopol, and the Black Sea Fleet are still rallying cries for Russian nationalists. In practice, Russia has paid its lease to Ukraine by netting out Ukrainian gas arrears.

As a follow-up, on May 31, 1997, Russia finally recognized Ukraine's borders by signing the Treaty on Friendship, Cooperation and Partnership between the Russian Federation and Ukraine. Repeatedly and in detail, this treaty clarifies the two countries' mutual respect for each other's territorial integrity and the inviolability of their borders. A territorial dispute that remained was the demarcation of the sea border on the Azov Sea and the Kerch Strait. Amazingly, the Ukrainian Rada did not understand that this was the best they could possibly obtain from Russia. Only on

December 25, 1998, one and a half years later, did the Rada finally ratify the treaty, after which the comparatively propresidential Russian Federation Council did the same (Rossiiskaya Federatsiya 1999). At the same time, Russia abolished all the many trade barriers it had raised against Ukraine.

These Russian-Ukrainian agreements were a great success for Kuchma and the high point of the Russian-Ukrainian relationship. Russia had accepted Ukraine's legal demand, although the Ukrainians had, of course, wanted a higher payment. Russia had reconfirmed its recognition of Ukraine's sovereignty of Crimea and Sevastopol in a ratified interstate treaty.

But Ukraine could not do much more with Russia. Cooperation with the Commonwealth of Independent States (CIS) led nowhere because Russia remained a bully, with covert neoimperialist agenda that could not appeal to any partner. As neither Russia nor Ukraine were members of the World Trade Organization (WTO), they lacked a rulebook for free trade (Olcott, Åslund, and Garnett 1999). Kuchma's view of Russia was simple: "We are doomed to live in friendship."[8]

Kuchma valued his excellent relations with the United States the most, and US-Ukrainian friendship flourished. In November 1994 Kuchma received the honor of an official visit to Washington. The *New York Times* (November 23, 1994) reported President Bill Clinton's compliments to Kuchma: "Your boldness in the face of daunting problems reminds us of one of our greatest leaders, Franklin Roosevelt, who provided leadership in a time of great hardship. You have blazed a path ahead on the two most critical issues for the future: economic reform and nuclear weapons." In May 1995 President Clinton responded with a visit to Ukraine, which became a lovefest. Vice President Al Gore was a frequent guest of Kuchma's.

The European Union was much more reserved. Its institutional cooperation with Ukraine was rudimentary. It treated Ukraine like any other CIS country, although it was a European country and thus entitled to apply for EU membership according to its founding Rome Treaty of 1957. The European Union offered partnership and cooperation agreements (PCA) valid for ten years to the CIS countries. The Ukrainian PCA was concluded in 1994 but did not come into force until 1997. Although it was comprehensive, covering political dialogue, goods and services trade, and economic, environmental, scientific, cultural, and legal matters, it contained little of substance. On trade, it codified WTO principles only for non-WTO members, while the European Union concluded free trade agreements with many other countries and association agreements with the EU candidate members in Eastern Europe. The European Union's

8. *Zerkalo nedeli*, October 16, 1998.

only subsequent trade policy for Ukraine was its conclusion of a textile agreement that eliminated its import quotas.

The contrast between the development of exports to the European Union from the 10 postcommunist EU candidate members in Central and Eastern Europe and Ukraine was huge in the 1990s. Barely half of the exports from Central and Eastern European countries went to the European Union in 1989, but they rose to 67 percent in 2000. By contrast, 33 percent of Soviet exports went to the European Union in 1989, but Ukraine's exports to the European Union comprised only 16 percent of its total exports in 2000, showing that Ukraine was especially disadvantaged. Given economic geography—Ukraine's location, transportation routes, and the relative size of adjacent economies—the European Union should be Ukraine's all-dominant export market, buying 60 percent of its exports (Åslund and Warner 2004). Ukraine suffered from extreme EU protectionism because two-thirds of its exports consisted of goods especially sensitive to protectionist measures, namely steel, chemicals, agricultural goods, and textiles.

Throughout the 1990s the main EU interest in Ukraine was to close down the Chornobyl nuclear power station, where one reactor melted down in April 1986. However, two other reactors continued to produce electricity. They were major energy assets to Ukraine, and the Ukrainian government demanded compensation through the completion of two almost-finished nuclear power reactors at other locations if Chornobyl was closed. The European Union engaged the European Bank for Reconstruction and Development, which did not trust the safety of the Soviet-designed reactors. The European Union wanted Ukraine to build other power stations, which would be much more expensive, but it was not prepared to pay. On April 19–20, 1996, Ukraine was invited to a nuclear safety summit with leaders of the Group of Seven (G-7) and Russia in Moscow and agreed to close Chornobyl. It closed one reactor in November 1996 and on December 15, 2000, the last reactor.[9] It completed two of the almost-finished nuclear reactors, which have worked well.

But Kuchma wanted to integrate Ukraine into Europe. The European organization that was open to Ukraine was the Council of Europe. It is separate from the European Union and has a larger membership. It is primarily an interparliamentary organization focused on human rights, election monitoring, judicial standards, and constitutions. Its Venice Commission is a major authority on the design of constitutions. In November 1995 Ukraine became a member of the Council of Europe, which has played a major role in Ukraine's democracy building. In a speech to the Parliamentary Assembly of the Council of Europe in April 1996, Kuchma stated that Ukraine's strategic goal was full membership

9. See the Nuclear Threat Initiative's website at www.nti.org (accessed on August 7, 2008).

in the European Union (Solchanyk 2001, 92). But his public request was followed by a deafening silence from the European Union.

Kuchma also favored Ukraine's integration into the North Atlantic Treaty Organization (NATO), pursuing a piecemeal approach suggested by NATO. In May 1997 Russia and NATO concluded their Founding Act on Mutual Relations, and Ukraine hastened to establish the NATO-Ukraine Commission two months later at the NATO summit in Madrid. The only serious domestic reaction against Kuchma's Western-oriented foreign policy occurred in 1999, when NATO bombed Yugoslavia in defense of the Kosovars. Most Ukrainians took a strong stand for their Orthodox brethren in Serbia, as did the Russians. Even so, in July 1999, Ukraine decided to deploy 800 soldiers in Kosovo. Ukraine has persistently provided peacekeeping troops to the various stages of Yugoslavia's partition.

An innovation was the formation of the regional grouping GUAM, an abbreviation of the four member states, Georgia, Ukraine, Azerbaijan, and Moldova. Cooperation between these four countries started during discussions about revising the Treaty on Conventional Forces in Europe in late 1996. The common denominators among GUAM's members are that they are all reluctant members of the CIS, wanting to keep a certain distance from Russia, and they are all Black Sea countries. GUAM was formed to safeguard their common security interests, which have been extended to energy, but they have always been careful to underline that their cooperation is not directed against Russia. In 1999 Uzbekistan joined the group, which then became GUUAM, but it withdrew in 2005 because it had little in common with the other members. After the massacre in Andijan in May 2005, Uzbekistan improved its relationship with Russia, which showed more understanding for the massacre than the United States did. In practice, GUAM is little more than a consultative forum (Olcott, Åslund, and Garnett 1999).

Not without reason, Kuchma took great pride in his foreign policy, which was his main preoccupation (beside elections) in the late 1990s: "I was criticized a lot for my multi-vector policies, but I'm proud of my foreign policy and consider it an important achievement. . . . It helped me preserve Ukraine's sovereignty."[10]

Intricacies of the Gas Trade

The gas trade was the greatest source of rent seeking in Ukraine, although Ukraine imported three-quarters of the natural gas it consumed, but it is

10. Radio Free Europe/Radio Liberty (RFE/RL), "Ukraine: Former President Observes 'Ukraine Without Kuchma'," August 7, 2006.

a major transit country.[11] Ukraine's energy intensity was even greater than Russia's. At the outset, both countries had equally low energy prices and were dominated by heavy industry.

At its worst in 1995, Ukraine used 28 times more energy to produce $1 of GDP than energy-efficient Italy.[12] The scope for energy saving was enormous. Ukraine's consumption of natural gas declined from 115 billion cubic meters in 1990 to about 80 billion in 1995, but it has stayed more or less constant at that level, as energy saving has proceeded, while production has picked up (Lovei 1998a).

The modalities for gas trading changed every few years, but prices were always greatly distorted, the trade nontransparent, and arrears substantial. The two dominant sources of gas have been Russia and Turkmenistan. Their weights have varied, but Russia has preferred to let Turkmenistan deliver gas to Ukraine because gas prices for Ukraine were lower than for Europe, and it was difficult to extract payments from Ukraine.

Most things about the gas trade were strange. Prices were low and subsidized, but even so, arrears were notorious and often forgiven by Gazprom or the Ukrainian state. The arrangements for gas trade changed almost every year between different state and private companies. The changes occurred because gross corruption was revealed, arousing political criticism. However, things rarely improved. All these companies were nontransparent, and top officials and select businessmen in Turkmenistan, Russia, and Ukraine seemed to cash in large corrupt revenues (Global Witness 2006).

Russia's Gazprom was amazingly tolerant with the Ukrainian arrears, but not out of benevolence. It transformed its arrears into Ukrainian bonds, for which it demanded debt-equity swaps, preferably acquiring gas infrastructure. Gazprom acquired large chunks of the gas pipeline systems in Georgia, Moldova, and later Belarus, and Ukraine was its prime target. In addition, the world's largest gas storage facilities were located in western Ukraine, and they were of great value to Gazprom (Lovei 1998a). The Ukrainian parliament responded in late 1996 by prohibiting the privatization of Ukraine's transit gas pipelines and its gas storage (Balmaceda 1998, 264).

From 1992 to 1995 the Ukrainian state company Ukrhazprom imported natural gas from Russia and Turkmenistan, and Ukraine accumulated about $6 billion of state debt/arrears for these gas deliveries (Lovei and Skonik 1997, 204). During these years, Ukraine received very substantial

11. Good overall sources are Balmaceda (1998), Lovei (1998a), and Von Hirschhausen (1999).

12. Measured at current exchange rates. See Energy Information Administration, "World Energy Intensity," table E.1g, available at www.eia.doe.gov (accessed on July 14, 2008). If measured in purchasing power parity, Ukraine and Russia were five times less energy-efficient than Italy.

oil and gas subsidies from Russia. Gregory Krasnov and Josef Brada (1997, 840–41) estimated them at approximately 1.3 percent of Ukrainian GDP annually from 1992 to 1995.

In early 1994 the Ukrainian state recruited a private company, Respublika, headed by Ihor Bakai, to pay Turkmenistan mainly with barter, but it failed to do so, and Kuchma ousted Respublika and Bakai (Global Witness 2006, 33). Instead, the Gazprom-related private trading company Itera and Lazarenko and Tymoshenko's UESU took over the gas trade from 1995 until 1997. In October 1996 Gazprom's CEO Rem Vyakhirev suggested that Itera receive monopoly on selling Russian gas to Ukrainian companies (Balmaceda 1998, 264). Prime Minister Lazarenko refuted the offer, but after his fall Itera sold all Russian gas to Ukraine. As was their habit, the gas traders did not pay Gazprom, which eventually forced the Ukrainian state to pay (Balmaceda 1998, 270–71; von Hirschhausen and Vincentz 2000).

In 1998, after the fall of Lazarenko, Kuchma brought together state oil and gas enterprises into the new Ukrainian state company Naftohaz Ukrainy to control Ukraine's gas trade. An obvious aim was to secure campaign financing for the presidential election in 1999. The company's first chairman, Ihor Bakai, stayed until 2000. Presumably, Kuchma thought he needed the most unscrupulous gas trader to recover full control after Lazarenko. For this period, Naftohaz Ukrainy did not release any financial information or audits (Global Witness 2006, 29). It was an obvious source of leakage of hundreds of millions of dollars every year. Within Ukraine, a number of regional distributors were given regional monopolies, aggravating the boondoggle. In the fall of 1998, Bakai, unabashedly stated: "All rich people in Ukraine made their money on Russian gas" (Timoshenko 1998).

The techniques of enrichment were many and varied. Most blatant but least prominent was theft of gas from the main pipeline through Ukraine to Western Europe. Another means was not to pay Itera/Gazprom, but as Itera happily continued the trade, suspicion lingers that it was paid. Yet Gazprom/Russia demanded that the Ukrainian state guarantee these payments by private Ukrainian importers. A third form of rent seeking was payment through barter and offsets, which usually brought about a discount of about 50 percent. In addition, Russia paid in kind for gas transit through Ukraine, which disappeared into private hands. Altogether, a few Ukrainian oligarchs netted at least $1 billion a year on this dubious gas trade, but their identity varied from year to year.

Rise of the Oligarchs

One of the most controversial topics is the oligarchs. In Russia, oligarch became a popular label for the wealthiest tycoons around 1994, when the first truly rich people emerged, and that notion was soon accepted in

Ukraine as well. Oligarch is an ancient concept, and an oligarchy is traditionally defined as "government in the hands of a few." In fact, it has been more applicable to Ukraine than to Russia.

In Ukraine an oligarch was understood as a very wealthy and politically well-connected businessman, a dollar billionaire, or nearly so, who was the main owner of a conglomerate of enterprises and had close ties to the president. The oligarchs were few, and it might be more appropriate to call them plutocrats, as their aim was to make money and they saw politics as a means to accomplish that goal.

Oligarchs are not unique to Russia and Ukraine but the international norm. Randall Morck, Daniel Wolfenzon, and Bernard Yeung (2005, 693) concluded in a survey of recent literature on ownership around the world: "Control pyramids effectively entrust the corporate governance of the greater parts of the corporate sectors of many countries to handfuls of elite, established families, who can quite reasonably be described as *oligarchs*." The United States and the United Kingdom are exceptions.[13]

In Ukraine, we may distinguish among three waves of oligarchs or big businessmen. The first group rose to prominence around 1994. In July 1994, when Kuchma was unexpectedly elected president of Ukraine, he disrupted the old corrupt networks. At least three people were already known as oligarchs: former prime minister Zviahilskiy, who was a coal and steel trader; media oligarch and steel trader Vadym Rabinovich; and gas trader Ihor Bakai. They had worked with Kravchuk and all fell out of favor with Kuchma. Zviahilskiy and Rabinovich were even prosecuted in an anticorruption drive. Yet the old oligarchs managed to mend their fences with the new president as the Kuchma regime succumbed to corruption.

A second wave of Kuchma oligarchs were gas traders. In 1996–97, the biggest gas trading group was Lazarenko and Tymoshenko's United Energy Systems of Ukraine, which branched out into other industries, becoming a conglomerate.[14] Another early big oligarchic group was led by Kyiv businessman Hryhoriy Surkis and his partner Viktor Medvedchuk. They formed a large conglomerate, trading gas and owning plenty of real estate in Kyiv. In the late 1990s they went into electricity distribution on a big scale. Surkis owned the famous Dynamo soccer club in Kyiv. Ihor Bakai, the tenacious gas trader, patched up his relationship with Kuchma and stayed an oligarch, uncharacteristically moving between private and state companies. Oleksandr Volkov was primarily a courtier and presidential adviser. He was a dealmaker, never identified with any company, although he was a major oil importer (Gongadze 2000).

13. For further general elaboration on oligarchs, see Åslund (2007a, chapter 10). I have provided more detail on the Ukrainian oligarchs in Åslund (2006).

14. It was a private Ukrainian company and had nothing in common with the eponymous company in Russia, which was the state-controlled utility company.

None of these early corporate beginnings has survived. They were all murky offshore trading companies, escaping taxation, being the masters of nonpayments and barter. UESU was a real enterprise, but Kuchma destroyed it in 1997–98 by pursuing it with the various arms of law enforcement. The Surkis and Medvedchuk group has probably broken up into different enterprises, whose ownership remains unclear. Bakai and Volkov never had serious corporate structures. Bakai fled to Russia after the Orange Revolution, and Volkov has been marginalized. These early oligarchs held high state positions: Lazarenko was prime minister, Medvedchuk first deputy speaker of the parliament, Volkov presidential adviser, and Bakai head of the state oil and gas company (Naftohaz Ukrainy), in 2003–04 responsible for real estate in the presidential administration. Surkis and Medvedchuk had regional bases in Kyiv and Transcarpathia in the west, and Lazarenko in Dnipropetrovsk, while Bakai and Volkov operated in the presidential circles in Kyiv.

A third wave of oligarchs emerged in the late 1990s and rose to prominence after 2000. They also had made their initial capital on commodity trading but they were all steel producers and developed substantial corporate structures. They had bought up the Ukrainian steel mills, which had been privatized in the 1990s, partly through voucher privatization and partly through insider privatization. The oligarchs restructured the steelworks to boost their production, rendering them highly profitable. Soon Ukraine was dominated by four large industrial groups, each with about 100,000 employees and worth more than $10 billion by the spring of 2008. They were all located in eastern Ukraine, two in Donetsk and two in Dnipropetrovsk.

The Industrial Union of Donbas (ISD), founded in 1995, has been the traditionally preeminent group in Donbas. It owns steelworks in Ukraine, Poland, and Hungary. Its main owners are billionaires Vitaliy Haiduk, Serhiy Taruta, and Oleg Mkrtchan. Haiduk and Taruta are engineers, former state enterprise managers from the metallurgical industry, and managing partner Taruta has a past in a Soviet foreign trade organization.[15]

The competitor of ISD in Donetsk is System Capital Management (SCM), by far Ukraine's biggest company, with about 160,000 employees. It was formed as late as 2000, and it is almost completely owned by Rinat Akhmetov (born in 1966), who in the late 1990s suddenly emerged as Ukraine's richest man. He comes from a poor Donbas coalminer's family. SCM is a holding company, with steelworks, iron-ore mines, and coal mines as well as heavy machine-building plants. Akhmetov rules as the king of Donetsk with control over the regional

15. Interview with Serhiy Taruta, December 2004; Zimmer (2003); Yevhen Dubohryz, "More-or-less Civilized," *Kontrakty*, January 17, 2005.

administration.[16] SCM and ISD previously shared ownership of many steelworks, but they have divided their properties. SCM got the bulk of them, and ISD claims to have been squeezed out.

Victor Pinchuk's Interpipe (renamed EastOne in 2007) in Dnipropetrovsk might be the second wealthiest company in Ukraine, but its employment is smaller. It was founded in 1990 and specializes in high value-added steel products, such as steel pipes and railway wheels. Pinchuk, who is a metallurgist with a doctoral degree, also owns three medium-sized TV channels (ICTV, Novy Kanal, and STB) and until early 2008 owned Ukrsotsbank.[17] Pinchuk married Kuchma's only daughter, Elena Franchuk, in 2002. EastOne and SCM pride themselves on having the most rationalized and Westernized corporate structures, both employing many westerners.

Privat Group in Dnipropetrovsk is probably the second biggest corporation in terms of employment and wealth after SCM. It was founded in 1992 and is headed by three billionaire partners: Ihor Kolomoiskiy, Gennadiy Bogoliubov, and Alexei Martynov. Kolomoiskiy, another engineer, is the managing partner. Privat Group controls Ukraine's biggest bank (Privatbank), a vertically integrated oil company (Sintoza and semi-state-owned Ukrnafta), a vertically integrated mining-and-steel company, large electricity holdings, and many other companies. It is a true conglomerate. Like the Surkis-Medvedchuk group, Privat Group does not have clear corporate structures, and much of its ownership is hidden in offshore companies. Privat Group and Interpipe are even fiercer competitors than ISD and SCM.[18]

Three cities dominate Ukrainian big business, Kyiv, Donetsk, and Dnipropetrovsk, but large enterprise groups also emerged in other regions, mainly in the east because of the inherited industrial structure. Ukraine had no less than 23 billionaires in the spring of 2008, and seven of the biggest oligarchic groups concentrate on steel and mining.[19] The transformation of big business from gas trade to steel production improved their

16. Interview with Rinat Akhmetov, December 8, 2004; Zimmer (2003); Adrian Karatnycky, "A Ukrainian Magnate Tries to Mend Fences," *Wall Street Journal*, January 14, 2005; Yevhen Dubohryz, "More-or-Less Civilized," *Kontrakty*, January 17, 2005.

17. Interview with Victor Pinchuk, March 2003.

18. Interview with Gennadiy Bogoliubov, March 2003. "Sekrety gruppy 'Privat'—mesta starta kar'ery Tigipko" ["Secrets of the Privat Group—the Starting Place of the Career of Tyhypko"], *Ukrainskaya pravda*, August 3, 2004; "Semeniuk suditsya za sobstvennost' Pinchuka, Akhmetova, Privata i Ruslana" ["Semeniuk Is Suing for the Property of Pinchuk, Akhmetov, Privat and Ruslan"], *Ukrainskaya pravda*, February 9, 2005.

19. *Korrespondent*, "List of 50 Richest Ukrainians," July 14, 2008. The seven biggest oligarchic groups are System Capital Management, EastOne, Privat Group, Industrial Union of Donbas, Ferrexpo (Konstantin Zhevago), Zaporizhstal, and MMK imeni Ilicha (Volodymyr Boiko). Kryvorizhstal was eventually bought by ArcelorMittal, but otherwise all the steel groups were owned by Ukrainian citizens.

business practices. The leading corporations could no longer hide as commodity traders can. They had to make their accounting official and legalize their business practices.

By 2000 the characteristics of oligarchs were easy to establish. Most of them were around 40 years of age and mostly engineers from Kyiv, Donetsk, or Dnipropetrovsk. They went into business in 1988, when the Soviet Law on Cooperatives was adopted, which allowed legal private enterprise and facilitated the transformation of dead noncash money into real cash. Nearly all the oligarchs manage huge companies themselves in a highly centralized manner. While the oligarchs of the 1990s were primarily courtiers and arbitrage traders, the current oligarchs are self-made entrepreneurs who have made their fortunes by reanimating existing Soviet mastodons.

The rise of Ukrainian oligarchs had much in common with that of oligarchs in other countries, such as America after its Civil War or Europe during the Industrial Revolution.[20] One cause of this generation and concentration of wealth was the sudden achievement of great economies of scale in certain industries, nota bene steel.

A second feature common to the Industrial Revolution and postcommunism was rapid structural change, which facilitated great accumulation of wealth among the few who knew how to take advantage of the convulsion. A third economic characteristic was the presence of rent, which is often difficult to distinguish from economies of scale, as the intricacies of the Microsoft antitrust case have taught us.

Fourth, US robber barons benefited from the free distribution of state assets, notably land around the railways, and cheap state credits, since multiple early railway companies went bankrupt because of insufficient state support to reach the desired economies of scale (De Long 2002). In Ukraine budding oligarchs bought up cheap steelworks that many thought were condemned to die as was the case in Central Europe.

Fifth, the absence of strong legal institutions required oligarchs. Even today, Ukraine has few relevant corporate and property laws. The judicial system functions poorly, and bailiffs barely exist. Such conditions breed poor corporate governance, impeding the evolution of financial markets. Without strong corporate legislation and a potent judicial system, partners find it difficult to agree or resolve conflicts. Nor can principals (owners) control their agents (executives), so they are compelled to manage their companies themselves. Therefore, businessmen with concentrated ownership tend to be more successful than those who have to deal with many minority shareholders, as has indeed proven to be the case in Ukraine (Grygorenko, Gorodnichenko, and Ostanin 2006). "When institutions are weak, doing business with strangers is dangerous and unreliable" (Morck, Wolfenzon, and Yeung 2005, 672). Businessmen

20. The ensuing section draws on Åslund (2007a, chapter 10).

escape concluding contracts that they cannot secure in court by rationally opting for vertical integration, choosing corporate hierarchies over horizontal markets (Williamson 1975).

Economically, the oligarchic systems have proven highly adaptive. The Ukrainian oligarchic corporations EastOne and SCM have excelled in buying international services of all kinds, notably auditing and management services, while the state companies resisted doing so. They have bought and sold companies at great speed, specializing and altering their corporate structures.

Only Ukrainian and Russian oligarchs appear able to restructure large Soviet industrial enterprises, which requires rather peculiar skills. Close relations with both the central and regional governments are necessary. In the absence of a functioning legal system, the owner/manager must be able to secure property rights and enforce contracts in an effective extralegal fashion. A prime task at a Soviet plant is to root out rampant theft by employees. Ukraine has plenty of social regulations, but only some are honored, and a businessman needs to know which. Soviet enterprises were chronically overstaffed, and only local businessmen have the guts to lay off workers as is necessary. Soviet factories were typically overloaded with equipment, most of which had to be scrapped. Foreign businessmen tend to gut the factories, using little but the premises. Local businessmen with less capital are anxious to utilize valuable physical capital and technology, thus preserving more value. Soviet management had its peculiarities, and in factories with thousands of workers, knowledge of the old management is necessary to successfully renew these factories, while outside financial and management skills can be brought in. Therefore, local businessmen tend to do better than foreign investors in the early stages of restructuring of Soviet metallurgy. Later on, other skills are likely to be more relevant, such as know-how and international networks, lending a new premium to foreign investors.

Yegor Grygorenko, Yuriy Gorodnichenko, and Dmytro Ostanin (2006) analyze a sample of almost 2,000 Ukrainian companies and found that oligarchs picked underperforming firms with large capital stock and sales and firms owned by oligarchs had much higher productivity growth than others. This finding tallies with that of an earlier empirical study of Russian financial-industrial groups in the mid-1990s, which found that these hierarchical groups were more efficient in their real investment than independent owners (Perotti and Gelfer 2001).

Two major conclusions can be drawn. First, only a few businessmen with concentrated private ownership and supreme knowledge of the informal rules could manage large Soviet enterprises in the early transition. The real alternatives were to keep them state-owned and unreformed until they collapsed or to sell them off to foreign investors, who usually closed them down not knowing how to manage them. The question was whether the state would allow big local businessmen to emerge or not, and only a few countries did so. The oligarchs have been more successful in restructuring large Soviet mining and metallurgical industries.

Second, the oligarchs were not guilty of the existing conditions that arose, but they responded rationally. Whenever state regulation created wedges between fixed state prices and market prices, businessmen arbitraged between these prices to their personal benefit. When privatization was launched, they transferred state property to themselves in the cheapest way. During mass privatization, they bought vouchers and stocks. Given that many enterprises were privatized unexpectedly and suddenly, they bought what they could until mass privatization had been completed, acquiring more assets rather than investing in already purchased enterprises. After mass privatization was completed, some oligarchs elaborated business strategies, streamlined their assets, specialized in a few industries, and invested heavily.

In the late 1990s, Kuchma was deeply engaged with the oligarchs, balancing three major oligarch groupings against one another—Medvedchuk-Surkis, Volkov-Bakai, and Pinchuk—but others were also in play. Kuchma and the oligarchs had a symbiotic relationship. The oligarchs needed state support for their businesses, while Kuchma desired ample political campaign financing. He checked the oligarchs through his skillful divide and rule strategy, making sure that no single force could consolidate power.

The oligarchy amounted to a "partial reform equilibrium," as Joel Hellman (1998) and Rosaria Puglisi (2003) have seen it. In Hellman's words, the winners took all, and the winners were the oligarchs. They maintained and reinforced their rents or state resources in return for political support through campaign financing, media, and mobilization of regional constituencies.

However, most of the big and powerful in 1999 would lose their privileges sooner than anybody had imagined because competition prevailed and offered a lifeline to this seemingly stagnant society. Kuchma avoided consolidating power and building a strong vertical command, which President Vladimir Putin and President Nursultan Nazarbayev did in Russia and Kazakhstan, respectively.

Crime and Law Enforcement

In the early postcommunist period, crime skyrocketed, as is typical during liberalization after a severe dictatorship, but society found defense mechanisms that shifted over time.[21]

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21. The best analysis of post-Soviet crime and defense mechanisms is Volkov (2002), who in turn draws on similar observations in Sicily by Diego Gambetta (1993). I have elaborated on this in Åslund (1997a, chapter 9).

In Ukraine the number of homicides and attempted homicides more than doubled, from 2,100 in 1985 to a peak of 4,900 in 1996. The murder rate remained at this high level until 2000, after which it fell substantially (figure 4.2). The Ukrainian homicide rate was slightly higher than the US rate, but it has persistently been less than half the extraordinary Russian rate. Within Ukraine the rate was much higher in the urbanized east than in the more rural west.

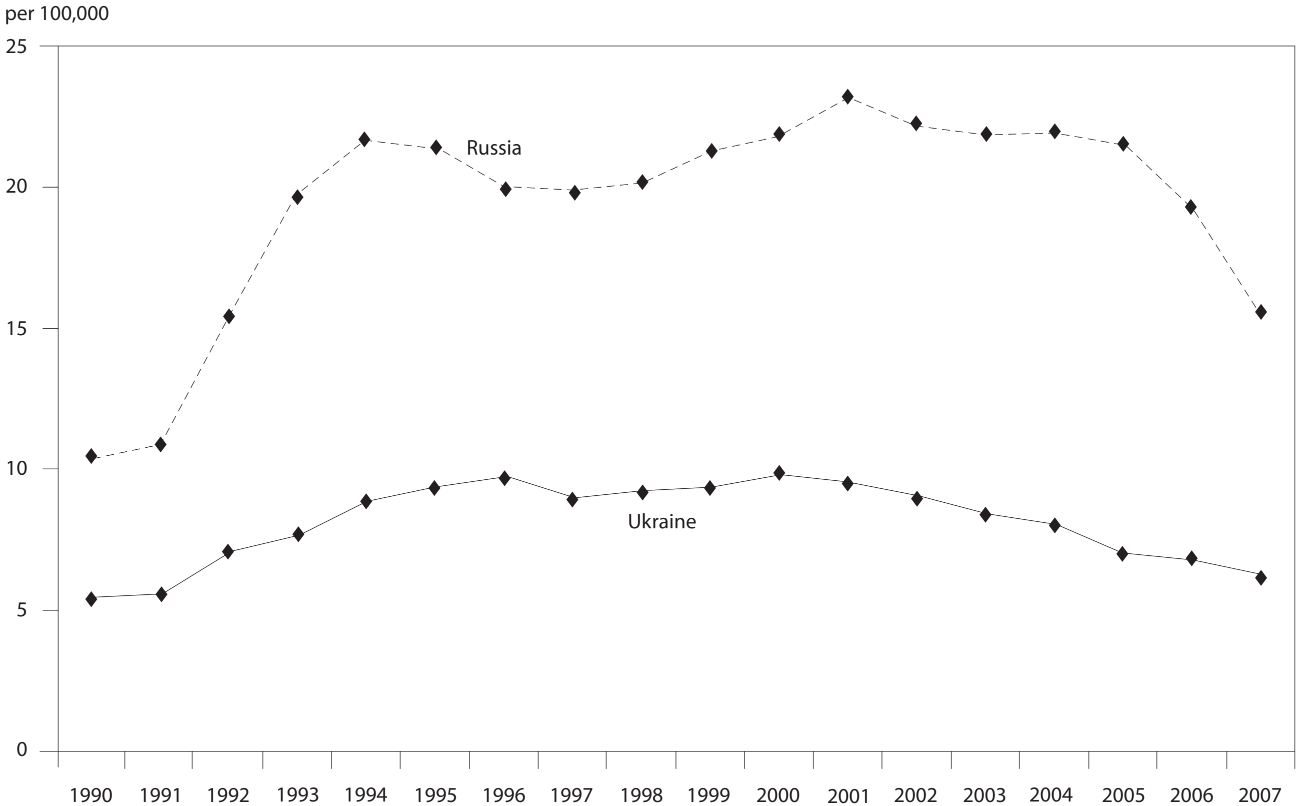
Individual crime became unbearable. Every businessman was exposed to racketeering, but since multiple claimants competed over turf, they did not know whom to pay. Many never figured out but saw their premises burned and some were killed. A friend of mine attended the birthday party of Ihor Bakai on the banks of the Dnieper in 1995. He counted 72 bodyguards; a few were trying to enhance security by waterskiing with their Kalashnikovs. In hindsight, it may sound exotic, but it was frightening. In 1995 and 1996, two businessmen in Donetsk (Ahati Bragin, a.k.a. Alik the Greek, and Yevhen Shcherban) were murdered, presumably by their competitors, though their cases were never solved. Bragin was killed in the midst of 150 bodyguards at Shakhtyar stadium in Donetsk and Shcherban at Donetsk airport. Never before had bodyguards been so prominent and numerous in Kyiv's few good restaurants.

In response to this criminal anarchy, a second stage evolved in 1996, when crime was soon rationalized. Under Prime Minister Lazarenko (1996–97), organized crime appeared to have taken power. Organized racketeers had divided urban territories among themselves, and businessmen knew which racketeer they had to pay. Protection rates declined as did racketeering murders. I used to eat at a nice Italian restaurant, Di Mario, on Saksaganskogo Street in Kyiv. Every evening a group of four Chechen brothers would hang out there, working their mobile phones. Between them sat bored beautiful blond girls smoking their long, slim cigarettes. Reportedly, they comprised one of the city's two main racketeering groups, but police did not bother them.

By 2000 the oligarchs took over from organized crime. By establishing their own large armies of security guards, they freed themselves. Although the threat of bloodshed persisted, carnage among businessmen dwindled, as did the number of bodyguards, and the cost of protection declined.

Eventually, law enforcement recovered but became a law unto itself. In Ukraine, the four main law enforcement agencies are the huge and multifaceted Ministry of Interior, the elitist Security Services of Ukraine (SBU, the old KGB), the large new State Tax Administration, and the Prosecutor General. Three strong men loyal to Kuchma controlled the main branches of law enforcement. Minister of Interior Yuriy Kravchenko commanded Ukraine's 420,000 policemen, Leonid Derkach the SBU with only 28,000 officers, and Mykola Azarov the State Tax Administration, which,

Figure 4.2 Rate of homicides and attempted murders in Ukraine and Russia, 1990–2007



Sources: Ministry of Statistics of Ukraine (1994, 477; 1996, 514; 1997, 488; 1998, 515; 2000, 499); State Statistics Committee of Ukraine online database, www.ukrstat.gov.ua (accessed on July 18, 2007); European Bank for Reconstruction and Development online database, www.ebrd.com (accessed on July 1, 2008); Federal State Statistics Service of Russian Federation, www.gks.ru (accessed on July 22, 2008).

with its 70,000 inspectors, was the most politicized and dangerous repressive force. Azarov was also a major politician from Donetsk, usually a deputy in the Rada, and one of the leaders of the Regions Party, the regional party of Donbas. The three agencies became centralized, commercial organizations, competing among themselves as oligarchic groups. Justice was their least concern, but law entitled them to carry arms and arrest people.

Kuchma handled law enforcement as he did the oligarchs, playing them against each other, while making sure that strong and loyal men headed each service. The military with some 200,000 men in uniform played no political role.

Demise of Media Freedom

In the early 1990s, the Ukrainian media were in financial disarray, suffering from the general economic decline. State financing dried up and private advertising revenues did not become significant until after 2000. The transportation of newspapers became too expensive, eliminating national newspapers and rendering the press entirely regional. As the print media shrank, the vast majority of Ukrainians stopped reading newspapers, and television and radio became all the more dominant. Quality remained poor. Ukraine had relatively few trained journalists, since Soviet media were dominated from Moscow. Still, media were very free.

In the mid-1990s Kyiv had about 10 small daily newspapers, mostly owned by minor entrepreneurs, though the parliament owned one newspaper and the government another. The main TV channels were state-owned and poorly financed, while a few small private channels were emerging. Ukraine had one early media tycoon, Vadym Rabinovich, who was rumored to own one-quarter of Ukraine's media at his peak in 1994. He seemed to be Ukraine's response to Russia's Vladimir Gusinsky, but he was accused of being involved in organized crime and was barred from entering the United States. He never came as close to Kuchma as to Kravchuk. In 1999 Rabinovich fell out with Kuchma and fled to Israel (Wilson 2002, 198, 265).

The most viable television programming consisted of rebroadcasts of Russian programs, but direct broadcasts from Russia were banned in 1995 (Wilson 2002, 270). At the time, it was perceived as an act of boosting Ukrainian language broadcasts, but it also increased the government's opportunities to control television.

Soon the Kuchma administration began circumscribing media freedom. In 1995 one of Kyiv's small but good newspapers, *Kievskie vedomosti*, published that Minister of Interior Kravchenko had built a big private house with state money. Kravchenko, who was a Kuchma loyalist, did not suffer, and the president defended him publicly, but the newspaper was evicted from its premises because of a supposed fire hazard.[22] This was the first harbinger of a repressive media policy that flourished in 1997–98 before the parliamentary and presidential elections.

Later on, *Kievskie vedomosti's* competitor, *Vseukrainskie vedomosti*, published damaging revelations about Kyiv tycoon Hryhoriy Surkis. It was sued for libel and sentenced to pay confiscatory damages of more than $1.5 million. The general prosecutor closed down several other critical newspapers (Wilson 2002, 198). Media freedom had been severely curtailed, but repression remained limited to media that were an acute nuisance to the authorities. The main means were tax inspection, police, prosecutors, and the courts. Independent media survived, but they were marginalized.

Two big private channels, 1+1 and Inter, dominated television and fell under the control of Medvedchuk, who also commanded the main state-owned television channel, UT-1. In 1996 former prime minister Marchuk started a daily newspaper, *D'en*, which has survived as one of Kyiv's best newspapers, but it was not independent because Marchuk led Medvedchuk's party. Every big businessman had some media outlet, and before the parliamentary elections in March 1998, Ukraine's media were dominated by tycoons friendly with Kuchma. However, the media remained underfinanced and of poor quality, and their impact on Ukrainian public opinion was remarkably limited.

Because of the weak national media, foreign radio stations broadcasting in Ukrainian—BBC World Service, Radio Free Europe, and Voice of America—were important sources of information and analysis, but Russian television beat them all.

Parliamentary Elections, March 1998

On March 29, 1998, Ukraine held its ordinary parliamentary elections. These were Ukraine's lamest elections. Kuchma remained the most popular politician in the country. Overall he was still a centrist, but he had leaned to the right on economic reforms, state-building, and foreign policy. Therefore the main opposition came from the left, though it was neither inspired nor enthusiastic. The chief novelty was electoral reform.

Ukraine finally abandoned its pure majority elections with single-mandate constituencies.[23] The 1994 elections had not filled all seats, and the parliament had discredited itself by being too unstructured and fluid, rendering decisions exceedingly complex. A broad sense prevailed that political parties had to be reinforced. Ukraine largely adopted the Russian

22. I wrote a monthly column about economic policy in *Kievskie vedomosti* in 1995.

23. The main source of this section is Birch (2000a, 101–107).

Table 4.1 Results of election to the Supreme Rada, March 29, 1998

Party	List votes (percent)	Seats
Total Left	40.6	173
Communist	24.7	122
Socialist/Rural	8.6	34
Progressive Socialists	4.0	16
Total Center	30.8	102
Greens	5.4	19
People's Democrats	5.0	29
Hromada	4.7	23
Social Democrats (United)	4.0	17
Total Right	19.4	59
Rukh	9.4	46
Independents		116
Against all	5.3	
Total	100[a]	450
Voter turnout (percent)	71.2	

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

Sources: Birch (2000a, 107); Central Election Commission of Ukraine, www.cvk.gov.ua (accessed on September 31, 2007).

semiproportional system, which was the main source of inspiration. The 1998 electoral law prescribed that half of the 450 members were to be elected in a proportional election with party lists, with a threshold for representation of 4 percent of the votes. The other 225 seats were elected as before in single-mandate constituencies, but through simple majority and without any turnout requirement.

Another novelty was that these elections were less free and fair than the 1994 elections. The regime-controlled television channels openly ridiculed opposition candidates, and so-called administrative resources were used extensively. The State Tax Administration undertook tax audits of those who financed Kuchma's opponents, and law enforcement pursued them as well.

The election results were confusingly similar to those of 1994. The hard left, represented by the communists, socialists, and the progressive socialists, performed somewhat better than in 1994, receiving 41 percent of the votes in the proportional vote and 38 percent of the total seats. The right was weakened, with only Rukh passing the 4 percent hurdle with 9 percent of the votes and 10 percent of the seats, presumably suffering from Kuchma's turn to the right. The victor was the oligarchic center, which had reinforced its party structures (table 4.1).

Four centrist parties scraped over the hurdle for proportional representation. The Popular Democratic Party was the party of power, led by Prime Minister Pustovoitenko. Their miserable showing was quite a shame, but initially many independents were persuaded to join that party faction. The Social Democratic Party (United) was formally headed by former prime minister Marchuk, and former president Kravchuk joined it, but the real leaders were Medvedchuk and Surkis. Despite its name, it was a corporate party, closely allied with Kuchma. The Greens sounded like an environmentalist party, but it had been bought by a group of businessmen owning the steelworks Zaporizhstal. They were in politics for opportunistic business reasons so they wanted to be close to power.

The fourth centrist party was Lazarenko's *Hromada*, which was a corporate party with support in the Dnipropetrovsk region that sharply opposed Kuchma. It suffered the most from repression during the preelection campaign, but this did not arouse major protests because Lazarenko's party was reminiscent of a criminal gang. Yet the persecution of *Hromada* undermined legal standards.

As is usual in initial proportional elections, far too many parties emerged. No less than 30 parties and electoral blocs contested the ballot. Of these, eight passed the 4 percent hurdle, and no less than 34 percent of votes were wasted on parties that failed to reach that threshold. Participation remained high at 71 percent.

Big businessmen swarmed into parliament. Many centrists and independents were businessmen, whose share of the seats rose from one-fifth in 1994 to one-third in 1998. A deputy jokingly told me that it cost about $1 million to enter the Rada, which was normal because it cost the same to become a member of the New York Stock Exchange, and the Rada performed the same function.

The centrists and independents organized themselves into eight centrist factions, Rukh split in two, and the electoral bloc of the Socialist Party and the Rural Party did so as well. Thus, in the spring of 1999, the Rada had four left-wing factions and ten centrist or right-wing factions, comprising a total of 14 factions (Wilson 2002, 186–87).

An informal alliance of four oligarchic factions supporting Kuchma became the driving force of the new parliament: the Social Democratic Party (United), whose leader Medvedchuk became first deputy speaker; the Democratic Council, led by Oleksandr Volkov and Ihor Bakai; Labor Ukraine, headed by Victor Pinchuk and Serhiy Tyhypko; and the Donetsk clan's party the Regions of Ukraine, which was still taking shape. The oligarchs had reinforced their political power.

Kuchma's Reelection, October–November 1999

The parliamentary elections were seen as a primary for the real elections, the presidential election in October–November 1999. Soon after Boris Yeltsin won the second round against Russian communist leader Gennady Ziuganov in July 1996, Kuchma and his advisers decided to do the same.[24] As Andrew Wilson (2002, 204) saw it: "Kuchma's strategists planned a Ukrainian version of Russia-96, and basically that is what they got, all rather too easily in fact."

The scenario was evident. Kuchma would stand as the incumbent, representing the least evil and not proposing any new program. He would run against a credible communist threat, so communist leader Petro Symonenko was needed for the second round. Huge financing from oligarchs would facilitate a massive media campaign and the ample utilization of "political technologies" and "administrative resources."

Unlike Yeltsin, Kuchma was in good health and reasonably popular, since he had been quite successful. He was usually the most popular politician in the country, although he trailed Moroz and Symonenko in one poll in late 1998. His first task was to eliminate any threat from the democratic right. Rukh was badly divided and readily accepted Kuchma's candidacy.

Viktor Yushchenko, the popular chairman of the NBU, had been toying with the idea of running for president, but he stopped doing so in April 1998 after his potential campaign manager and funder, Vadym Hetman, his predecessor as chairman of the NBU and a wealthy commercial banker, was murdered in a contract hit in Kyiv. The murder was never solved, but Yushchenko would hardly have had any chance of winning in 1999. The old Rukh leader Vyacheslav Chornovil died in a mysterious traffic accident that year, which was widely blamed on the Kuchma administration. These suspect political murders marked a degradation of political freedom and scared the opposition.

On the left, there were three potential candidates. Socialist leader Oleksandr Moroz had the greatest potential popularity, while communist leader Petro Symonenko had the highest opinion poll rating. Natalia Vitrenko of the Progressive Socialist Party was a wild, extreme leftist.

The Kuchma camp's tactical goal was to make Symonenko gain more votes than Moroz in the first round on October 31, 1999. Their first draw was to block the reelection of Moroz as speaker of the parliament. Their determined actions paralyzed the parliament for four months after the March 1998 elections, but finally Oleksandr Tkachenko, leader of the Rural Party, a leftist with views similar to Moroz but with less popular appeal, was elected speaker.

The leading Ukrainian oligarchs had gathered huge sums for the Kuchma campaign. The main cashier was Oleksandr Volkov. A public claim was that he held campaign funds of as much as $1.5 billion (Wilson 2002, 202). That seems an exaggeration, but the election funds surely amounted to hundreds of millions of dollars. The big Kuchma-friendly businessmen

24. The main source of this section is Wilson (2002, 200–206).

Table 4.2 Results of presidential election, 1999 (percent of votes)

Candidate	First round, October 31, 1999	Second round, November 14, 1999
Leonid Kuchma	36.5	56.3
Petro Symonenko	22.2	37.8
Oleksandr Moroz	11.3	
Natalia Vitrenko	11.0	
Yevhen Marchuk	8.1	
Yuriy Kostenko	2.2	
Gennadiy Udovenko	1.2	
Others, against all, or not valid	7.5	6.0
Total	100	100
Voter turnout (percent)	70.2	74.9

Source: Central Election Commission of Ukraine, www.cvk.gov.ua (accessed on July 17, 2008).

already controlled all major television channels. They also hired a large number of Russian "political technologists," who had proven their mettle in the Russian presidential elections in 1996. One of them happily told me that he had never seen so much money being spent on an election.

During the presidential campaign, the regime-controlled television was even more biased than during the 1998 parliamentary elections. Naturally, Kuchma received the most positive publicity, but Vitrenko and Symonenko were also favorably treated, while Moroz was denigrated.

In October 1999 a small bomb went off at a Vitrenko rally in Dnipropetrovsk but no one was injured. The state media blamed the local organizer of the Moroz campaign, but the purported perpetrators who later surfaced in Russia blamed Vitrenko herself. Thus this incident hurt both Vitrenko and Moroz (Wilson 2002, 201).[25]

The elections themselves were relatively free, and they panned out exactly as the Kuchma camp had planned. In the first round, Kuchma received 36.5 percent against Symonenko's 22.2 percent, with 11 percent each for Moroz and Vitrenko (table 4.2). Former prime minister Yevhen Marchuk, who had run as an alternative left-of-center candidate to Moroz, received 8 percent and was immediately offered the post of secretary of the National Security and Defense Council, a direct parallel to Yeltsin's appointment of General Aleksandr Lebed after the Russian 1996 elections.

In the second round on November 14, the communist threat was vivid, boosting voter participation to 75 percent. The Ukrainian population

25. A Russian political technologist told me that he recognized the people who carried out the attempt on Vitrenko. They were former Federal Security Service (FSB) officers who worked for Boris Berezovsky, who had thrown in his lot with the Kuchma camp but tended to work very independently.

mobilized behind Kuchma, who obtained 56 percent of the votes against 38 percent for Symonenko, much less than the 45 percent the united left had received in the first round. This time, Kuchma won primarily in the west, but the regional disparity was not as great as in 1994, and the fear of the country breaking up did not arise. Kuchma and his associates easily accomplished what they wanted with relatively limited violations of democracy, rendering Ukraine semidemocratic.

Underreform Trap

By the end of 1999 the picture of Ukraine was pretty clear but somber. At this stage, Kuchma's greatest successes were national integrity and foreign policy. The worries that had existed in 1994 about Crimean separatism and a division of Ukraine between east and west appeared a distant memory. Ukraine was whole and free. In 1997 Kuchma had settled the outstanding problems with Russia, rendering Ukraine more secure than ever.

The domestic situation, by contrast, appeared all the more disturbing. Ukraine seemed unable to solve its economic and political problems. Economically, Ukraine had ended up in an underreform trap, which had political causes (Åslund, Boone, and Johnson 2001). Ukraine shared this dilemma with Russia, Moldova, Bulgaria, and Romania. All these postcommunist countries had started with slow and partial reforms because of lacking political support for radical and comprehensive market economic reform, which had proven to work so well in Central Europe and the Baltic countries (Åslund 2007a).

The big businessmen indulged in rent seeking, and the great economies of scale of rent seeking reinforced their wealth and political power (Murphy, Shleifer, and Vishny 1993). The unreformed but overregulated state imposed confiscatory taxes on, and extorted, ordinary entrepreneurs, driving them into the unofficial economy. The combination of a flourishing parasitical rent-seeking economy and a repressed productive economy caused a long-lasting decline in output and welfare.

The economic underreform trap had a political counterpart. Because of the miserable economic performance of postcommunism, the communist party remained popular and stayed orthodox. Their voters recognized the robber capitalism that Karl Marx had described so vividly, reinforcing their socialist mindset. The communists demanded high taxes and public expenditures, state ownership, more state regulation, and protectionism.

The big businessmen formed the political center. Paradoxically, they and the communists advocated similar policies. The oligarchs favored high taxes (because they paid fewer taxes than their smaller competitors), large enterprise subsidies (to themselves), and maximum regulation (which kept potential competitors down). The oligarchs opposed the rule of law out of convenience, while the communists did so on ideological grounds. The only major disagreement was private ownership, which the oligarchs favored for themselves, unlike the communists.

Ukraine's few true free marketers faced an impossible dilemma. They could not win on their own until a real market economy had come into existence, and they could not join hands with the communists who contradicted everything they stood for. Thus, classical liberals, such as Yushchenko, Yekhanurov, and Pynzenyk, were forced to compromise with the oligarchic center or stay in the political wilderness as Lanovyi. No electoral backlash could prompt the reforms necessary to break free from the underreform trap.

Paul D'Anieri (2006) has identified similar problems with Ukraine's constitutional design. Ukraine's persistent problem was that the parliament was a marsh of deputies floating between a dozen party factions, which made it almost impossible to form a parliamentary majority. First, "the stronger the executive, the less incentives for parliamentarians to compromise in order to form a majority coalition." Similarly, the "less power and privilege that accompanies the formation of a parliamentary majority coalition, the less reason there is to pay the costs. . . . In sum, then, the very existence of a strong presidency reduces the chances of maintaining a parliamentary majority." Kuchma did not help: "Several efforts to form a center-right majority were foiled through pressure by Kuchma on individual members, at the very same time that Kuchma was arguing that the absence of such a majority demonstrated the need for stronger executive powers" (D'Anieri 2006, 55).

Second, the weakness of the political parties made it more difficult to form a coalition, but electoral and constitutional arrangements had caused this frailty. Until 1998, political parties endured discrimination in the elections. The parliamentary rules still discriminated against large parties: ". . . because each party or 'faction' receives funding, staff, and membership on the presidium, parties that split into two receive more of those benefits as two small parties than as one big one. A strictly rational choice analysis would predict that parties would fragment to the smallest possible size in order to maximize the number of party leadership slots and staff funding available. Thus, the once-powerful Rukh split into three factions."[26] The weakness of the political parties caused a vicious cycle: "Because many parties are new, and have little to contribute in terms of money, organization, or reputation, individual politicians gain little from them. Similarly, prominent politicians have little to lose if they abandon their party" (D'Anieri 2006, 59).

The political and economic shortcomings of the semireformed post-communist countries, typified by Russia and Ukraine, were connected.

26. Herron (2002) pursues the same argument.

Since these states were neither full market economies nor full democracies, they did not deliver the virtues of those systems. Their populations were left with two alternative conclusions: They could blame their suffering either on the new system or on insufficient reforms. The key was to find a lever that could lift society out of its political and economic underreform trap.

One option was to strengthen presidential power further, proceeding to full authoritarianism: "First, with the parliament ineffective, many people viewed increased presidential power as the only alternative to deadlock. Second, even when many in parliament became worried about Kuchma's behavior, the parliament was ineffective in checking his power" (D'Anieri 2006, 58). D'Anieri (2006, 53) takes this point to its logical extreme: "Simply put, both left and right . . . saw Kuchma's authoritarianism as a lesser threat than the success of their adversaries." Russia chose this option under President Vladimir Putin, but Russia had already returned to sound fiscal policy and high growth because of the financial crash of August 1998, which made the politically impossible feasible (Åslund 2007b). Similarly, financial crises in 1997 had taken Bulgaria and Romania out of their underreform traps (Åslund 2007a).

An alternative way out of the underreform trap was increased economic and political competition among the elite: "Economically, rents need to dwindle through competition and new entry, while political power needs to be dissipated as a consequence of competition within the elite. The policy goal should be to foster such competition" (Åslund, Boone, and Johnson 2001, 89). Effectively, Ukraine chose this road.