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Why Ukraine Can and Should Opt for Radical Reforms Now

To wait means to fail.

—Mart Laar (2014), former prime minister of Estonia

Russian military aggression has plunged Ukraine into an existential crisis, necessitating urgent radical reforms for survival. It is unclear what Russian president Vladimir Putin intends to do with Ukraine. We therefore need to consider a reform strategy that holds water in various scenarios. Many have questioned whether democratic and market economic reform can be pursued during war and wonder whether Ukraine can reform in spite of Russian aggression. The answer is yes, as long as the war is limited to a small area and not a major economic distraction. A minor war on national territory could even spur the country to realize that it can no longer continue its old bad ways and has to pursue reinvigorating reform.

Many countries have fought substantial wars on their own territories and endured severe economic crises while carrying out major economic reforms. Turkey did so under Prime Minister Recep Tayyip Erdoğan (2003–14), while pursuing a bloody civil war against Kurdish insurgents. Another example is Colombia under President Álvaro Uribe Vélez (2002–10), who executed an even bloodier war against left-wing guerillas. Israel stands out as an example of a country that has maintained sound economic policies regardless of its many wars. Closer to Ukraine, the Russian-Georgian war of August 2008 spurred the Mikheil Saakashvili administration to undertake more radical reforms. The three Baltic republics rated as top reformers in the early 1990s, while harboring as many as 150,000 Russian soldiers on their territories. The last Russian soldiers departed from the Baltic states in August 1994, when Estonia and Lithuania completed their key reforms.

What kind of reform strategy should Ukraine pursue? In its current rampant crisis, Ukraine needs front-loaded, radical, and comprehensive reforms from the top down. Only such reforms have been truly successful in postcommunist countries, and the more difficult the situation, the more radical the reforms should be. The power of the oligarchs has to be broken. Ukraine is the last post-Soviet country where oligarchs remain truly powerful, but they are currently under great pressure.

The successful postcommunist countries—Poland, the Czech Republic, Slovakia, Estonia, Latvia, Lithuania, and Georgia—are the most relevant reform prototypes for Ukraine. These countries share several similarities with Ukraine, economically, politically, and socially, and show that radical reform is possible in turbulent times.

Skeptics ask whether Ukraine can succeed when it has failed so many times. The nation has not suffered a more severe existential crisis before. To survive it has to reform hard and fast or risk oblivion. In the absence of tough reforms, a financial meltdown with unpredictable but probable negative political consequences is all too likely. Few incentives to reform are stronger than that.

What Are Putin's Intentions?

On the night of February 27, 2014, so-called small green men (*zelyonye chelovechki*), Russian special forces without insignia, occupied the regional Crimean Parliament in Simferopol. They appointed a minor local politician, Sergey Aksyonov, prime minister, although his party had received only 4 percent of votes in the recent regional elections. The following night, these "small green men" occupied Crimea's two international airports, opening them to Russian military transport planes. Russian agents had thoroughly infiltrated the Ukrainian army, and the new Ukrainian military command was even more penetrated. The newly appointed commander of the Ukrainian navy defected to Russia. Within days, Russian special forces seized the whole of Crimea without killing more than one Ukrainian solider. They celebrated their success with video clips on YouTube.[1] Interestingly, they announced that they started their operation on February 22, the day Viktor Yanukovych fled. On March 18, Russia formally annexed Crimea (Putin 2014a).

By April, "small green men" were popping up in southern and eastern Ukraine. On May 2, during clashes in Odessa many of them were killed in a fire that broke out in the building they were in. Only in half of Donbas, the easternmost region in Ukraine, did the Russian insurgents find significant local support, but even there they did not appear to find a majority favoring secession from Ukraine. In September 2014, an admittedly small and imperfect poll by the Democratic Initiatives Foundation named after Ilko Kucheriv and the Kyiv International Institute of Sociology found that 42 percent of Donbas residents wanted to stay in Ukraine but with more autonomy from Kyiv and 7 percent wanted to stay in Ukraine with no changes, while 26 percent wanted

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1. The Russian special forces televised their success on YouTube, www.youtube.com/watch?v=XUZmHUsLic4 and www.youtube.com/watch?v=FAdcV8Xg6X.

the Donetsk People's Republic or the Luhansk People's Republic to be independent and 16 percent wanted to join Russia—that is, 49 percent were for Ukraine and 42 percent for Russia.[2]

The secessionist movement did not start as a domestic rebellion but as Russian military aggression, though locals as well as Russian mercenaries were recruited. Thousands of regular Russian soldiers and hundreds of tanks and armored vehicles have been involved. Ukrainian forces had been advancing until August 22, and the Ukrainian leadership believed that they could oust the Russian forces.

But then Russia sharply increased its military engagement, losing many soldiers and armaments in Ukraine. The Ukrainian leadership realized that Ukraine could not win militarily against Russia and clear its own territory. On September 5, Presidents Petro Poroshenko and Vladimir Putin concluded a ceasefire agreement (OSCE 2014a) and added a more detailed agreement on September 19 (OSCE 2014b). Despite the ceasefire, fighting did not stop, but it was contained. According to the Office of the United Nations High Commissioner for Human Rights (OHCHR 2014, 4) from mid-April to October 31, "at least 4,042 were killed and 9,350 were wounded in the conflict-affected area of eastern Ukraine." Unofficial assessments were three times larger.

This book is not about the Russian-Ukrainian war or the Western economic sanctions imposed on Russia. But to understand how reforms in Ukraine may or may not proceed, we have to make some assumptions about Russia's aims and future behavior. The natural starting point is President Putin's statements. His most substantial statements were in his big speech to the Russian Federal Assembly on March 18 and his annual television call-in program on April 17.

Putin's novel point was to define nationality by language and ethnicity and not by statehood or passport. He also unapologetically embraced revanchism: "The USSR fell apart.... It was only when Crimea ended up as part of a different country that Russia realized that it was not simply robbed, it was plundered." His concern went far beyond Crimea: "Millions of people went to bed in one country and awoke in different ones, overnight becoming ethnic minorities in former Union republics, while the Russian nation became one of the biggest, if not the biggest ethnic group in the world to be divided by border" (Putin 2014a). In these statements, he returned to what he had said at the North Atlantic Treaty Organization (NATO) summit in Bucharest in April 2008.

The Russian president expressed sympathy for what he depicted as the poor Ukrainians: "I understand why the Ukrainian people wanted change. They have had enough of the authorities in power during the years of Ukraine's independence. Presidents, prime ministers, and parliamentarians changed, but their attitude to the country and its people remained the same. They milked

2. Democratic Initiatives Foundation, "Majority of Donbas Population Wants to Live in Ukraine," September 2014, http://dif.org.ua/en.

the country, fought among themselves for power, assets, and cash flows and did not care much about the ordinary people" (Putin 2014a).

At the same time, he saw the new Ukrainian rulers as illegitimate: "However, those who stood behind the latest events in Ukraine had a different agenda: They were preparing yet another government takeover; they wanted to seize power and would stop short of nothing. They resorted to terror, murder, and riots. Nationalists, neo-Nazis, Russophobes, and anti-Semites executed this coup" (Putin 2014a).

Against all this injustice, Putin offered assistance to what he claimed to be the suffering ethnic Russians living in Ukraine: "Those who opposed the coup [in Ukraine] were immediately threatened with repression. ...[T]he residents of Crimea and Sevastopol turned to Russia for help in defending their rights and lives, in preventing the events that were unfolding and are still under way in Kiev, Donetsk, Kharkov, and other Ukrainian cities. Naturally, we could not leave this plea unheeded; we could not abandon Crimea and its residents in distress. This would have been betrayal on our part" (Putin 2014a).

In the end, Putin blamed the West: "Our Western partners, led by the United States of America, prefer not to be guided by international law in their practical policies, but by the rule of the gun. They have come to believe in their exclusivity and exceptionalism, that they can decide the destinies of the world, that only they can ever be right. They act as they please: Here and there, they use force against sovereign states, building coalitions based on the principle, 'If you are not with us, you are against us'" (Putin 2014a). He failed to address the fact that by annexing Crimea Russia had violated half a dozen ratified international treaties.

Putin's version of recent history was clearly at variance with reality. In the same March 18 speech Putin (2014a) stated: "Russia's Armed Forces never entered Crimea; they were there already in line with an international agreement. True, we did enhance our forces there...." One month later, however, he effectively admitted that he lied when he denied sending in Russian troops: "Russia did not annex Crimea by force. Russia created conditions—with the help of special armed groups and the Armed Forces, I will say it straight—but only for the free expression of the will of the people living in Crimea and Sevastopol" (Putin 2014b). The Kremlin has continued to insist that it is not a party to the war in Ukraine and has persistently denied using military force in eastern Ukraine, but these denials cannot be taken seriously, since evidence of the opposite is overwhelming.

On April 17, Putin started talking about "Novorossiya"—New Russia—an old tsarist term referring to eastern and southern Ukraine coined at the time of Catherine the Great in the late 18th century. The Bolsheviks banned this term soon after the revolution because of their new regional division of the Soviet Union. By reviving this old imperialist term, Putin appeared to lay a Russian claim to eight eastern and southern regions of Ukraine. Since 2008, he has repeatedly claimed that Ukraine is not a country (Åslund 2009) and has continued to use the imperialist term of Novorossiya.

There are at least three plausible interpretations of Putin's intentions. One is that he is ready to take what he can through war, while being intentionally vague. Second, since the NATO summit in Bucharest in April 2008, the Kremlin has made clear that it does not accept Ukraine becoming a member of NATO (Åslund 2009, 227–28). Since the summer of 2013, the Kremlin has also objected to an Association Agreement between Ukraine and the European Union. A third hypothesis is that Putin does not accept any democratic breakthrough in an East Slavic country, perceiving this as dangerous precedent for Russia justifying a possible preemptive strike. Putin's vehement reaction against the Orange Revolution points in that direction. Given that the democratic breakthrough already took place in February 2014, one may presume that Putin's prime interest is that Ukraine will fail.

My preferred interpretation is that Putin wants Ukraine to collapse economically and thus politically to prove that democracy is not suitable for Eastern Slavs. This version is consistent with his interest in keeping Ukraine out of Western alliances, and it does not contradict gradual Russian territorial expansion. If Ukraine's failure is the Kremlin's objective, Putin has no obvious need for further military aggression. Nor does he have any interest in peaceful coexistence with Ukraine. Accordingly, Russia can be expected to carry out various forms of aggression against Ukraine.

From this perspective, Russia's destruction of vast parts of the Donbas infrastructure makes sense. Russian forces have bombed bridges and power stations in areas under their control in Donbas, and they have looted at least one armaments factory in Luhansk, Luhansk Electrical Factory, transferring it to Russia.[3] These actions suggest that the Kremlin is not intent on annexing the occupied territories in Donbas. Instead, its two Minsk accords with Ukraine seem to aim at imposing all the costs for providing Donbas with pensions and other social costs on Ukraine, while depriving Ukraine of all revenues from this area.

Russia's interest in further military advances could be balanced by three factors: the rising cost of Western sanctions against Russia, Ukrainian military resistance, and domestic Russian attitudes to the war with Ukraine.

The war with Russia has severely damaged the Ukrainian economy. The loss of Crimea has deprived Ukraine of 3.7 percent of its GDP. It is no longer included in official statistics, while Donbas is. To a considerable extent that means costs but no benefits. In October 2014, the occupied territories accounted for 2.6 percent of Ukraine's area, 3.3 million people (7.3 percent of the population), 10 percent of GDP, and 15 percent of industrial output (Dragon Capital 2014). In December, most forecasters predicted a decline in GDP of 7 percent in 2014. Roughly two-thirds of the decline derived from the war in Donbas, which is the old coal and steel region of Ukraine. In October,

3. "Lugansky elektromekhanichesky zavod perenosit proizvodstvo v Rossiyu" ["Luhansk Electrical Plant Is Transferring Its Production to Russia"], *Ostrov*, September 24, 2014, www.ostro.org/lugansk/economics/news/454963 (accessed on October 25, 2014).

Ukraine's coal production was down by 66 percent and its steel production down by one-third.

Of the region's population of 3.3 million, about 900,000 had fled by late October. According to the Ukrainian State Emergency Service, 417,410 people were internally displaced in Ukraine, while the Office of the United Nations High Commissioner for Human Rights recorded that 454,339 people had fled abroad, 387,355 of them to Russia (OHCHR 2014, 24). These numbers tally with opinion polls suggesting that preferences in the occupied territories are roughly divided between Russia and Ukraine.

The military front has not moved since September 5, although a very bloody battle took place over Donetsk Airport. Without delving further into war scenarios, I shall simply assume that the ceasefire holds in the sense that the front does not move, though plenty of blood may be spilt.

In the long term, Ukraine of course wants to regain all its territory and safeguard its national integrity. In the interim, Ukraine has three clear interests. First, it wants to maximize its security while minimizing the cost of war. Second, given that Ukraine does not receive any tax revenues or value added from the occupied parts of Donbas, Ukraine should also minimize its expenditures on this region. On November 15, President Poroshenko signed a decree that cut off all Ukrainian state funding to the occupied territories. Energy subsidies should also be withdrawn. Third, the territories held by Ukraine and the rebels should be demarcated in some way, so that people can gain elementary security. For the purposes of this book, I assume that Ukraine will succeed in these three endeavors.

Why This Time Is Different in Ukraine

Most of the time countries do not pursue reforms until they really have to. Given how formidable and multifaceted the crisis in Ukraine is, the new government has no rational option but to undertake reforms as fast as possible for multiple reasons. Muddling through is no longer an option, and the only real alternative is a financial meltdown (see section at the end of this chapter). The question is how able the government is to act rationally.

First, Ukraine is running out of money. In July 2014, the International Monetary Fund (IMF) foresaw that in a stress scenario Ukraine's public debt would surge to 134 percent of GDP in 2016 (IMF 2014d, 49). If Ukraine does not change course, it will default before that happens. In October 2014, IMF managing director Christine Lagarde stated that to "assume that the additional funding will have to come from the IMF I think is rather far-fetched."[4] Accordingly, Ukraine has to cut public expenditures sharply in 2015.

Second, radical reform is a matter of national survival. Ukraine is at war with far stronger Russia. So far, the war has been limited, but nobody knows

4. Ian Talley, "Ukraine Will Need More Bailout Funding, IMF's Lagarde Says," *Wall Street Journal,* October 9, 2014.

how it will evolve. Ukraine has to strengthen its military, which requires economic potency, leaving it little choice but to carry out the key reforms swiftly.

Third, Ukraine should use this crisis to break the preponderance of corruption and oligarchic rule. The oligarchs have suffered considerable damage to their assets in the war-torn areas of Ukraine, rendering them weak. The crisis offers a chance to finally break their disproportionate influence over the state for good. Yet, if the main rent-seeking mechanisms are not eliminated soon, resourceful businessmen will find new ways of making money on the state.

In today's Ukraine, the main form of rent seeking is gas arbitrage. Under Yanukovych, a couple of his oligarchs appear to have benefited from this trade. If the domestic prices are not unified at the market level soon, somebody else will pick up this business.

Fourth, the war with Russia has forced Ukrainians to come together as never before. As the great political scientist Charles Tilly (1992) put it: "War made the state and state made war." Marches with people wearing traditional Ukrainian folk shirts, *vyshyvanki*, are being held all over the country, and youngsters are painting railings in the Ukrainian national colors blue and yellow. The Orange revolutionaries did not use the Ukrainian national symbols to avoid being divisive and instead chose the neutral orange color. The blue-and-yellow Ukrainian flag is no longer controversial but unites the nation. One sees Ukrainian flags everywhere.

This national cohesion has the Ukrainian people demanding action and results. I passed by the parliament on September 16, when it discussed the draft law on lustration. Thousands of people demonstrated in support of the law. Even so, the parliament still dominated by the old elite adopted this law with a single vote. Parliament Speaker Oleksandr Turchynov caught the public mood, shouting to the parliament: "If you do not vote for lustration, there will be castration instead."[5] One parliamentarian opposing lustration was dumped in a garbage bin. Popular suspicion runs high, and many are talking about a third Maidan if the current government does not reform the state.

The public supports most reforms, obviously the elimination of red tape and cumbersome taxation. People want the rule of law through good courts and an honest police force. Ukrainians are dissatisfied with the current provision of health care and education in their country.

For all these reasons it is easier to carry out big reforms when the public is most eager and ready for reforms, even if they are unpopular. Latvia's prime minister Valdis Dombrovskis realized that it was politically easier to carry out a fiscal adjustment of 9.5 percent of GDP in the midst of the crisis in 2009 than a minor budget adjustment of 1.5 percent of GDP in 2012. He closed half the state agencies, sacked one-third of all civil servants, and cut public wages by 28 percent. Somewhat to his surprise, he found that this was popular and he was reelected twice (Åslund and Dombrovskis 2011). He concluded that he

5. Parliament Today, video, *Ukrainskaya pravda*, September 16, 2014.

should have front-loaded the reforms even more. People are prepared to accept a lot of suffering for a year or two, but after that they do not understand why they should continue to tighten their belts.

Also, people accept a paradigm shift much more easily than a partial change within the existing paradigm. If one minor liberalization occurs, people ask why that specific liberalization took place. If most sectors are liberalized, people instead ask why the rest have not been liberalized as well, because they have accepted the new liberal paradigm.

Reforms should ensure an early return to economic growth because people also expect to see results reasonably soon. In the 1990s, Ukraine pursued gradual and tepid reforms. As a result, it had no economic growth for a decade. Even before the current crisis, Ukraine had not recovered its output level of 2007. Similarly, after the global financial crisis, Greece undertook many relatively small fiscal adjustments, which kept the economy contracting for seven bitter years. By contrast, Estonia, Latvia, and Lithuania quickly returned to growth after only two years from similar output contractions in 2009, and these three countries have been growing fast since then because they carried out radical fiscal adjustments and combined them with structural reforms.

Ukraine's new government seems to realize the need for urgent radical reforms and has elaborated a "Strategy for Reform 2020" (Reforms in Ukraine 2014), in which it identifies eight priority reforms: tax reform, anticorruption reform and lustration, judicial reform, decentralization and state governance reform, deregulation and development of entrepreneurship, reform of the law enforcement system, reform of the national security and defense system, and healthcare system reform. The strategy contains two state programs on energy independence and global promotion of Ukraine and also lists 62 additional reforms. Ukraine requires a handful of competent and decisive managers to take charge of economic policy on the basis of a democratic parliamentary majority and swiftly push through fundamental changes. This is not the time for building consensus and certainly not with the old establishment, which is naturally opposed to losing power and wealth. Since Euromaidan and the elections, the old vested interests have been somewhat subdued, but they won't be for long. The government, therefore, needs to act before the old elite recovers and gathers strength. Fast action is the best way of convincing them that the rules of the game have changed. President Poroshenko and Prime Minister Arseniy Yatsenyuk have to prove that they are up to this Herculean task.

Thus, the arguments are overwhelmingly in favor of Ukraine undertaking key reforms as soon as possible now that the parliamentary elections are over and a new government has been formed (cf. Åslund 2013a, 41–44). But the question remains whether the new leaders are really determined and able to do so.

Most Relevant Reform Prototypes

Given the many similarities among postcommunist countries in the former Soviet bloc, the most relevant models are those where reform succeeded in the midst of severe economic crisis, notably Poland in 1989 (Balcerowicz 2014), Czechoslovakia in 1990 (Klaus 2014), Estonia in 1992 (Laar 2014), Georgia in 2003 (Bendukidze and Saakashvili 2014), and Latvia and Lithuania in 2009 (Åslund and Dombrovskis 2011).

All too often, Western economists draw on experiences of Western countries, which are at best irrelevant but often harmful. The institutional setup is so different in postcommunist countries, and the level of economic development so much lower, that few things characteristic of developed Western economies also apply to these countries (Åslund 2013a).

Poland represents classical early, comprehensive, and radical reform (Balcerowicz 1992, Sachs 1993). Poland and Estonia stand out as having more than doubled their GDP in real terms after communism. Since 2003, Georgia has been a star reformer. During the global financial crisis, Latvia and Lithuania stood out for their resolute crisis management, which led to high economic growth.

All these countries pursued reforms that were radical, comprehensive, and front-loaded. No country has failed because it attempted too fast and radical reforms, but all gradual reforms in crisis situations have failed. The list is long: Romania, Moldova, Ukraine, Belarus, Azerbaijan, Kazakhstan, Tajikistan, Turkmenistan, and Uzbekistan. Most Central and East European governments lose elections, but the radical reformers have won more often than the nonreformers and several have returned to power.[6] A politician who wants to be reelected would be well advised to firmly resolve his or her country's problems.

Economics is not a precise science, but the successful postcommunist countries share many common lessons. One is that the window of opportunity for reforms after a democratic breakthrough is brief and has to be utilized (Balcerowicz 1994). Therefore, it is important to front-load reforms so that many, comprehensive reforms are carried out as fast as possible, because, in the words of former Estonian prime minister Mart Laar (2014, 77), "to wait means to fail." Delay in implementing reforms will only allow the old rent-seeking establishment to mobilize its resistance and defeat the reformers. Laar (2002) also noted that reforms are best adopted in big chunks, because the resistance will be as great against small changes.

The problem with the Ukrainian state is that the old Soviet system remains alive and well with all its bureaucracy and centralization. Political will to

6. The outstanding success is Václav Klaus. The Estonian and Latvian governments were reelected after their shock cures in 2009. Mikulas Dzurinda has been Slovak prime minister thrice. Balcerowicz and Laar were both returned to power. Mikheil Saakashvili and his party were reelected.

pursue a fundamental reform has never prevailed. Even the Orange Revolution failed to make a dent in Ukraine's tenacious old structures.

Former Czech president Václav Klaus (2014, 55) taught the "necessity of a total and unconditional liquidation of the communist political and economic system." The old Soviet system has proven more stable than desired in the postcommunist countries, so its disruption should be maximum, because the danger does not lie in instability but in the persistence of the old system.

Reformers increasingly recognize that "you cannot change the behavior of people, so you have to change the people in charge instead" (Åslund and Djankov 2014, 6). Another lesson is that the "secret police has turned out to be the worst part of the old elite because it is the least transparent, but powerful, professionally competent, international, lawless, ruthless and it has strong networks. It has proven ideal as an organized crime network" (Åslund and Djankov 2014, 7). Ukraine needs a sweeping lustration to oust corrupt and criminal senior officials of the old establishment. Estonia carried out the most radical lustration, which has served the country well; it has the least corruption of all postcommunist countries according to all corruption indexes.

Georgia, widely considered a failed state in the early 2000s, reformed successfully. After the Rose Revolution in 2003, President Saakashvili turned his nation around. The key to his success lay in his pursuit of very radical reforms in one area after the other. Reforms disrupted the status quo in the selected sectors, but they were not implemented in parallel (Bendukidze and Saakashvili 2014). Ukraine should also select key sectors for reform and then proceed to others. Georgia is particularly inspiring for Ukraine because it carried out these reforms long after the end of communism when corruption was the main problem.

In both Georgia and Estonia, the reform ministers were very young, mostly in their thirties and some in their twenties, because the reform leaders wanted to draw on young talent not poisoned by the old system. Georgia attracted many nationals who had studied and worked abroad for several years, which Ukraine could also do. Young, inexperienced people make mistakes, but they dare to do what older people wrongly consider impossible. To attract Ukrainian youth living abroad, the government must raise public service salaries as an incentive for them to return and live comfortably.

Overall, Estonia offers the ideal package of early and comprehensive radical reforms. Poland, which is about the same size as Ukraine, went through more complex reforms, but the leading ideas were the same. Georgia, Slovakia, Latvia, and Lithuania have carried out great catch-up reforms.

The Power of the Oligarchs Has Declined

The ultimate argument of reform skeptics in Ukraine is that the oligarchs will not allow reforms. This argument is weak because Ukraine's oligarchs are on the wane.

"Oligarch" is an ancient concept, with an "oligarchy" defined as "government in the hands of a few."[7] In Russia and Ukraine, oligarch became a popular label for the wealthiest tycoons around 1994. An oligarch in Ukraine is a very wealthy and politically well-connected businessman, a dollar billionaire (or nearly so) who is the main owner of a conglomerate of enterprises, usually including media, and has close ties to the president.[8]

Bradford de Long (2002, 179) has suggested that a present-day billionaire would be a good proxy for a "robber baron" of 19th century America. It might be more appropriate to call them plutocrats, because their aim is to make money rather than to rule the state. Joel Hellman (1998) has coined the phrase "state capture" to characterize the relationship between big businessmen and the state in a country such as Ukraine, because these big businessmen influenced the state by multiple means.

In Newport, Rhode Island, the palaces, or "cottages," of the American robber barons have stood intact since the 1890s. They have been preserved but the original fortunes are gone. The robber barons made their wealth on coal, steel, and railways during the great commodity boom before World War I (Morris 2005). In the 1960s and 1970s, their palaces were sold for a mere 2 percent of the original real cost. Similarly, Ukraine's steel, gas, and coal barons made their fortunes in the 1990s and 2000s (Frishberg 2008). They and their mansions in Koncha-Zaspa, the elite area southwest of Kyiv, may meet a similar fate as the US robber barons and their Newport cottages.

A combination of economies of scale and state capture during the Industrial Revolution created robber barons or oligarchs. Typically, they thrived in industries with large economies of scale—transportation (railways and shipping), commodities (steel, coal, oil, and timber), and banking. Strong oligarchic groupings are common also in well-governed countries such as Canada, Finland, and Sweden. In fact, oligarchy is the normal state of corporate governance in most of the world (Morck, Wolfenzon, and Yeung 2005). Yet, it can be broken up, which is common in developed societies. Two recent examples are Finland and Canada.

The big Ukrainian fortunes in the 1990s were made on gas trade with Russia. The business model was parasitical arbitrage, in which corrupt business players purchased gas at low state-controlled prices and then reaped huge profits by selling the gas at free markets. The gas traders did not have large companies but were opportunistic dealmakers. Their practice was called "sitting on the pipe," because they benefited from price differentials between the two ends of the pipe, that is, at a state enterprise and on the free market.

Ukraine's reforms of 2000 brought about an abrupt change. The fortunes of the steel and coal barons, who produced rather than just traded, surged

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7. As defined in the Oxford University Press Dictionary.

8. Four excellent journalistic books on the Russian oligarchs show how they evolved and operated: Brady (1999), Freeland (2000), Hoffman (2002), and Klebnikov (2000). Less has been written on the Ukrainian oligarchs; see Puglisi (2003), Grygorenko, Gorodnichenko, and Ostanin (2006), and Åslund (2006).

with the commodity boom (most of all Rinat Akhmetov, followed by Victor Pinchuk). Suddenly, the oligarchs owned concrete producing companies, and they certainly knew how to increase production and productivity fast (Grygorenko, Gorodnichenko, and Ostanin 2006). The new big businessmen were so resourceful that they succeeded in organizing production where most failed, not allowing any red tape to stop them. Oligarchic privileges persisted, but they were largely limited to tax benefits, state subsidies, transfer pricing, select state procurement, and exclusive privatizations.

Daron Acemoglu (2008) has explained that oligarchs can be quite productive, stimulating economic growth at an intermediate level of economic development by keeping taxation low and labor markets free. At a higher level of economic development, however, other factors become more important, namely a good business environment and easy entry for startups. Dominant big businessmen are not prone to supporting such endeavors. Therefore democratization is vital for successful market economic reform.

> An "oligarchic" society, where the political power is in the hands of major producers, protects their property rights but also tends to erect significant entry barriers against new entrepreneurs. Democracy, where political power is more widely diffused, imposes redistributive taxes on producers, but tends to avoid entry barriers. When taxes in democracy are high and the distortions caused by entry barriers are low, an oligarchic society achieves greater efficiency. Because comparative advantage in entrepreneurship shifts away from the incumbents, the inefficiency created by entry barriers in oligarchy deteriorates over time. The typical pattern is one of rise and decline of oligarchic societies. An oligarchic society may first become richer, but later fall behind a similar democratic society. (Acemoglu 2008, 1)

A simpler explanation is that little can be produced without a modicum of law and order. In the early post-Soviet years, lawlessness and disorganized crime ravaged Ukraine and Russia. In a first step, crime became organized and therefore less unpredictable and bloody. In a second step, producing oligarchs established their own security forces, which greatly facilitated production (Volkov 2002, Brady 1999).

Today, oligarchic privileges are falling apart under pressure from international financial institutions and civil society. Subsidies to oligarchic enterprises are difficult to defend; the State Fiscal Service is going after transfer pricing; and the public demands competitive and open public procurement and privatization auctions.

The only substantial source of old-style oligarchic revenues is the domestic trade of natural gas, which is bought at $30 per thousand cubic meters and resold at $380 per thousand cubic meters (Kobolyev 2014). If natural gas prices are swiftly adjusted to the market this business will disappear and with it the oligarchs. The main gas trader, Dmytro Firtash, is out of jail on bail in Vienna,[9]

9. Angelika Gruber, "Ukrainian Industrialist Firtash Released after Posting Bail," Reuters, March 21, 2014.

while Ukraine's last energy oligarch, Serhiy Kurchenko, has been sanctioned by the European Union and Canada.[10]

In most post-Soviet countries, oligarchs have lost out as political power brokers. In Russia and Kazakhstan, the rulers seized control of the big private corporations years ago, expanding their own crony empires, and independent oligarchs are merely a distant memory (Dawisha 2014). In 1992, Estonia wiped out its metal-trading gangs by liberalizing exports and commodity prices, becoming the most honest and transparent postcommunist country (Laar 2002, Transparency International 2013). Neighboring Latvia, by contrast, delayed its deregulation of oil prices and exports by one year, allowing three oligarchs to capture the political system until the crisis of 2008 exposed them. Only in 2010 and 2011 did parliamentary elections finally cut them down to size (Åslund and Dombrovskis 2011).

At present, Ukraine stands out as the last postcommunist outpost where tycoons wield substantial political power, but they are being dealt one blow after the other. The global commodity boom is over. Steel, iron ore, and coal prices have fallen and are not likely to rise any time soon. Businessmen who own commodity assets are suffering, including most of the big ones: Rinat Akhmetov, Ihor Kolomoisky, Hennadiy Boholiubov, Victor Pinchuk, Serhiy Taruta, Borys Kolesnikov, Vadim Novinsky, and Kostyantin Zhevago. Ukraine's banking sector is also reeling under the current economic crisis, which has hit many banks, notably the two main owners of PrivatBank, Ukraine's largest bank, Kolomoisky and Boholiubov. Firtash's Bank Nadra is effectively bankrupt (table 2.1).

Yanukovych tried to follow Putin's example by attempting to expropriate the fortunes of the old oligarchs. Russian economists Sergei Guriev and Konstantin Sonin (2009, 1) have modeled this drama "a weak dictator does not limit rent-seeking. A strong dictator does reduce rent-seeking but also expropriates individual oligarchs." Yanukovych followed that model, but he moved too fast, which contributed to his fall. Still, the old tycoons remain weakened, and the Yanukovych family has been banished.

The war in Donbas has caused significant damage to those with assets there, in particular Akhmetov, Firtash, Taruta, Novinsky, and Kolesnikov. Firtash also owns two big factories in Crimea. Russian trade sanctions are designed to hit pro-European businessmen, especially Poroshenko, Pinchuk, and Taruta.

Public demands for transparency are reducing the possibilities for big businessmen to buy politics and even to evade tax. Every day, the media exposes suspect deals to criticism, dissuading businessmen from conducting dubious transactions. The public demand to cut political campaign expenditure means loss of revenue for owners of television channels, namely Firtash (Inter),

10. *Official Journal of the European Union*, "Council Regulation (EU) No. 208/2014 of March 5, 2014, concerning restrictive measures directed against certain persons, entities and bodies in view of the situation in Ukraine," European Commission, March 6, 2014.

Table 2.1 Main oligarchs in Ukraine, 2014

Oligarch	Partners	Industries	Main companies	Forbes wealth assessment, 2014
Rinat Akhmetov	Vadim Novinsky	Steel, coal, electricity, banking	System Capital Management, DTEK, Metinvest, TV Ukraina	$10.4 billion, $1.5 billion
Victor Pinchuk		Steel pipes, television	Interpipe, ICTV, STB, Nova Ukraina	$3.0 billion
Ihor Kolomoisky	Hennadiy Boholiubov	Banking, oil, ferroalloys, airlines	PrivatBank, Ukrnafta, Ukrainian International Airlines	$1.4 billion, $1.7 billion
Dmytro Firtash	Serhiy Lyovochkin, Yuriy Boiko	Gas, chemicals, television	Ostchem, Stirol, Severodonetsk Azot, Inter	$500 million
Serhiy Taruta		Steel	Industrial Union of Donbas	Lost most
Petro Poroshenko		Chocolate, sugar, agriculture, shipbuilding	Roshen	$1.2 billion

Source: Forbes, The World's Billionaires, www.forbes.com/billionaires/#tab:overall_country:Ukraine.

Akhmetov (television channel Ukraina), Kolomoisky and Boholiubov (1+1), and Pinchuk (ICTV).

Because of the war, Russian big businessmen have lost their voice in Ukrainian politics. The Russian state banks (VTB, VEB, Sberbank, and Gazprombank), Gazprom, Lukoil, Tatneft, Alfa Bank, and mobile phone companies MTS and Vimpelcom (Kyivstar) have all played major roles in the Ukrainian economy, but now they have little say.

A couple of developments have gone in the opposite direction of buttressing the strength of some oligarchs, however. The election of Poroshenko, the seventh wealthiest businessman in Ukraine, as president is of course the most striking event. As the war started in the east, President Poroshenko tried to appoint several top businessmen as regional governors. As of November 2014, however, only one of them remains, Kolomoisky as governor of Dnipropetrovsk region. This is an important post, and Poroshenko would be well advised to limit his authority or remove him from office when the worst of the war is over. The October 2014 elections appear to have sharply reduced the share of businessmen in parliament.

Since 2000, Akhmetov has been Ukraine's richest man by a big margin. His wealth is comparatively easy to assess, since he uses normal corporate structures, and assessments of his fortune illustrate the decline of Ukraine's tycoons. In January 2013, *Forbes* ranked him the 26th richest man in the world with a fortune of $22.2 billion. In October 2014, by contrast, *Forbes* lowered its estimate of his wealth to $10.4 billion (Babenko 2014). He is continuing to bleed because about half of his business empire is located in the occupied territories of Donbas, where several of his coal mines and steelworks stand still.[11] Other major Ukrainian businessmen are likely to see a similar dwindling of fortunes.

The point is often made that the oligarchs should pay back and contribute to the resolution of Ukraine's financial crisis. On the face of it, this might sound like a good idea, but on second thought it is not. The government has two options. One is to try to defeat the oligarchs, in which case it should not expect their support but tax them as normally as possible. The alternative is to make a deal with the oligarchs, which Ukrainian politicians do all the time, but that is the fundamental problem and must be avoided. In 1994, President Leonid Kuchma chased the oligarchs of the day away—Yuhym Zviahilsky, Ihor Bakai, and Vadim Rabinovich. Zviahilsky and Rabinovich even fled from Ukraine for one to three years (Åslund 2009, 87). Kuchma's mistake was that a year later he started compromising with the oligarchs and made deals with them. Similarly, seven big Russian bankers financed Boris Yeltsin's reelection campaign in 1996. After succeeding, they wanted to be repaid far more, blocking reforms (Freeland 2000). This mistake must not be repeated, but then the Ukrainian state should not expect any voluntary contributions from the oligarchs either.

Another idea is that the new Ukrainian government should confiscate the assets of the Yanukovych family and apply them to state funding. While a sound legal idea, it is not likely to generate large state funds. Former prosecutor general Oleh Makhnitskiy claimed that the Yanukovych regime took $100 billion out of the country, but only a negligible portion is likely to be returned. To begin with, the total amount is probably exaggerated and is perhaps only half that amount. For months, the prosecutor's office failed to build any case against the supposed culprits due to a combination of a lack of relevant laws, presumed corruption among the investigators, and difficulties finding evidence (Vorozhbyt 2014).

Turkish statistics show a capital inflow of $8.5 billion from Ukraine during the critical week at the end of February when the Yanukovych regime collapsed.[12] Far more money is likely to have flown to other jurisdictions outside the reach of Western courts, such as Russia, where most of the Yanukovych clan seems to be in exile. Until the Ukrainian criminal law and criminal-procedural law were amended in the fall of 2014, the Ukrainian state could not prosecute anybody in absentia, which saved the Yanukovych refugees, who were largely,

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11. On September 13, 2014, Maxim Timchenko, CEO of Akhmetov's power and coal company DTEK, told me that out of their 140,000 employees, 80,000 worked in rebel-held territories.

12. "Vo vremya Madana iz Ukrainy v Turtsiyu mogli vyvesti $8,5 mlrd" ["During Maidan They Could Transfer $8.5 Billion from Ukraine to Turkey"], *Ukrainskaya pravda*, October 16, 2014.

perhaps all, in Russia. According to the Ukrainian State Financial Inspection, the total assets of the Yanukovych gang that were frozen amounted to $1.42 billion in mid-November.[13] In a simultaneous statement, Prosecutor General Vitaliy Yarema claimed that more than $2 billion of assets had been frozen.[14] In general, little is collected of the loot of corrupt dictators and never more than $1 billion and it usually takes years. Because of its poor legal system Ukraine is likely to collect less than most (Vorozhbyt 2014).

Surprisingly, most Ukrainians still think their oligarchs are powerful, although they have suffered one blow after the other and lost out in other postcommunist countries. By international standards, their wealth is quite limited. The Russian war on Ukraine has devastated many of their companies located in the east, and several have been hit by Russian trade sanctions. They are mainly in old commodity industries, which are likely to face low prices for years to come. Several have had to flee Ukraine. The parliamentary elections in October 2014 clearly hit them, and the government program aims at sharply reducing their benefits. All around Ukraine, big businessmen have lost out and now claim to accept the new rules of the game. Ukrainian state and civil society have never been as strong in relation to the tycoons as they are right now. The state has an opportunity to establish legal order and a level playing field.

The Threat of Populism Is Also on the Wane

Old-style communism is dead in Ukraine. In the October 2014 parliamentary elections, the Communist Party received only 3.9 percent of the votes cast and fell below the 5 percent threshold for representation. This was the first time since the Bolshevik Revolution in 1917 that the communists were not represented in the Ukrainian Parliament. Nor did any other socialist or left-wing party enter parliament. Ukrainian analyst Oleksandr Kramar (2014) summed up the situation: "Since the Orange Revolution, the traditional left-right electoral division has been increasingly supplanted by a civilizational choice between Russia as a continuation of the USSR and Europe."

Little understanding of market economic ideas has taken hold in Ukraine. For years, populism filled this ideological vacuum. Its essence was a popular conviction that economic constraints are not binding, which is the definition of populism in European lingo. A broad opinion has favored more social expenditures than the government can afford, although ordinary Ukrainians receive very little support from the state and have endured poor governance. Among the post-Soviet countries, not even unreformed Belarus has as high public expenditures as Ukraine. In recent years, Ukraine's public expenditures

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13. "Na schetakh Yanukovicha uzhe zablokirovali 1,42 milliarda dollravo" ["On the Accounts of Yanukovych $1.42 billion Have Been Blocked Already"], *Ekonomichna pravda*, November 18, 2014.

14. "Yarema: GPU arestovala 35 milliardov Yanukovicha i Ko" ["Yarema: The General Prosecutor of Ukraine Arrested 35 Billion Hryvnia of Yanukovych & Co."], *Ukrainskaya pravda*, November 15, 2014.

have lingered around 50 percent of GDP, while the average of the post-Soviet countries has been one-third of GDP (IMF 2014e).

Similarly, the fixing of the exchange rate has been popular, and few politicians have dared to speak in favor of a floating exchange rate, although Ukraine repeatedly has suffered from unsustainable current account deficits, being forced to drastically depreciate its currency in 2008 as well as 2014.

In spite of Ukraine's large budget deficit and burgeoning public debt, some Ukrainian economists and politicians talk about international financing for renewed economic growth. They advocate fiscal and monetary stimulus to achieve higher economic growth. In this thinking, they are greatly influenced by two Nobel Prize winning economists. Joseph Stiglitz (2002) preached that the Washington Consensus is wrong. A typical statement of his is that "the net effect of the policies set by the Washington Consensus has all too often been to benefit the few at the expense of the many, the well-off at the expense of the poor" (Stiglitz 2002, 20). The reality is very different. Poland and the other successful postcommunist countries followed the Washington Consensus policy of free markets, private enterprise, and responsible fiscal policy (Williamson 1990) and achieved high growth to the benefit of all, while Ukraine did not and achieved no growth but the enrichment of a few.

In one article after the other, *New York Times* columnist Paul Krugman has argued that austerity is always harmful, including in the successful Baltic states. He never noticed that seven EU countries have been forced into IMF financial stabilization programs since 2008, and countries such as Latvia and Greece lost a quarter of their GDP because of their severe financial crises in spite of ample IMF and EU financing. Ukraine's problem is that money is not a free utility printed by the central bank as in the United States. But international financing is neither free nor unlimited.

Estonia's president Toomas Hendrik Ilves has taken on Krugman. In 2012, when Estonia had emerged with the highest growth in Europe, he ridiculed Krugman's advocacy against its successful austerity, contending that "Krugman didn't know what he was talking about" when it came to his country. "We're just dumb & silly East Europeans," Ilves said sarcastically about Krugman. "Unenlightened. Someday we too will understand. Guess a Nobel in trade means you can pontificate on fiscal matters & declare my country a 'wasteland.'"[15]

A big blow to sound fiscal policy, alas, has been delivered by none other than the IMF. For years, the IMF helped to ensure global financial stability. Critics pay it a backhanded compliment when they say its initials stand for "It's mostly fiscal." When the IMF forgets that, it becomes part of the problem.

In October 2012, the IMF (2012) published a note in its authoritative semiannual *World Economic Outlook*, arguing that fiscal multipliers—the change in output induced by a change in the government's budget deficit—were larger

15. Melissa Jeltsen, "President of Estonia Slams Paul Krugman: 'Smug, Overbearing & Patronizing'," *Huffington Post*, June 6, 2012.

in current circumstances than previously thought. Tight fiscal policy, in other words, would squeeze output more than economic modelers had typically supposed. The implication was that fiscal adjustment should be delayed.

In January 2013, the IMF's chief economist, Olivier Blanchard, and his colleague Daniel Leigh (2013) explained this finding in a working paper, but it does not apply to policy on Ukraine. First, the whole paper is based on forecasts of economic growth. In the early stage of a crisis, forecasts tend to be widely off the mark. For example, in December 2008, the IMF forecast that Latvia's GDP would fall 5 percent in 2009; it plummeted 18 percent (Åslund and Dombrovskis 2011). The performance of the forecasts is just too poor to be taken seriously. Second, the argument presumes that a country has access to the capital market. But emerging economies in crisis usually lose access to private international funding—sometimes suddenly and unexpectedly, despite having little public debt. Third, in the midst of a crisis, the political economy is conducive to radical reform, as people are often ready to accept radical budget reform and severe belt-tightening. Later, it is much more difficult. A crisis is a terrible thing to waste.

Fourth, the Blanchard-Leigh paper is entirely short-term, focusing on GDP in the year after a fiscal adjustment, but what matters is long-term economic growth, and that depends on structural reforms. Ukraine faced a lost decade in the 1990s and has lost another six or seven years since 2009. Finally, Blanchard and Leigh dealt only with 27 developed European economies, which do not include Ukraine. It does not have access to international financial markets, which the authors seem to take for granted.

Wisely, Blanchard and Leigh (2013, 6) concluded, "The short-term effects of fiscal policy on economic activity are only one of the many factors that need to be considered in determining the appropriate pace of fiscal consolidation for any single country." Yet the IMF management went ahead and made fiscal forbearance its official policy, significantly damaging the serious debate about fiscal crisis resolution in emerging economies for which their arguments has no validity.

During the 2008–12 European financial crisis, the three Baltic countries carried out rapid fiscal adjustment of 8 to 10 percent of GDP in one year and returned to solid growth within two years thanks to rigorous structural reform and much lower public expenditures. Greece, by contrast, has suffered six years of persistent economic decline due to its tardy fiscal adjustment and structural reforms. In recent crises, radical and front-loaded fiscal adjustment with structural reforms have proven much better both economically and politically in economies in the euro area periphery than painful, slow reforms. The Baltic countries proved that a front-loaded fiscal adjustment leads to fast recovery of financial confidence, sound public finances, substantial and beneficial structural reforms, and early and vigorous economic growth. To top it all, the Estonian and Latvian governments were reelected (Åslund and Dombrovskis 2011). Why choose a clearly worse option in a real crisis? Oleh Lyashko, the leader of the Radical Party, stands out in this populist competition.

In his presidential campaign platform in May 2014, he called for lower taxes and even higher pension expenditures.[16] Before the October 2014 elections, he called for raising healthcare expenditures as a share of GDP to 40 percent by 2010 (Gorodnichenko et al. 2014). Former finance minister Viktor Pynzenyk, one of the few nonpopulists in Ukrainian politics, told me that in Ukrainian political parlance, "radical reform" means higher public expenditures.[17]

A group of Western-trained economists evaluated the economic programs of the political parties before the October 2014 elections. They ranked Yatsenyuk's People's Front at the top (22.1 percent of the votes cast) followed by the Poroshenko Bloc (21.8 percent). These were the two big winners of the elections, and the surge of the People's Front was a great surprise. Most populist was indeed the Radical Party, which received only 7.4 percent of the vote, followed by the Communist Party, which insists on far-reaching nationalization and redistribution but did not enter parliament (Gorodnichenko et al. 2014). The rather hopeful conclusion is that irresponsible populism is not all that popular.

In the October 2014 elections, the parties that formed the Ukrainian government won the public debate over populism. Now they need to use this political mandate while it is still valid and pursue the necessary economic reforms and public expenditure cuts.

The Alternative: Financial Meltdown

What if the government does not implement the reforms I prescribe in this book? Is there a middle way? Given how precarious Ukraine's situation was at the time of writing in December 2014, no middle way appears possible. The nation faces a stark choice between front-loaded, rigorous reform and a financial meltdown. The nature of financial meltdowns is well known (Reinhart and Rogoff 2009, Kindleberger and Aliber 2005). All indicators show that Ukraine is headed in that direction. A financial meltdown could be followed by the collapse of Ukraine as a state.

A financial meltdown in Ukraine would likely be reminiscent of the Russian financial crash of August 1998—default, high inflation, a frozen banking system, falling output, and panic. The critical factors at play are shrinking international reserves, a rising budget deficit, a falling exchange rate, rising inflation, and a collapsing banking system. These factors would kill output, which would devastate the economy and standard of living.

The crucial concern is the level of international reserves. They fell to $7.5 billion at the end of 2014, corresponding to just over one month of imports. As a consequence, the market has lost confidence in the Ukrainian hryvnia, whose value plummeted to 16 hryvnia per dollar in early November from 8 hryvnia

16. Radikalna Partiya Olega Lyashka (Radical Party of Oleh Lyashko), Programma (Program) 2014, http://liashko.ua/program (accessed on October 22, 2014).

17. Personal conversation on September 15, 2014.

per dollar, halving its value. As international reserves decline further, those who can are exchanging hryvnia for dollars or euros and taking the money out of the country. Ukraine has extreme currency regulations, and dollars don't seem to be available for businesses or individuals. Yet, the thinner the market becomes, the faster the currency can fall.

The critical factor in a potential financial meltdown is the banking system. The banks are suffering from currency mismatches, making huge losses on the falling hryvnia. The more the hryvnia depreciates, the greater the bank losses will be. The National Bank of Ukraine (NBU) and the Ukrainian government face a severe dilemma: Should they close or recapitalize the failing banks? If they close too many banks, credit would dry up and output contract. If they recapitalize the banks, the budget deficit would expand perilously, and the only financing available would be monetary emission or printing money. The NBU and related state banks financed by the NBU already hold 60 percent of Ukraine's public debt. The exchange rate of the hryvnia falls with every announcement of another bank recapitalization. An additional issue is that related lending is standard in large parts of the Ukrainian banking system. In fact, more than 80 percent of the lending of one particular bank has gone to enterprises belonging to the bank's main owner.

The scenario is all too clear. Ukraine has entered a depreciation-inflation cycle. As the exchange rate falls, more banks will collapse. As long as the government recapitalizes them, the budget deficit will increase, and monetary emission will rise, and so will inflation, which reached 25 percent in 2014. Inflation can surge far higher if the exchange rate collapses. Because of the extreme currency regulations, foreign payments barely work, and as this vicious cycle worsens the banking system will freeze. Output and the standard of living would then plummet.

Together three measures can prevent such a meltdown. First, Ukraine should close the truly insolvent banks rather than recapitalize them to minimize the needed public expenditures. Second, the government needs to cut its public expenditures on the order of 10 percent of GDP—as the Baltic governments did in 2009—to save the country and convince foreign creditors that it can manage the nation's finances. Third, after having proven its fiscal rigor, the government should call for sufficient international financing through a renewed IMF program, expanded EU financing, and a Marshall Plan for Ukraine as discussed in chapter 3.

Should the meltdown occur, ironically, it would force the government to undertake the same radical measures that it should have taken to prevent the meltdown to begin with. But the government would be doing so after suffering far more, almost as Ukraine did in 2000 or as Russia did after the crash of August 1998, and presumably that would be with a new government.