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Lessons from Ukraine's Transformation

We know we are a European nation and that we are going to join the European Union.
—Deputy Prime Minister Hryhoriy Nemyria[1]

Ukraine has gone through 17 turbulent years of independence. During this time, it has recorded many achievements. The greatest triumph is that hardly any Ukrainian questions the sovereignty of the state. Another feat is that Ukraine has become a democracy, and a third accomplishment is that the country has a market economy with predominant private ownership.

At the same time, many tasks remain incomplete. The European Union has not yet recognized Ukraine's long-expressed desire to become a member. The most blatant shortcoming is the malfunctioning constitutional order, which gives the president the power to block government decisions and legislation but no incentive to be constructive. A transition to a parliamentary order would be most helpful. The electoral system for parliament, however, has undergone a successful evolution.

Among postcommunist countries, Ukraine is an exception because it delayed reforms for three years and even so built a market economy and democracy. The delayed reforms greatly aggravated the social cost of reforms. Their eventual success was probably brought about by the Ukrainians' strong sense of nationalism. The International Monetary Fund (IMF) played an important and useful role in deregulation and financial stabilization.

1. Speech at the Yalta European Strategy conference, July 12, 2008.

In few countries are oligarchs as strong as in Ukraine, and they are a double-edged sword. They take advantage of their privileged access to state services, but they also offer a kernel of competition in politics as well as business, which should be encouraged. Ukraine's democracy has much going for it, but the critical test is whether it can deliver sufficient results to the population.

With its European location and open market economy, Ukraine is bound to catch up with the developed West with sensible economic policies. In foreign policy, Ukraine has little choice but to turn to the West because Russia does not offer anything. An important Ukrainian achievement is its membership of the World Trade Organization (WTO). The next step is an Association Agreement with the European Union. An outstanding controversial issue is Ukraine's relationship with the North Atlantic Treaty Organization (NATO).

Constitutional Evolution and Shortcomings

Ukrainian politics came alive with the election of the republican parliament in March 1990, and it has remained an exciting political laboratory. The country's gradual political and economic evolution is peculiar. Most Central and Eastern European postcommunist countries were radical reformers and quickly became democracies, while most countries in the Commonwealth of Independent States (CIS) moved slowly on reform and fell into an authoritarian trap (Åslund 2007a, Havrylyshyn 2006). Today Ukraine is the only country within the CIS that the authoritative Freedom House (2008) classifies as "free" or democratic.

In its political evolution, Ukraine is more reminiscent of nonrevolutionary democracies, such as England and Sweden, than other postcommunist countries that had a quick democratic breakthrough or became authoritarian. True, it experienced the Orange Revolution, but most political scientists classify it as a democratic breakthrough rather than a revolution (McFaul 2006a). Three fundamental constitutional issues have been the choice between presidential and parliamentary rule, the electoral system for parliament, and central-regional relations. A fourth, judicial reform, has barely entered the political agenda.

Because of problems in reaching a substantive compromise, the constitution of June 1996 left many things to be determined by laws, most of which have not been adopted. Ukraine has ended up with a dysfunctional hybrid between a presidential and parliamentary system. Leonid Kuchma tried to resolve the problem by becoming moderately authoritarian. The constitutional compromise of December 2004 transferred substantial power from the president to the government and parliament, but it barely hangs together. The Rada has adopted some laws of constitutional significance, notably the Law on the Cabinet of Ministers twice, but since it is only a law and not a part of the constitution, it has been contested and not stuck as a constitutional rule. Therefore, most constitutional issues remain open and need to be settled.

Presidential or Parliamentary Rule

Ukraine's crucial problem is that it has been caught in the gray zone between a presidential and parliamentary system. The president has substantial power and could oust the prime minister, but he can do little constructive beyond foreign policy and appointments, since detailed executive power rests with the cabinet of ministers. As a consequence, all the three presidents of independent Ukraine have suffered from an interminable temptation to dismiss their prime minister, who has regularly been sacked once a year regardless of performance.

Ukraine's dilemma has two logical solutions. Either the president obtains more power—though all postcommunist presidential systems but Georgia have become authoritarian—or a parliamentary system is adopted. All postcommunist countries with such a system are democracies. Therefore, Ukraine needs a parliamentary system.

The persistent strife over whether Ukraine should have a presidential or parliamentary system has been aggravated by the absence of the clear division of powers that Montesquieu [1748] recommended. Admittedly, Article 6 of the constitution provides for such a separation of state power among the legislative, executive, and judicial powers, but the organization of state power has not allowed that commitment to be substantiated (Futey 1997). The parliament has engaged in executive decision making, especially on budget allocation and privatization, while President Kuchma insisted on using his quasi-legislative powers to issue presidential decrees on major economic issues. Intermittently, the prime minister assumed substantial power, playing parliament and president against one another.

In comparison with other postcommunist countries, Ukraine has promulgated a minimum of legislation. A comparative World Bank study of 2005 singled out Ukraine and Georgia as reformist transition countries displaying a disconcerting lacuna of legislation (Anderson, Bernstein, and Gray 2005, 24). The president, and sometimes the prime minister, has complained about the parliament legislating too little, but the parliament has responded that the president aspired to authoritarian power without sufficient checks and balances. Both are right.

The stalemate developed into a caricature in 2008, when Prime Minister Tymoshenko could make no decision without President Viktor Yushchenko vetoing it. The parliamentary minority has also continued a long-held tradition of blocking work in parliament by walking out to eliminate a quorum or by physically occupying parliament. In the otherwise peaceful Ukrainian society, rowdy parliamentarians disregard elementary order.

Law does not apply to them because parliamentary immunity goes too far, and sabotage has worked.

Paul D'Anieri (2006, 55) has offered a plausible explanation for the dearth of legislation. The parliamentary majority had so little power over the executive that it had little incentive to form or maintain a majority and thus to legislate. By this reasoning, "the very existence of a strong presidency reduces the chances of maintaining a parliamentary majority." People interested in legislation did not try to enter parliament. Instead, businessmen intent on solving their personal business concerns paid big money for a seat. D'Anieri (2006, 56) concludes: "Ukraine's strong presidency is inherently problematic for the construction of liberal democracy."

A substantial political science literature has analyzed the comparative advantages of presidential and parliamentary systems, and the dominant view is that parliamentary systems are preferable from a democratic point of view (Linz 1990), as reflected in the postcommunist world. Moreover, in Central and Eastern Europe mixed presidential-parliamentary systems have evolved in a parliamentary direction with democracy. In the CIS, the most democratic countries—Ukraine, Kyrgyzstan, Moldova, and Armenia—have recently been moving in a parliamentary direction, while the authoritarian countries have reinforced presidential rule. The correlation between democracy and parliamentary system is strong (Åslund 2007a, Freedom House 2008).

Analytically, it is easy to understand why parliamentary systems breed stronger democracies in the postcommunist world. Parliamentary systems offer more transparency and accountability than a presidential system does. A parliament can supervise a government relatively closely, while presidents and their administrations tend to be nontransparent and unaccountable. In the former Soviet countries in particular, presidential administrations recreate the central committee of the communist party, and the gubernatorial administrations the regional party committees, with their "telephone law" of secretive, arbitrary, lawless, and unaccountable intervention. Characteristically, the Ukrainian presidential administration is housed in the old central committee building. Under these conditions, parliamentary rule is preferable.

An additional explanation is that the Central and Eastern European countries are members of the European Union. Although the European Union does not require parliamentary rule, peer pressure makes candidates conform to most political institutions of the older EU members.

Until his last year in power, President Kuchma called for more presidential power to carry out economic reform. Russian Presidents Boris Yeltsin and Vladimir Putin and President Nursultan Nazarbayev in Kazakhstan pursued the same argument. The postcommunist record, however, is the opposite: The stronger the parliamentary powers (and democracy), the more far-reaching and comprehensive the market economic reforms (Bunce 1999, Åslund 2007a).

In reality, however, presidential decrees have turned out to be far less effective than laws promulgated through parliament. Suddenly written and adopted presidential decrees lack both credibility and following, while laws that are scrutinized and amended in parliamentary committees are usually of superior quality and generate an influential support group. Thus, laws are preferable to presidential decrees for substantial reforms (Protsyk 2004; Remington, Smith, and Haspel 1998).

Kuchma's presidency had two reform periods, fall of 1994 and 2000. Pavlo Lazarenko easily reversed many of the 1994 reforms, most of which were carried out through decrees and could be easily changed, while none of the 2000 reforms was reversed, as they were properly legislated by parliament.

A strong state is legal, transparent, and accountable. Naturally, a vital complement is a far-reaching law on public information, which offers maximum transparency. Characteristically, the most far-reaching laws on public information exist in Scandinavian countries, which are parliamentary stalwarts.

Electoral System for Parliament

The evolution of the electoral system has been the most productive. In 1990 Ukraine started off with a one-chamber parliament elected entirely through majority vote in single-mandate constituencies, without parties but with repetitive elections because of high turnout requirements. This cumbersome system did not reveal the population's political preferences and multiple reruns were demoralizing, leading to weak party factions. On the positive side, Ukraine has stuck to a one-chamber parliament, which has facilitated the maintenance of democracy.

The 1994 elections brought no real change. Political parties were allowed but suffered from discrimination. Repeat elections were even worse than in 1990 because of higher voter turnout requirements, and the parliament was never completely filled. But these tedious reruns prompted electoral reform.

The 1998 parliamentary elections introduced two significant improvements. First, the turnout requirement was relinquished, ending the annoying repeat elections and allowing the parliament to be filled on election night. Second, the elections became semiproportional, with half the seats being elected through party lists, while the other half were still filled through majority vote in single-mandate constituencies. In the proportional elections, a threshold of 4 percent was introduced. This system rendered the party factions more cohesive, but at 14 they were still too many, because the internal parliamentary rules promoted splits in many party factions to achieve more committee representation and resources from the parliament.

In 2002 the same electoral rules applied as in 1998, and the results were overtly similar with 13 party factions, but these elections discredited the single-mandate constituencies, because the distribution of seats varied greatly from the proportional vote, exposing the outcome as grotesquely unjust. The opposition won no less than 70 percent of the votes in the proportional elections, but the incumbent government maintained power by buying or bullying "independent" deputies.

The 2006 elections introduced purely proportional elections, which profoundly changed the party system. At long last, the number of parties represented in parliament declined to five, with three big center-right parties and two small left-wing parties. The threshold for representation had been reduced to 3 percent. The Ukrainian parliament seemed to have found its structure. The extraordinary elections in 2007 produced a very similar result, with five parties being represented in parliament.

Thus, by 2006, Ukraine seemed to have found a suitable form of parliamentary representation. The electoral system had moved from individual to party-based, from a majority election in single-mandate constituencies to proportional party list elections with a threshold of 3 percent. The party system had consolidated into three major parties and two small parties. The only remaining discussion about the electoral system is the means to impose party discipline and whether the threshold for representation should be raised.

Unfortunately, much of the political activity aims at breaking up other parties rather than finding compromises with them. A solution, which Yuliya Tymoshenko has championed, is a so-called imperative mandate, making a party rather than the individual deputy owner of a seat in parliament. If a deputy abandons a party, he or she would have to give up the seat to the next person on the party list.

A major concern is political financing. The two recent parliamentary elections have cost about half a billion dollars each in private campaign financing, approximately as much as an election to the US House of Representatives, but the United States is nearly 100 times richer than Ukraine. This money is given by big Ukrainian businessmen who want to defend their assets and promote their commercial interests. Some businessmen have made politics their business. In the 2007 elections, some businessmen reportedly paid up to $10 million for safe seats on party lists compared with $5 million in the 2006 elections.

The best means of avoiding the purchasing of seats on party lists would be to introduce personal choice of any person within a party list, abandoning fixed party lists. The German and Finnish systems of proportional elections with personal choice have found such a solution. To return to single-mandate constituencies is no cure because the 2002 elections showed that businessmen preferred to buy such seats as they were cheaper than party list seats. Transparency in political funding would be desirable but appears utopian.

Finally, much less should be up for sale in parliament. If a parliament attracts this kind of financing, it should have no say in privatization, which needs to be completed, and less of a say in the distribution of public funding, which should be standardized, simplified, and made more transparent. Parliamentary and budget rules should minimize horse-trading in parliament. The corruption in parliament is a strong argument for a very small public sector in ownership and redistribution in Ukraine.

Central-Regional Relations

Ukraine maintains the communist overcentralization of state administration, and a rational division of power between the central state and regional and local governments is still to be found. The number of regional governments, 27, seems about right. The central government has feared losing control over the regional executives, but the outcome has been excessive centralization, leaving regional governments disfranchised and dysfunctional. At the same time, disputes have prevailed between appointed regional executives and elected regional assemblies, resulting in poor regional governance. Substantial state powers need to be decentralized to regions and municipalities. Ukraine must not try to reestablish the old communist or Putin's "strong vertical," which has caused such damage to Russia through policy paralysis and aggravated corruption.

Ukraine has inherited extreme financial centralization from the Soviet Union. As in the old Soviet system, virtually all taxes go to the central treasury, and the Ministry of Finance determines the expenditures of regional authorities, but formal power and actual control do not coincide. The situation is untenable. A first attempt at solution came through the 1996 constitution, which centralized power to the president, who received the right to appoint the regional governors. In parallel, the central government centralized financial flows.

However, the extreme financial and political centralization paralyzed the whole Ukrainian state because regional authorities had few legal rights to do anything on their own. Only a few percent of their financial resources originated in their own taxes. The central government's allocations were often haphazard because of poor budgeting and arbitrary sequestration. Barter and offsets evolved as a means for regional governments to divert tax revenues from the central state to the regions. Regional and local taxes started proliferating.

Each regional government invented taxes to cover its own needs. These taxes were usually licensing fees or penalties, extracted through arduous inspections, often designed for individual, profitable enterprises (Kravchuk 1999). As a consequence, profit-making enterprises without political protection were overgrazed, often fatally. In 1997 I met a devastated director of the Kyiv brewery Obolon, who told me that her cash-strapped city district had introduced a hefty licensing tax on mineral water. This brewery was the only producer of mineral water in that district, so this was an individual tax, which was actually legal.

Regional governments had flawed incentives, with no rewards for collecting more official revenues or delivering them to the center. Kravchuk (1999) found that the marginal tax effect on Ukrainian regional governments was over 100 percent. Thus, if they collected more revenue, they retained less income.

The incentives of regional and local governments need to be aligned so that they stop behaving like predators, raiding enterprises in the hunt for penalty fees. Shleifer and Treisman (2000) investigated the same problem in Russia. They argued that local authorities would respect enterprises if they were dependent on taxes from them. Similarly, if local governments were given charge of regional services, they would be more responsible. The logical conclusion was that taxes and expenditures should be clearly divided between the center, the regions, and the municipalities, while tax transfers should be minimized. Each level of government should be fully responsible for certain taxes with separate tax bases. Value-added taxes and foreign trade taxes are typical central state taxes, while land and small enterprise taxes are usually local taxes. Defense and foreign affairs are characteristic central expenditures, while schools, roads, and local infrastructure belong in the local sphere.

The necessary political complement to regional self-government is the full democratization of regional and municipal governments. Both regional and municipal executives and legislative assemblies should be elected, as is currently the case, but the regional governors should also be elected rather than appointed by the president. The central government should give real powers to regional and municipal governments.

Need for Judicial Order

One of Ukraine's greatest failures has been reform of its judiciary, which is corrupt and in a state of disarray. A profound and comprehensive judicial reform is needed. Elementary order must be established in the judicial system. Four criteria need to be fulfilled: a clear hierarchy of justice, independence and qualifications, sufficient financing, and transparency. In order to accomplish such a judicial reform, Ukraine would need to adopt a large number of laws (Blue Ribbon Commission for Ukraine 2005).

The 1996 constitution outlined the judicial system in too rudimentary a fashion. Judge Bohdan Futey (1997) identified its fundamental flaw: "[T]he Constitution, in fact, prevents the establishment of a truly unified judiciary, because divisions between the courts of general jurisdiction and the Constitutional Court are not clear." Often parties to a conflict are entitled to take one case to different courts at the same level, and the courts fight it out. A clear distribution of jurisdiction and hierarchy is needed. In particular, Soviet superiority of the prosecutors over the judges must end.

At present, judges depend on the executive for financing and appointments. Instead, the judicial system should be rendered independent of the executive but also be made accountable. Judges need a fair amount of freedom, but it should be possible to sack corrupt judges. Therefore, independent associations of judges should evaluate and appoint judges to reinforce the integrity of the judicial system. The qualification demanded of judges should be specified, and the appointment of judges should be transparent.

Corruption in Ukrainian courts is pervasive (EBRD and World Bank 2002, 2005). Bribes are paid at every step from entry into law school to the appointment of judges. Corruption has to be fought by many means. Transparent examination and evaluation of judges would be a start. Judges have to be decently remunerated, and courts need to be properly financed and equipped. Financing should be transparent and firmly regulated, free of administrative pressure.

Transparency is the best means of exposing corruption and incompetence, and the internet offers unique new opportunities. Not only all laws and decrees but also all verdicts should be published on the internet, exposing inconsistencies in judgments. Finally, if legal verdicts are to be respected, they have to be executed effectively and expediently within a reasonable time through an effective bailiff service.

To a considerable extent, Ukraine is evolving without a judicial system. Decent parties avoid going to Ukrainian courts, which are often coconspirators in corporate raiding. Instead, serious Ukrainian companies apply international law to settle their conflicts. As a consequence, Ukrainian lawyers are thriving on double work, having to avoid Ukrainian law as well as applying foreign law.

To date, Ukraine has been remarkably successful without a judiciary, but this good fortune is unlikely to continue. Functioning legislative and judiciary branches are necessary to guarantee property rights because foreign legislation and courts may be used to reinforce contracts but not domestic property rights (Acemoglu and Johnson 2005).

Ukrainians increasingly turn to the European Court of Human Rights at the Council of Europe in Strasbourg when they are dissatisfied with the judicial proceedings in their own country, and fortunately Ukraine recognizes the verdicts by this international court, which serves as an important corrective.

Why Ukraine's Capitalist Transformation Succeeded

Ukraine is a market economy, according to the definition presented in the introduction. Among the most important milestones are: Prices and trade have been sufficiently free since November 1994. In 1996 Ukraine's inflation had abated, and by 2000 its financial stabilization was secure. Since 2000, more than 60 percent of Ukraine's GDP has originated in its private sector (figure 3.3).

The most relevant measure of a country's degree of market economy is the composite transition index of the European Bank for Reconstruction and Development (EBRD), which ranks countries from no market economy (0) to normal Western market economy (1). By 2000 Ukraine had just about reached 0.7, the level of a full-fledged market economy (figure 5.2).[2]

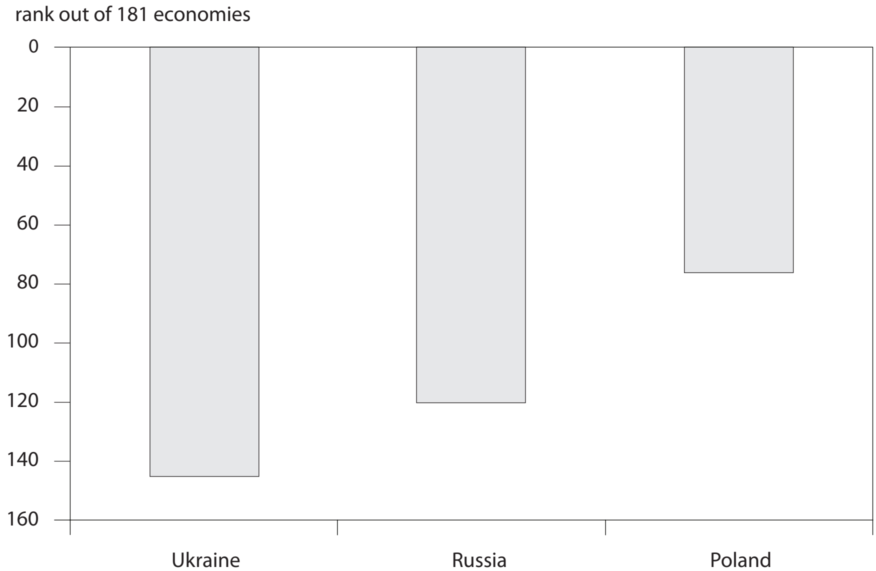
The key feature of a market economy is that free individuals and independent firms predominantly make economic decisions. Ukraine's distribution is completely private and independent. No State Planning Committee tells enterprises what to produce. Nor does the state allocate goods. Prices and trade are mostly free, and Ukraine's subsidies are small. Transactions are overwhelmingly monetized, and financial markets have evolved.

The most damaging features of the Ukrainian economy are the degree of lawlessness and bureaucratic interference. On the annual Doing Business index of the World Bank and International Finance Corporation (2008), Ukraine ranks 145th among 181 countries, while Poland ranks 76th and Russia 120th (figure 9.1). Curiously, Ukraine's only good rankings are for getting credit (28) and enforcing contracts (49), which is clearly not done through Ukrainian courts (figure 9.2). Ukraine is rated as one of the worst countries in the world when it comes to dealing with construction permits and paying taxes. All activities that involve the state are exceedingly difficult for enterprises in Ukraine, including closing a business, protecting investors, registering property, trading across borders, and starting a business. The Ukrainian business and investment environment is very poor.

Ukraine's transition to capitalism has arrived, and it appears irreversible. The remarkable thing about this transition is that it succeeded despite the three-year initial delay, during which Ukrainians had to endure hyperinflation and miserable economic failure. Hyperinflation usually leads to regime change, and in other semidemocratic former Soviet republics it augured authoritarianism, but in Ukraine its political effects were surprisingly limited.

2. This definition does not include any criterion for rule of law, which does not seem to be a necessary prerequisite.

Figure 9.1 Ease of doing business rankings, 2008



Source: World Bank, *Doing Business Report 2009*, www.doingbusiness.org (accessed on September 16, 2008).

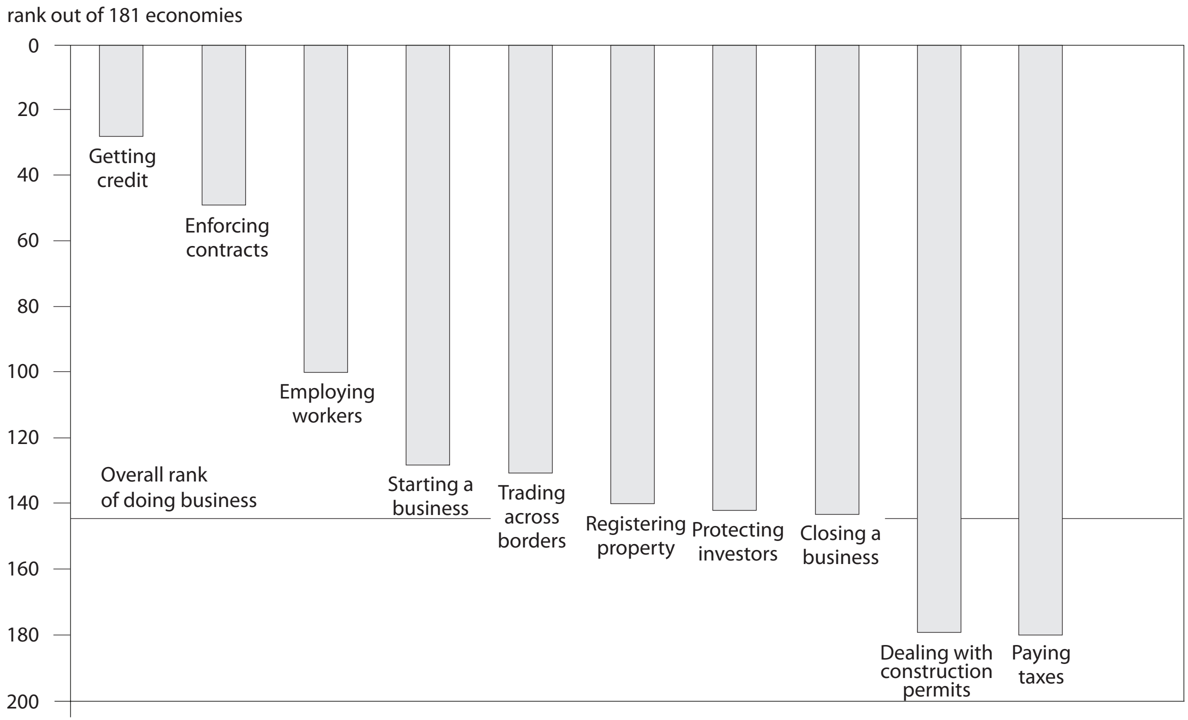
In economic terms, Ukraine verifies the danger of delayed transition to a market economy, which did not benefit the nation in any regard. It aggravated inflation, output collapse, social suffering, and corruption.[3] Nor did the agony contribute to any great intellectual insights. Those who complained about Russia's rash reforms (notably Stiglitz 1999, 2002) had better pair it with the far greater misery in Ukraine.

Yet, Ukraine displayed impressive moral strength, enabling its population to stoically endure. Nobody thought transition would be easy, but nobody showed more patience than Ukrainians. A major mitigating factor was Ukrainian nationalism. Ukrainians knew they were suffering in order to attain independence for their state, and they thought that was worth their endurance. Ukrainians say derogatively of themselves, *moia khata z kraju*, which means "my cottage is to the side," indicating their desire to stay out of world affairs. This indifference lasted until the Orange Revolution, when Ukrainians engaged in society and posed new demands.

After three years of no policy, 1991–94, Ukraine carried out a classical, orthodox macroeconomic stabilization. Public expenditures were cut by

3. De Melo and Gelb (1997), De Melo, Denizer, and Gelb (1997), Berg et al. (1999), Fischer and Sahay (2000), Havrylyshyn (2000), Havrylyshyn and Wolf (2001), Campos and Coricelli (2002), Fischer (2005), and Havrylyshyn (2006).

Figure 9.2 Ease of doing business in Ukraine, by category, 2008



Source: World Bank, *Doing Business Report 2009*, www.doingbusiness.org (accessed on September 16, 2008).

11 percent of GDP from 1994 to 1996, shrinking the budget deficit from 8.7 to 3.2 percent of GDP (figure 3.1). The stabilization was severely complicated by the delay. Because of no international creditworthiness, even such a limited budget deficit was difficult to finance. As a consequence, Ukraine's real interest rates were extremely high for years. The tax system had become confiscatory and driven a large part of the economy underground. An extensive system of rent seeking had developed, involving numerous tax loopholes, subsidies, and dishonest practices. An early stabilization could have halted these malpractices before they became entrenched (Boycko 1991; Murphy, Shleifer, and Vishny 1993).

The political origin of the financial stabilization was Kuchma's election as president in July 1994. The crowning of the stabilization was the symbolically important introduction of the hryvnia in September 1996, which was managed by the chairman of the National Bank of Ukraine, Viktor Yushchenko. As prime minister in 2000, Yushchenko completed the stabilization by cleaning out the worst remaining rent-seeking practices.

Also, with regard to privatization, Ukraine wasted its first years of independence. The breakthrough year was 1994, when a certain legal and administrative base was laid, and Yuriy Yekhanurov became chairman of the State Property Fund. Like Anatoly Chubais in Russia, he was determined to carry out Ukraine's privatization however possible. He chose a three-pronged approach: First, he accepted substantial insider privatization; second, he promoted mass privatization through vouchers; and third, he encouraged some outside purchases.

In the end, most stocks went to insiders because privatization had been delayed and the powers of the incumbents had grown too strong to be overruled. As elsewhere, privatization to outsiders was most controversial, and the more transparent such sales were, the more upset the public became, as the Kryvorizhstal auction showed. With some delay, privatization led to restructuring, and as in other postcommunist countries little positive happened before privatization (Estrin and Rosevear 1999; Akimova and Schwödiauer 2000, 2002, 2004).

Role of the IMF

From 1994 to 2000, the IMF was the dominant international organization in Ukraine. It played a major and very helpful role in the country's macroeconomic stabilization.

From early 1992 until August 1994, IMF missions visited Ukraine, but they failed to win the ear of the government and could thus not help in composing any reform or stabilization program. Still, the very presence of the IMF and iterative conversations helped the few progressive forces in the Ukrainian government to evolve and structure their economic thinking.

The finest deed of the IMF was the Systemic Transformation Facility that it agreed with the Ukrainian government in the fall of 1994. It started with a visit by IMF Managing Director Michel Camdessus, and throughout the 1990s both he and his first deputy Stanley Fischer kept a keen eye on Ukrainian developments. The IMF and the Ukrainian government acted with speed and agility. This agreement marked Ukraine's transition to a market economy, deregulating prices and trade as well as leading to financial stabilization.

The IMF was highly active in Ukraine during the period 1994–2000. It provided many services. Perhaps most important, it forced the Ukrainian government to focus on its financial problems and suggested solutions. The IMF had only a few technical resident experts in Kyiv, but they made major contributions. By and large, IMF policy advice was sound. The worst piece of advice was probably the adoption of a currency corridor from 1996 until 1998, as in Russia, which led to an abrupt devaluation in the fall of 1998 after a severe loss of international currency reserves.

The Ukrainian leaders listened carefully to IMF officials because the IMF was Ukraine's main source of international funding in these years of crisis. From 1994 until 1999, it gave Ukraine credits of a total of 2.5 billion special drawing rights (about $3.5 billion) in stabilization funding (Åslund 2002, table 10.5). This funding boosted Ukraine's meager international reserves, which tended to hover around $1 billion. The IMF also assisted Ukraine with its complex debt negotiations, primarily on gas arrears owed to Russia and Turkmenistan.

Ukraine and the IMF concluded approximately annual Stand-By Arrangements, and the IMF gave Ukraine a few hundreds of millions of dollars each year in credits. Importantly, the IMF carried out detailed reviews every quarter, and the money was disbursed in tranches. About every second time, the IMF held up its disbursements because Ukraine had not fulfilled some of the conditions. By frequently refusing to pay, the IMF imposed more authority and was listened to. At the time, the IMF was in the center of the public discussion about Ukraine, with some arguing that the IMF was too tough, while others claimed it was too lenient.

The irony is that when Prime Minister Yushchenko carried out Ukraine's second big reform in 2000, he had to do so without IMF support because the IMF had cut off Ukraine from credits after the revealed manipulation of central bank reserves in 1996–98, which had made the IMF pay three more tranches than it otherwise would have done (IMF 2000b). Yet the IMF persisted in the background and made an intellectual contribution by setting a standard for procedure and policy.

On the whole, the IMF as an organization can pride itself in having achieved its goals in Ukraine at limited cost and with limited resources. Ukraine has long paid back all the IMF credits with interest. Apart from the Soros Foundation, no other organization could measure itself in importance with the IMF. The World Bank also played an important role, but structural reforms, which are its bailiwick, are still lagging behind. Together with the US Agency for International Development, the World Bank can claim Ukraine's privatization as its greatest success.

When Ukraine unexpectedly entered a new financial crisis in October 2008, the IMF easily and effectively returned to Ukraine and quickly concluded a substantial Stand-By Arrangement both in terms of conditionality and financing ($16.4 billion).

Impact of the Oligarchs

Two critical intertwined questions for Ukraine's future are how its oligarchy will develop and whether its democracy will survive. Few societies are as oligarchic and still formally democratic. Oligarchies as well as democracies have certain characteristics that drive them in specific directions.

Daron Acemoglu (2003) investigated the problems of property rights in an oligarchic versus democratic society. He defined an oligarchic society as a "society where political power is in the hands of the economic elite," comparing its distortions with those of a democracy, in which political power is more equally distributed.

The disadvantage of democracies is that they tend to drive up taxes and redistribute income from entrepreneurs to workers, discouraging entrepreneurial investment. Ukraine faces this challenge. It has as high a tax burden on its official sector as the democratic Central Europe (figure 5.4, Tanzi and Schuknecht 2000). It rose with the Orange Revolution, and the tax revenues go predominantly to social transfers.

The problem with an oligarchic society, in Acemoglu's view, is that it offers a less level playing field. It restricts the entry of new enterprises, distorts the allocation of resources, and redistributes income toward entrepreneurs by reducing wages. One may say that oligarchs have less interest in law because laws and rule of law tend to defend the small against the big (Sonin 2003), which Ukraine confirms.

Growth depends on which distortion has the greatest economic impact. Acemoglu (2003) suggested that typically an oligarchy first grows faster but later is less dynamic than a democratic society. Postcommunist transition initially produced the opposite pattern. Until 1998, democracy drove market reforms and economic growth because the main problem was extraordinary rent seeking, which benefited the oligarchs. From 1999, however, the opposite pattern has emerged. The negative effects of high taxation, high social transfers, and overregulated labor markets kept growth down in Central Europe, while the CIS oligarchies took off in 1999 and delivered about 9 percent annual growth until 2007. Low taxes and free labor markets drove their growth (Åslund 2007a).

Yet the liberal argument for leveling the playing field, reducing corruption, and facilitating entry of new entrepreneurs remains strong and sound. Corruption in Ukraine is severe and benefits the wealthy, endowing them with more rights than other people have. Eventually, the wealthiest will have an interest in reinforcing their property rights. The scare of reprivatization in 2005 showed that not even the richest were safe. Currently, the Ukrainian oligarchs spend inordinate amounts of money on politics to reinsure their property rights in each election. But these expenditures warrant them great privilege unattainable to ordinary businessmen. Legally, political financing is strictly limited, which has only rendered it clandestine.

Oligarchy and democracy are often discussed in static terms, but dynamics are key. Ideally, competition among big oligarchic groups should be so intense that they check each other's power and elaborate standardized rules, and that many competing business groups emerge. This happened from 2000 until 2004, laying the foundation for the Orange Revolution, in line with Robert B. Ekelund and Robert D. Tollison's (1981) interpretation of the evolution of competition between the crown and the parliament in Britain, which led to both economic and political competition—that is, a competitive market economy and democracy.

The situation after the Orange Revolution, however, is more reminiscent of a suboptimal equilibrium or a game without a stable solution. Three major oligarchic groups back three different oligarchic parties, and they balance one another so effectively that hardly any decisions are made. Neither progress nor regression occurs, which is characteristic of a conservative society in equilibrium. However, this equilibrium is probably only temporary because all the four leading oligarchic groups are primarily in steel, and they have benefited from an extreme boom in international steel, which ended in 2008 and is not likely to be repeated. The financial crisis and steel recession will probably lead to profound political and economic change.

The worst threat to democracy would be that one oligarch buys Ukrainian politics lock, stock, and barrel and runs it as his private enterprise, as Kazakhstan's President Nursultan Nazarbayev or Azerbaijan's President Ilham Aliyev have done. After the elections, such an oligarch could recoup his investment through a couple of friendly privatizations. The current concentration of wealth combined with the absence of law and ethical standards make it all too tempting to buy politics. However, the risk of such an oligarchic purchase is not all too likely in Ukraine because its civil society and freedom are too great.

Ukraine is still run by its steel barons, who have rationalized and streamlined their corporate structures (Frishberg 2006), but several of them will probably not be able to survive or move to other industries. The weakest companies will lose out, and some owners will choose to sell their assets. It is easy to predict that the steel groups that are not shielded from price vagaries through vertical integration or diversification will go under. Businessmen in other industries will rise and overtake the steel barons in wealth. Structural change is likely to result in increased economic and political pluralism.

When asked how to normalize their society, Ukrainian oligarchs' usual answer is complete privatization. Big businessmen invest so much in unreliable politicians because the government has many valuable companies left to sell. If privatization were completed, the incentives for extreme corruption would dwindle. Even if privatization has been standing almost still since the Orange Revolution, it appears irreversible and is making some progress. One huge privatization within reach is that of agricultural land, which will occur when private sales of agricultural land are permitted.

Ukraine is strongly influenced from abroad by both East and West. Strong, positive Western influences are apparent, from foreign trade and investment, from Ukrainian investment activities abroad, and from EU peer pressure.

Foreign direct investment in Ukraine is a powerful influence. Often, foreign companies buy big enterprises that Ukrainian businessmen have restructured. In recent years the Ukrainian banking system has been cleaned up because the country's big bankers realized they could sell their banks to foreigners for splendid profits if they cleaned up their corporate structures and accounts before selling them. About 40 percent of Ukraine's banking assets belong to foreign banks, twice as much as in Russia. The Ukrainian banking system is almost entirely private and, as a consequence, stronger and cleaner than Russia's banking system, which is half owned by the state. Russia, however, has better commercial legislation and a functioning judiciary.

In recent years, big Ukrainian businessmen have been selling shares of their companies through initial public offerings, usually on the London Stock Exchange. Because of such prospects, Ukraine's biggest businessmen, Rinat Akhmetov and Victor Pinchuk, streamlined their corporate structures and maintained internationally audited accounts for years before selling shares of their companies. Meanwhile, the publicly assessed value of their assets multiplied.

The European Union's enlargement process puts multiple peer pressures on burgeoning new members. Ukraine aims to become a member of the European Union, so the prospect of this peer pressure exists, but it has not become effective as yet. Ukraine has already committed itself to dozens of institutional improvements in the initial action plan that it concluded with the European Union in February 2005 as part of the EU European Neighborhood Policy. Ukraine is currently negotiating a European Association Agreement, which will contain many more institutional demands. The European Union is offering direct institutional interaction through its twinning of state agencies. The European Union also directly influences Ukrainian subjects. The big Ukrainian business corporations, notably the Industrial Union of Donbas, System Capital Management, and EastOne, are all interested in investing in the West and are aware that they can do so only if they keep up their reputation.

However, these positive trends are counterbalanced by bad habits such as corporate raiding. Some businessmen know that old-style business is their comparative advantage, and they do not want to move on. Corporate raiding thrives in Ukraine, and it is sustained by the rudimentary corporate legislation. An expanding businessman can buy any court. According to Ukrainian corporate law, a general shareholders' meeting must gather 60 percent of the votes to achieve quorum, which has made it possible for Privat Group to control Ukrnafta for years with only 42 percent of the shares, although the state owns the majority (EBA 2004, OECD 2004). Thus strong vested interests long opposed the adoption of an ordinary law on joint stock companies.

To a considerable extent, Ukrainian companies have escaped these problems when enforcing contracts by applying international law and utilizing private arbitration courts abroad, but they always risk a Ukrainian court declaring such practices illegal. The combination of rudimentary legislation, arbitrary courts, and contested state power is hazardous and uncertain because the state interferes in the most surprising fashion.

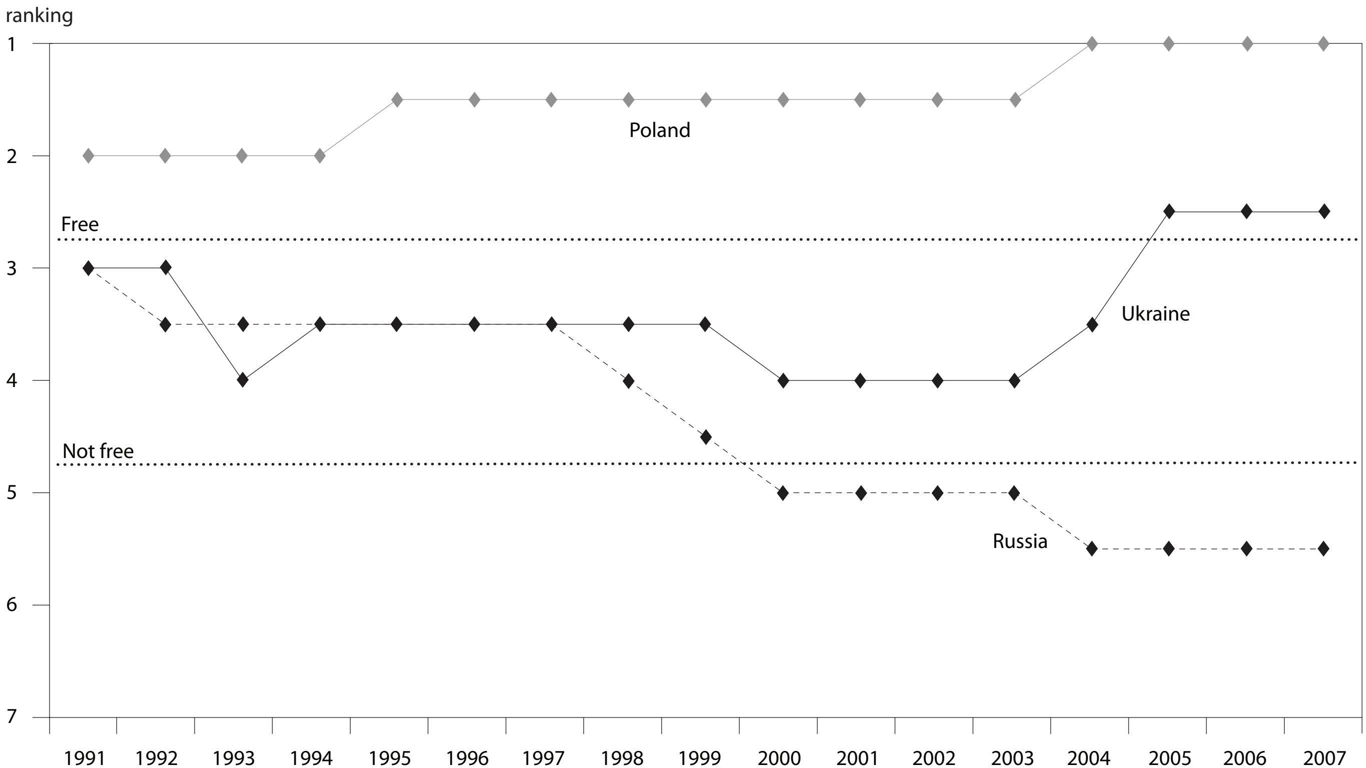
A big question is whether Ukraine can impose the rule of law on its oligarchs. The introduction of guaranteed property rights would mark the crossing of the threshold to mature capitalism, and the Ukrainian oligarchy would gradually reduce its corruption and be transformed into a democracy. Then a normal legal system, which can discipline the oligarchs, could evolve. This usually happens when developing semiauthoritarian countries become democracies, and the Orange Revolution seemed to complete that process. Yet no political solution is likely to hold if it is not supported by a strong and broad ideological commitment to the sanctity of private property. If people are not convinced that they need capitalism for their own good, they are not likely to accept the permanence of the super-rich.

Will Ukraine's Democracy Survive?

The postcommunist countries have chosen either full democracy or authoritarianism. Ukraine is unique, in that it is the only CIS country Freedom House (2008) ranks as free. Figure 9.3 contrasts Ukraine with Russia and Poland. Poland, like the rest of Central Europe and the Baltic states, became free with the end of communism and has stayed democratic.

Ukraine and Russia, however, were semidemocratic in the 1990s. Substantial political and civil freedom was granted as communism collapsed, but they were not properly legislated or implemented. Still, Boris Yeltsin

Figure 9.3 Civil and political rights, 1991–2007



Source: Freedom House, *Freedom in the World Historical Rankings*, http://freedomhouse.org (accessed on September 16, 2008).

and Leonid Kuchma did not try to concentrate all power in their hands. They played everybody against each other, being the ultimate arbitrators. As a consequence, pluralism prevailed. In the late 1990s freedom in Russia started declining and the country became successively more authoritarian under Vladimir Putin, who concentrated power in his own hands with the help of the old KGB structures (Åslund 2007b).

Ukraine never endured the same decline in civil and political rights as Russia under Putin, thanks to Kuchma's continued divide and rule. The Orange Revolution enhanced freedom, rendering Ukraine a democracy. The freedoms of media, expression, assembly, and belief have been fully respected, and Ukraine has held three free and fair elections. Its main shortcomings are poor rule of law and a high level of corruption.

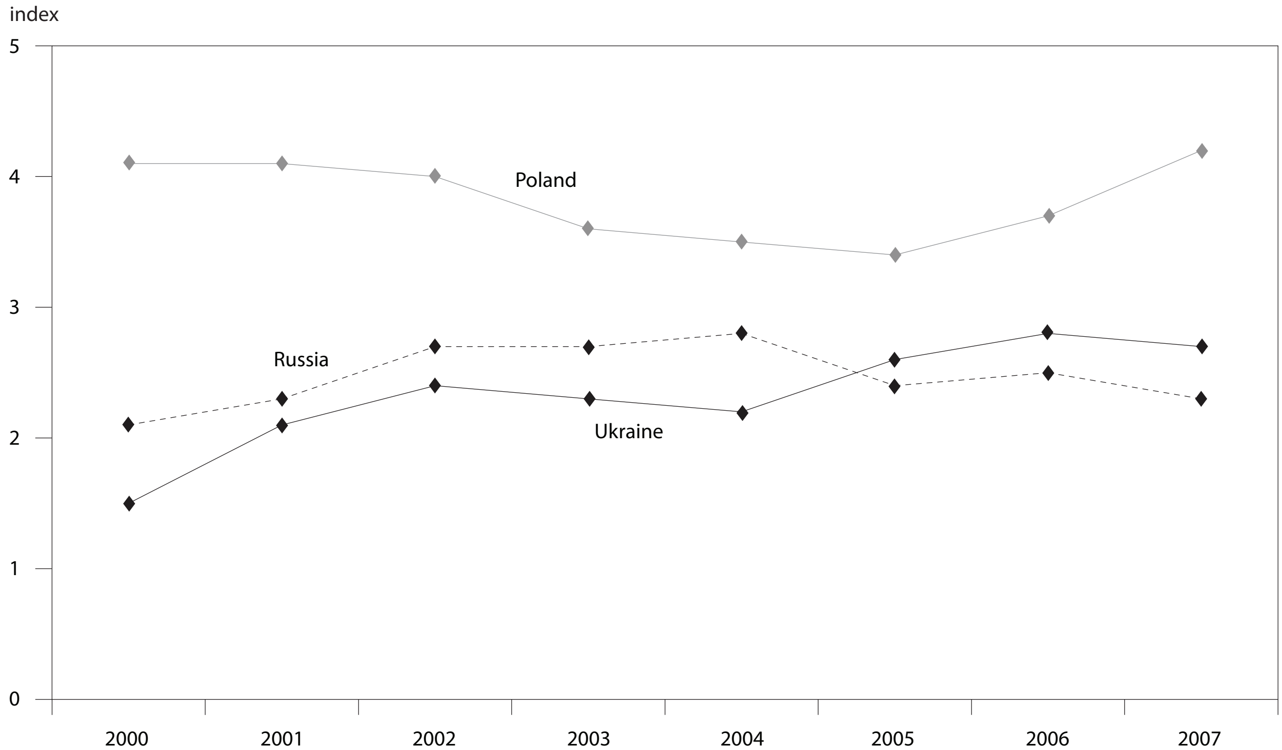
Again, a comparison with Russia is helpful. Both Ukraine and Russia are profoundly corrupt by international standards. Transparency International's (2008) corruption perceptions index offers an annual comparison (figure 9.4). From 2000 until 2004 Ukraine was more corrupt than Russia, but since 2005 Ukraine has become less corrupt and Russia more so. The Orange Revolution exposed corruption, while Russia's increased authoritarianism facilitated corruption. The Business Environment and Enterprise Performance Survey (BEEPS) carried out by the EBRD and the World Bank in 2002 and 2005 offer the same conclusion (Anderson and Gray 2006). Yet anecdotal evidence adds another dimension. Businessmen are often exasperated with Ukraine because it is impossible to get decisions made due to disorderly corruption. They do not know whom to pay, or the official they have paid does not deliver (Shleifer and Vishny 1993). In Russia, by contrast, it is usually easier, but the ultimate problem is when a top official decides to take over an enterprise because then no rescue exists.

Will Ukraine lead the CIS countries toward democracy, or will it succumb to the authoritarianism characteristic of this region? As discussed in the introduction, Ukraine easily fulfills the criteria for a democracy that Juan Linz (1978, 5) offers: freedom to formulate and advocate political alternatives, rights to free association and free speech and other basic freedoms, free and nonviolent competition among leaders with periodic validation of their claim to rule (elections), inclusion of all effective political offices in the democratic process, and freedom to participate in the political process regardless of political preferences.

The critical issue is whether the nation, its political institutions, and socioeconomic system may be considered legitimate. Linz's (1978, 18) minimal definition of "a legitimate government is one considered to be the least evil of the forms of government."

The legitimacy of the nation falls into two issues: the security of the borders and the cohesion of the nation. Dankwart Rustow (1970) emphasized the importance of securing the borders of a state before any democracy could be built. A state without secure borders cannot be stable (McFaul

Figure 9.4 Corruption perceptions index, 2000–2007



Note: The index is from 0 (highly corrupt) to 10 (highly clean).

Source: Transparency International, www.transparency.org (accessed on July 1, 2008).

2001, 9). Thanks to Yeltsin guaranteeing the security of the borders of the former Soviet republics early on and peacefully dissolving the Soviet Union in December 1991, Ukraine's borders were quite secure, even if various Russian politicians grumbled about Crimea from time to time. The Russian-Ukrainian Treaty of 1997 seemed to settle the integrity of the Ukrainian nation for good.

The Ukrainian elections might have appeared to divide the country on occasion, notably the presidential elections in 1994 and 2004, but these divisions were fortunately quite superficial, and no serious separatism erupted. However intangible, Ukraine appears to have bred a national identity.

After the Orange Revolution, Ukraine developed a remarkable ideological consensus. In 2007 all the three dominant parties embraced confusingly similar liberal-democratic ideas, and the left was marginalized. Common values were democracy, freedom, private ownership of the means of production, market economy, international openness, and European integration. Three free and fair elections in the course of four years were held. Ukraine's political institutions as well as the socioeconomic system were considered highly legitimate.

Nor do the armed forces or the security police pose any danger, while they were major forces in Russia's reversal to autocracy. Also Ukraine's economic performance has contributed to the legitimacy of the regime, with a steady average growth rate of 7.5 percent a year from 2000 to 2008.

In comparison with Russia, Ukraine is blessed with the absence of several Russian curses. First, with small oil and gas revenues, it does not suffer from the curse of energy rents that a small elite can easily extract (Fish 2005, Diamond 2008). Second, Ukraine does not have Russia's strong authoritarian tradition, which Richard Pipes (2005) has emphasized. Third, Russia suffers from imperial nostalgia, while Ukrainians see their newly won independence as a blessing.

The frailty of Ukraine's democracy, however, is captured in Alfred Hirschman's (1965) phrase that democratic leadership must prove its ability. Ukraine suffers from three related weaknesses. First, legislation securing property rights is missing and it is too limited to satisfy society's need for law and order. Second, the government lacks efficacy. Third, corruption remains extensive and disruptive.

The risk of outrageous mismanagement of the state is evident, and by most measures the efficacy of the state seems to have declined after the Orange Revolution, while public demands have increased. Rising popular demands and patent state failure provide a potentially explosive cocktail. Yet in a free society, people find many means of solving their problems without the state. Ukraine's democracy underperforms, but its demise is neither evident nor necessary. The financial crisis that erupted in October 2008 will offer Ukraine's democracy a severe test.

European Economic Convergence

A dominant idea in economic growth theory is that with the same economic system, similar preconditions, and similar economic policies, economies should converge at a similar economic level (Barro and Sala-i-Martin 2004).

Central and Eastern Europe have provided beautiful examples of such convergence. In 2007 their GDP per capita in purchasing power parity (PPP) averaged half of the level of the old EU-15 countries (IMF 2008). In current exchange rates their GDP per capita was just under one-third of the old EU-15 level. Russia has already undergone a similar convergence, having reached one-quarter of the EU-15 level in 2007 (IMF 2008).

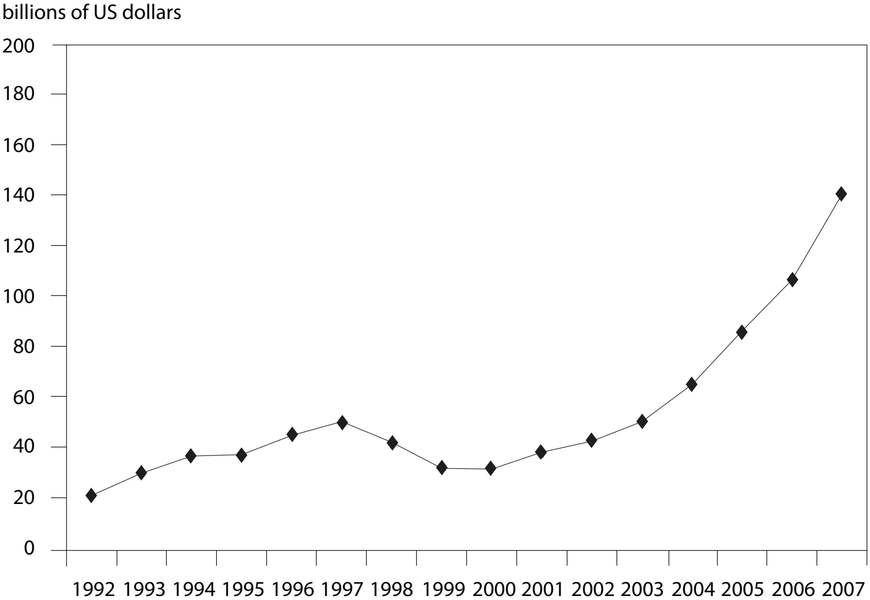
Ukraine has jumped on this bandwagon. From 1992 to 2000, its GDP in current dollars vacillated at a low level, but from 2000 to 2007 it grew steadily by an average of 24 percent a year, surging from $31 billion in 2000 to $140 billion in 2007 (figure 9.5). This meant that Ukraine's GDP per capita at current exchange rates nearly tripled from 2.8 to 7.4 percent of the level of the eurozone (IMF 2008). Ukraine is lagging so far behind the other Central and Eastern European countries that its growth rate may continue at a high rate until Ukraine reaches one-third of the EU-15 level.

In the next decade, Ukraine should have superior nominal growth. The market economy has come to stay and enjoys solid political support. Two-thirds of the GDP comes from the private sector, and the share is set to increase. Ukraine is a very open economy, and it will become even more so with its WTO accession. After the financial crisis, growth should return with a vengeance. Corruption is a serious problem, but that is true of many fast-growing economies.

So far the European Union has adopted a rather passive approach to Ukraine, but EU engagement is increasing. The European Union will put pressure on and engage with Ukraine to undertake multiple institutional reforms, most of which will be growth-enhancing. It has a sound habit of putting the most liberal reforms, such as market access and cutting of red tape, first. It will set a peer standard that is likely to dominate Ukrainian institutional thinking and debate, as has been the case in Central and Eastern Europe.

In spite of the ravages of the current financial crisis, the material reasons why Ukraine's long-term economic growth should stay high are many. Remonetization has boosted the volume of money (M3) as a ratio to GDP from 16 percent in 2000 to 47 percent in 2007 (figure 9.6). The increasing demand for money is reflected in a long credit cycle, leading to greater investment. Thus, investment as a share of GDP has increased in parallel, from barely 20 percent in 2000 to 27 percent in 2007, and it should rise further after a temporary lull in the business cycle (figure 6.3).

Figure 9.5 Ukraine's GDP in US dollars, 1992–2007



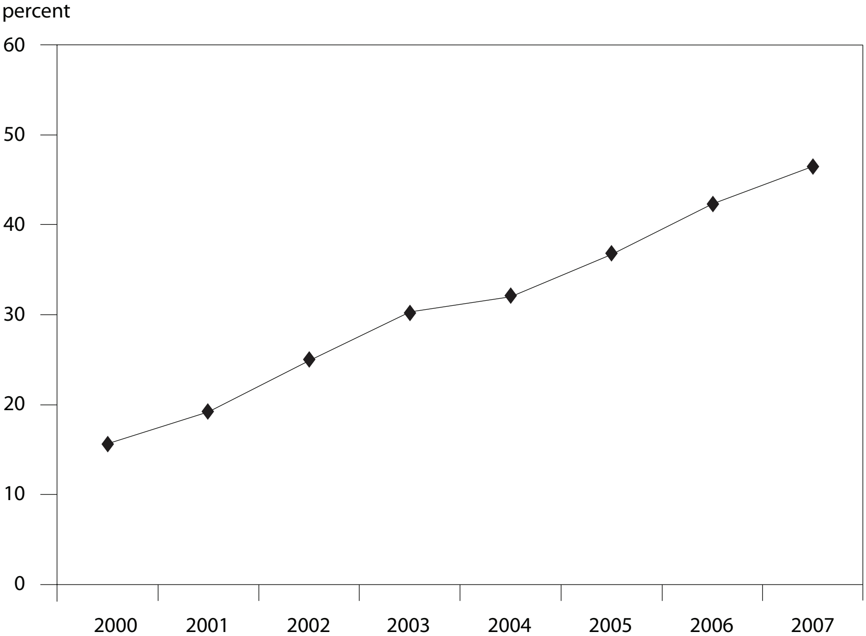
Source: IMF (2008).

Part of the rising investment is foreign direct investment (FDI), which is increasing relentlessly and reached 6.5 percent of GDP in 2007 (figure 9.7). With little notice, Ukraine has caught up with Central European countries such as Poland in FDI as a share of GDP, and it is far above Russia. Apart from temporary disturbances, FDI is likely to stay high for a long time judging by the Central European experience. Also, structural normalization proceeds as underperforming Soviet enterprises close down, while other industries evolve.

The most important growth potential lies in the 73 percent of Ukrainian youth who opt for some form of higher education, making a huge investment in their own and the country's human capital.

Ukraine is an open market economy centrally located in Europe, and it is quite integrated. The European Union is its model and institutional standard, and even if Ukraine has so far imitated the European Union relatively slowly, it endeavors to do so. After 2000, it gained better market access to the European single market, which is now its largest export market. Ukraine's proximity to the European Union is no guarantee of convergence, but its politicians would have to make many mistakes to fail to achieve European convergence.

Figure 9.6 Ukraine's volume of money (M3) as a ratio of GDP, 2000–2007



Source: Concorde Capital, March 2008.

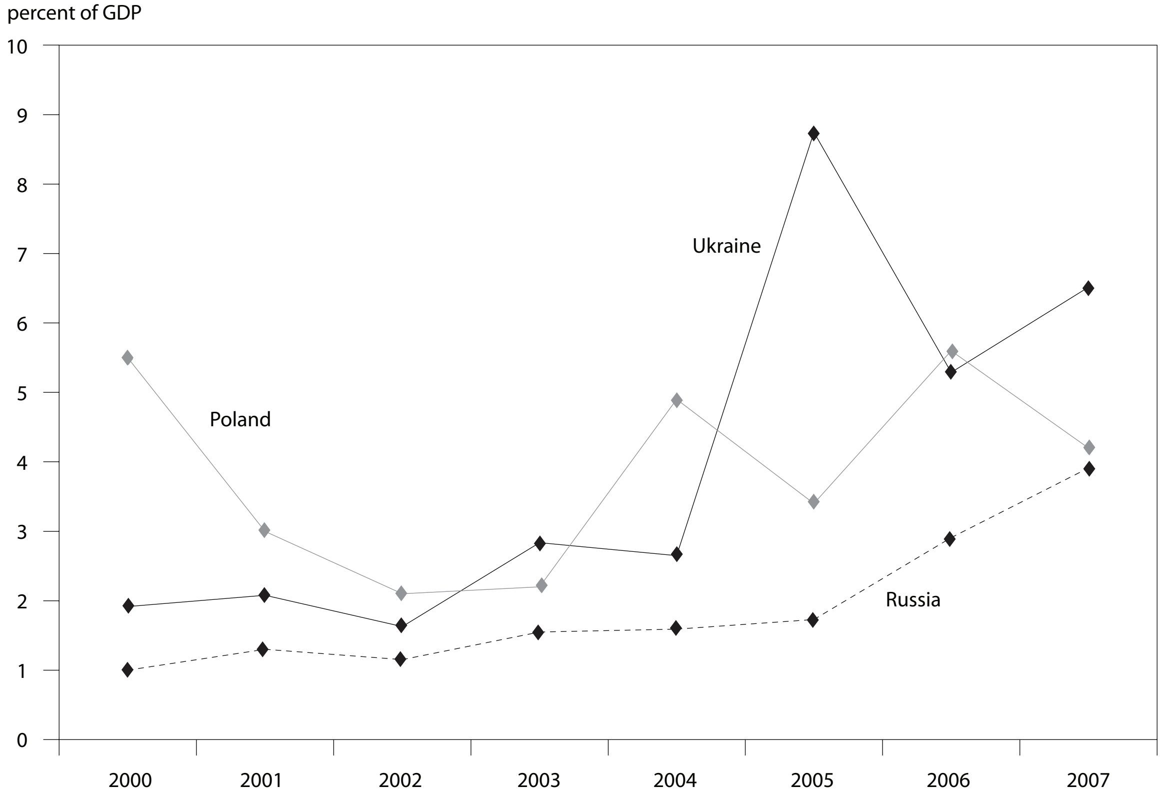
Putin's Alienation: Ukraine Turning to the West

Ukraine's foreign policy has gradually become ever more Western-oriented since independence. Leonid Kravchuk's term may be characterized as isolationist. Ukraine was too preoccupied with itself to deal with the outside world, and its only important asset was nuclear arms.

Kuchma wanted to improve Ukraine's relations with both Russia and the West. His policy was pragmatic, using opportunities as they opened up. In 1994–96 two international forces dominated Ukraine: the IMF and the United States. The IMF helped Ukraine to undertake its financial stabilization, and the United States instigated Ukraine's denuclearization and provided substantial technical assistance. President Bill Clinton's visit to Kyiv in May 1995 stands out as the high point in US enchantment with Ukraine. In the ensuing years, human rights and arms trade caused rising concerns in the United States. After Ukraine's economy turned around in 2000, the role of the IMF was naturally reduced.

In 2001–04 the West turned its back on Ukraine after the Heorhiy Gongadze murder, giving Kuchma little choice but to turn to Russia. The

Figure 9.7 Foreign direct investment as a share of GDP, 2000–2007



Sources: Dragon Capital, July 2008; JPMorgan, July 2008; Eurostat, April 2008.

Ukrainian population had reacted against the 1999 NATO bombing of Yugoslavia as the Russians in solidarity with orthodox Serbs. In 2003–04, President Vladimir Putin undertook Russia's greatest charm offensive toward Ukraine, offering the Common Economic Space, substantial tax and trade concessions, plentiful campaign financing, and more bilateral meetings than ever. However, the Russian initiative to form a Common Economic Space in 2003, the Tuzla border conflict with Russia in October 2003, and the massive Russian intervention in the Ukrainian presidential election in the fall of 2004 aroused sharp Ukrainian reactions.

After the Orange Revolution, Russia offered nothing. Having had 12 meetings with President Kuchma in 2004, President Putin minimized his contacts with Ukraine. He visited Yushchenko in Kyiv once in 2005 as well as 2006, but on the whole Russia ignored Ukraine. Hardly any Russian ministers visited the country. Russia's policies toward Ukraine boiled down to four hostile activities: threatening Ukraine with higher gas prices, declaring an embargo on one Ukrainian export product after the other, making populist noises about Crimea and the Black Sea Fleet, and complaining about Ukraine's desire to join NATO. In short, Russia's Ukraine policy consisted of four sticks and no carrots. As if to add insult to injury, Russian television, which was watched in half of Ukraine, indulged in stark anti-Ukrainian propaganda.

Putin had transformed Russia's policy toward Ukraine to one of outcries and embargoes. Ukraine could do nothing but be repelled. The unspoken rationale of Putin's policy was that democratic and Western-oriented Ukraine offered an alternative to the Russian public. If Ukraine's democracy succeeded, it would be a devastating threat to Putin's authoritarian system. Therefore, Putin had every interest in seeing Ukraine fail through destabilization. Then he could tell credulous Russians that democracy unfortunately did not work in East Slavic countries.

Russia left Ukraine with only one choice, namely to turn to the West, which meant the WTO, the European Union, and NATO. Ukraine had applied for membership of the WTO in December 1993, and in May 2008, it was accepted. An effect was that Ukraine's access to EU markets became much safer, but as Russia remained outside the WTO, its market was as inaccessible as it had been.

With Ukraine's European location, one would assume that the European Union would have a great impact on its postcommunist transition. Sadly, that was not the case. President Kuchma pleaded for Ukraine's membership in the European Union starting in 1996, but the European Union barely responded. Throughout the 1990s the greatest EU demand was that Ukraine close down the Chornobyl nuclear power station without offering financing for this expensive undertaking. Yet, however passive the European Union was, it was the Ukrainians' ideal model.

The Orange Revolution became a breakthrough for Ukraine's relations with the European Union. Europeans supported human rights in

Ukraine, and European politicians acted as mediators between the two presidential candidates. The European Union had already offered its European Neighborhood Policy to Ukraine, and after the Orange Revolution the ensuing action plan became more substantial than had been expected and was agreed in February 2005. On September 9, 2008, the European Union decided to offer Ukraine a European Association Agreement, which contains a free trade agreement and more. It aims at deep free trade with far-reaching integration. As a consequence, the European Union is likely to become Ukraine's all-dominant export market.

The third leg of Ukraine's Western orientation is NATO. In the 1990s Russia and Ukraine stepped up cooperation with NATO in parallel. Under Putin, however, Russia started treating NATO as an enemy, while Ukraine continued to cooperate ever more closely with it. In January 2008 Ukraine applied for a membership action plan with NATO, which was the natural next step in their ever closer relationship. However, the NATO summit in Bucharest in April 2008 turned down this application because Ukrainian popular support for NATO membership was minimal, and Russia strongly opposed it. The Russian opposition is a two-edged sword. The stiffer Russia's opposition is toward Ukraine's membership of NATO, the more endangered Ukraine's national security seems (Pifer 2008).

Ukraine's concrete need today is security, not NATO. The United States has amply guaranteed Ukraine's security through the trilateral US-Russian-Ukrainian declaration of January 14, 1994, and the Strategic Arms Reduction Treaty (START). It would be more appropriate for the United States to refer to these commitments already made rather than pursuing a course that facilitates the Kremlin's intention to destabilize Ukraine.

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As this book goes to press in March 2009, three big clouds darken Ukraine's path forward: domestic political instability; a renewed, explicit Russian threat to Ukraine's sovereignty; and a severe financial crisis.

The answer to these challenges lies in the quotation that opens this chapter, Deputy Prime Minister Hryhoriy Nemyria's assurance: "We know we are a European nation and that we are going to join the European Union." Immediately after the end of communism, the Central European countries declared their "return to Europe." Ukraine did not do so because of its preoccupation with building the shattered Ukrainian nation. That great task has been accomplished, and Ukrainians have set their eyes on Europe as a model, civilization, community, and market. The European Union needs to respond by offering a substantial European Association Agreement. It should include not only deep free trade but also considerable support for cooperation in higher education to help Ukraine build the necessary capacity for its development.

The next assignment is to improve Ukrainian constitutional order. As I have argued in this book, Ukraine needs full Western European parliamentarianism, for which the European Union offers the best models. The European Union should also assist Ukraine in building its state agencies and civil service.

As long as Russia offers no other policy than destabilization, Ukrainian leaders have to manage that relationship at arm's length, which they know how to do.

The current financial crisis will severely test Ukraine's democracy, and hopefully it will improve it. Many of the existing big corporations will undoubtedly go under. Old businesses will be streamlined or go bankrupt. Bad business practices, such as corruption, will be exposed and questioned. Then much of the current political financing will disappear. Ukraine can come out with a more level playing field economically and a better democracy. This is a time for Ukrainians to demand more and better laws and deal a decisive blow against corruption. It will not be easy, but it may be productive.

The United States has played an important and positive role in the life of independent Ukraine, and it needs to continue doing so. Uniquely, only the United States can guarantee Ukraine's security, and it has committed itself to doing so in multiple agreements on Ukraine's denuclearization. The United States should also catch up with the European Union and offer Ukraine a bilateral free trade agreement to favor economic integration between the two countries. Ukraine needs to develop a new elite, and the United States can help by offering a large number of student scholarships at American universities. Finally, the United States should facilitate visa regulations for Ukrainians, all the more so as Ukraine allows all American citizens to enter Ukraine without a visa.