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The Maidan and Beyond

OLIGARCHS, CORRUPTION, AND EUROPEAN INTEGRATION

Anders Åslund

***Anders Åslund** is senior fellow at the Peterson Institute for International Economics in Washington, D.C. His books include* How Ukraine Became a Market Economy and Democracy *(2009)*

A key to understanding any society is its informal institutions, which influence both its economy and its politics. In Ukraine, the most important such institution is endemic corruption. Aside from Russia's campaign against Ukraine's territorial integrity and sovereignty, corruption is the main threat to the nation.

Many countries are very corrupt, but Ukraine is an especially severe case. Currently, Transparency International ranks it 144 out of 177 countries on its well-known Corruption Perceptions Index. Corruption is pervasive in Ukraine, but most damaging is the high-level corruption that has been highlighted by public display of the crassly ostentatious homes owned by former president Viktor Yanukovych and top members of his administration.

Since the mid-1990s, Ukraine has lived under the domination of a score of oligarchs. These big businessmen control several sectors of the Ukrainian economy, notably energy, metallurgy, mining, and the chemical industry. The open and competitive sectors have mainly to do with retail trade, high technology, and agriculture plus its related industries. The big businessmen sponsor various political parties, including even the Communists and Socialists, but have no ideology and seek only narrow self-interest. Sometimes these business figures compete against one another and sometimes they collude; they are, above all, astute dealmakers.

In the 1990s, all the truly wealthy Ukrainians made their money in the natural-gas trade. Its essence was to buy Russian gas at an artificially low, state-regulated price and then sell it at a high, monopoly-shielded price. Gazprom, the Russian state company, sold all the gas imported by Naftogaz, the Ukrainian state company. The gas flowed directly from Russia across the border into Ukraine via pipelines that these two com-

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panies owned. Oddly, however, during every year except 2009 some intermediary company became involved in handling this trade. The only explanation for this strange circumstance is corruption: Each year, a few Russian officials and a few Ukrainian businessmen shared several billion "extra" dollars. In order to defend their outrageous robbery, they elevated the trade to a matter of Russo-Ukrainian national conflict.

The gas-trade scam represents rent-seeking at its worst. It is a cancer that harms Ukraine's politics and economy. Rather than doing anything productive, several of Ukraine's foremost businessmen focus on this lucrative trade. Thanks to the ample rents they rake in, they are able to buy Ukraine's politics. The most recent "gas king" was Dmytro Firtash. In March 2014, Austrian authorities arrested him in Vienna at the request of the FBI.

Acting Prime Minister Arseniy Yatsenyuk has accused the Yanukovych regime of having stolen US$37 billion from the state during its four years in power. That corresponds to somewhat more than a fifth of Ukraine's nominal 2013 GDP of about $176 billion. Yanukovych stands out for having driven public-asset theft to a new level and for having concentrated so much of the loot in his own hands and those of his son Oleksandr, plus a group of their young associates who are collectively known as the Yanukovych "family."

The Yanukovych family is thought to have piled up a fortune worth $12 billion. It also turned a 27-year-old manager, Sergiy Kurchenko, into a billionaire. In a single year, Kurchenko built a business empire in oil refining, media properties, the energy trade, and banking worth some $3 billion. Now it is collapsing, and his two banks have been closed.

The self-enriching exploits of Yanukovych and company made clear the problems that beset Ukraine's economy. The corruption took three forms. The first had to do with the trade in natural gas (not only gas taken from the ground in Russia, but gas from Ukrainian deposits also). Since 2009, Russia has charged high prices for its gas, but rent-seeking in the Ukrainian gas trade persists domestically. Each year, Naftogaz bought 18 billion cubic meters of domestically produced gas at the extremely low price of $53 per 1,000 cubic meters (mcm). The alleged reason for this was to provide consumers with cheap gas, but probably half the volume wound up being leaked to the commercial sector, where gas prices were based on the Russian price of $410 per mcm. Somebody close to Yanukovych made a fortune reselling gas to industrial customers. The potential for privileged arbitrage was around $350 per mcm times 9 billion cubic meters, which equals $3.15 billion. Presumably, this was the main reason why Yanukovych so adamantly opposed higher gas prices. Similar but smaller-scale rent-seeking took place in other energy sectors, notably coal and nuclear. The IMF estimates that 7.5 percent of Ukraine's GDP had been going to energy subsidies that were passed on to privileged "businessmen."

Second, Yanukovych handed out large infrastructure projects at his personal discretion. Many of these were linked to the Euro 2012 soccer tournament held during June of that year in Donetsk, Kyiv, Kharkiv, and Lviv as well as several Polish cities. In general, the Ukrainian government paid twice as much as needed for such projects. Judging from the infrastructure allocations in the state budget, I would assess such infrastructure-related corruption to have been worth at least $2 billion a year to the Yanukovych family. Dishonestly run infrastructure projects are common in economically corrupt countries, but a kickback of 50 percent is very large. In 2010, the IMF forced Yanukovych to adopt legislation requiring competitive bidding in matters of public procurement. He quickly amended the law in ways designed to facilitate his misdealings.

The third form that corruption took was outright stealing from the government, notably the State Tax Administration and the State Customs Committee. In Ukraine there is a special word (*deriban*) for theft from the state budget, which is considered a fine art. The Yanukovych family mastered this art, stealing billions of dollars each year. The government that replaced his administration in February 2014 has been assessing how much per year was embezzled from each ministry. The numbers so far are large, with the total annual larceny estimated at $3 billion to $5 billion.

Over each year from 2010 through 2013, these three sources of embezzlement and corruption appear to have generated about $8 billion to $10 billion in ill-gotten annual gains for Yanukovych and his family. And that is only *public* corruption. Yanukovych's family stole from private businesses too, of course. Many large enterprises changed hands during his years in power, usually at very low prices because the Yanukovych family was forcing the sale. Such "corporate raiding" particularly afflicted Western-owned banks, most of which went to family members for a fraction of their fair market value. Thanks to Ukraine's excellent independent media, especially the websites *Ukrayinska Pravda* and *Mirror Weekly,* we know how money was embezzled and who benefited.

The economic effects of this larceny have been massive. According to the World Bank, Ukraine is one of five former Soviet republics that now produce less output per capita than it did in 1989. In that year, Ukraine's per capita GDP was about equal to that of Poland or Russia; today it is only about a third of theirs.

For the last two years, Ukraine has had no economic growth. In the wake of the Yanukovych splurge, the country is suffering from both budget and current-accounts deficits, each of which is equal to 9 percent of its 2013 GDP. Last year, Ukraine's situation was somewhat cushioned by an agricultural boom that brought its tiny and even poorer neighbor Moldova 9 percent growth. This year will be much worse for Ukraine. The IMF predicts an output contraction of 5 percent, but any forecast is highly uncertain because nobody knows what the country's actual policies will be. The main impediment to economic growth in Ukraine has been corruption.

The Impact on Politics

Corruption is not only the main business in Ukraine; it is also at the heart of Ukrainian politics. Like the U.S. Senate in the Gilded Age, Ukraine's parliament is a club of dollar millionaires in an otherwise poor country. The political corruption has many interlocking features. Despite Ukraine's poverty, its election campaigns are (in proportionate terms) among the world's costliest. The total amount spent by all the candidates in a typical presidential election or set of races for the 450-seat parliament is about $2 billion, or 1 percent of GDP. In relation to GDP, that is two-thousand times more than is spent on a U.S. election campaign.

Most of the political spending that goes on in Ukraine is unofficial and illegal, but nobody can be elected without buying lots of expensive television advertisements. Before Yanukovych fled, he was rumored to have gathered a war chest of $3 billion in preparation for the scheduled March 2015 presidential election. Every party needs a large secret fund, or *obshchak*. The word is also used to refer to the common funds that organized criminal gangs maintain. In fact, the parties' need to raise illicit campaign cash has led them to share many features with organized crime. Each party has a "gray cardinal" whose job is to be in charge of its *obshchak*. He (they are all men) is usually a parliamentarian and a prominent businessman, though the top businessmen refuse to indulge in this dirt.

Only Yanukovch's Party of Regions could fill its *obshchak* through extortion. The other parties had to sell concrete goods and services. A safe seat in parliament could fetch up to $5 million. Businessmen were known to buy seats and then trade them to the winning party at a profit. The ruling party or coalition could offer high bidders "profitable jobs" (*khlebnye mesta*). These included posts chairing state committees and running state enterprises, to mention some of the more valuable ones. There was a healthy trade in judgeships and provincial governorships, too (in Ukraine a governor is a presidential appointee). In coalition governments, the gray cardinals of the coalition partners got together in order to agree on who would be allowed to sell which jobs. In this regard, the Ukrainian government proved quite efficient: Jobs were quickly auctioned off without much difficulty.

Once people had bought their offices, they needed to finance their purchases and turn a profit. They did so through corruption: *deriban*, kickbacks on public-procurement contracts, extortion, and corporate raiding. In most cases, therefore, to be a member of parliament or a senior official meant being committed to corruption.

Certain industries, such as nuclear energy, have tended to stay under the control of the same shady businessmen regardless of who is ruling. As the reins of government have changed hands, so have the political affiliations of these operators. In other privileged industries, such as gas, the key businessmen often change with elections. Some of the biggest shady businessmen refuse to focus on single industries, preferring instead to buy the required political services regardless of who is in power. Most hold seats in parliament in order to stay fully informed and able to influence regulations and budgets. The most important businessmen seek to maintain their leverage by controlling sizeable blocs of seats. The legislators in any given bloc may well be drawn from varying parties, since for these purposes party affiliation matters little.

Oleh Rybachuk, who had served as chief of staff for President Viktor Yushchenko, realized the depth of corruption a year after the Orange Revolution. He resigned and started an NGO called Chestno (Honestly). Chestno checked the legally declared incomes of all members of parliament against their apparent personal spending and concluded that not one of them could possibly be living on his or her official income.

The fundamental insight is that corruption pervades not only Ukraine's economy but also its politics, and this corruption depends only marginally on who is in power. The current system will allow no one to come to power who is not prepared to play the old corrupt game. When there is a change at the top, weary Ukrainians ask not whether corruption will decline, but rather who will benefit the most from it under the new rule.

Democratic development requires legitimate institutions. The most legitimate institution had been parliament. It was elected in October 2012 in a reasonably democratic fashion in spite of substantial fraud that helped Yanukovych. The just-restored 2004 Constitution has some legitimacy as well, but it proved fairly dysfunctional from 2006 to 2010 and requires amending. The successful carrying out of free and fair presidential elections set for 25 May 2014 should render new president Petro Poroshenko legitimate. The next steps should be early legislative elections to form a more legitimate parliament, accompanied by the amendment of the constitution, which could take place before or after the parliamentary elections.

How to Banish Larceny from Politics

Corruption is often discussed as if it were solely an economic problem, but breaking its vicious cycle in Ukraine is in fact a political task of the highest order. Other countries have found ways to do this. In the post-Soviet sphere, the prominent success stories include Estonia during the early 1990s and Georgia following its 2003 Rose Revolution. Let there be no mistake, however: Curbing corruption will require a major effort, and if the problem is not understood, it cannot be resolved.

The greatest need is to reduce the cost of election campaigns. Many

European governments have done so by strictly regulating the amount of campaign-related programming that can be aired on television. A number of official televised debates should be agreed upon, while televised political ads should be banned. If Ukraine could cut the total amount that candidates and parties typically spend on an election from $2 billion to a more normal figure of $20 million or so, the other needed reforms will become perfectly feasible. Interestingly, Victor Pinchuk, one of Ukraine's wealthiest businessmen, wrote in *Ukrayinska Pravda* in late March of the need to prevent money from being the path to political power, and power from being the path to riches. In fact, public opinion might be bringing about a change. In the current presidential campaign, none of the candidates has invested a lot in television ads or billboards, since that would reveal their corruption.

The Ukrainian parties need to be transformed from organized-crime syndicates into normal political parties funded by membership fees and public financing.

Political financing should be strictly limited. Only two sources of it should be allowed: public financing and party-membership dues. Similar restrictions are standard in many European countries. This is particularly important today because without rigorous transparency rules Russian political money will surely flood the country during all future campaign periods.

To expose what is going on, the nation needs a far-reaching right-to-information law demanding as high a degree of transparency as the pioneering Scandinavian laws that date from the eighteenth century (Sweden's was the first, in 1766), when those countries were highly oligarchic and corrupt. Since Yanukovych's fall, parliament has adopted a public-information law, but the legislature needs to demand more radical transparency. The current income and wealth declarations of senior Ukrainian politicians are a joke—it is routine to claim only minimal resources—and they are not being audited.

The Ukrainian parties need to be transformed from organized-crime syndicates into normal political parties funded by membership fees and public financing. If the parties want to gain credibility, they need to oust their gray cardinals. The parties should also become subject to independent financial auditing.

The problem goes beyond parties and elected officials. Ukraine's civil service is pervasively corrupt. Its cleansing will require multiple approaches. To begin with, the state should limit its regulatory role to what makes sense. Many of the existing state agencies should be merged or abolished, as currently their main function is to wrap things in red tape. The practice of auctioning off high offices must end. It should be strictly illegal, and punishable by several years in prison, to buy or sell a post of public trust. A clear line should be drawn between political appointments and civil-service jobs. The number of the former must be reduced: Cabinet ministers and their deputies can continue to be political appointees, but the rest of the public administration should be recruited and promoted via merit-based criteria. The president should lose the power to name regional governors. Instead, these officials should be elected so that they respond to local constituents rather than to Kyiv. Those currently holding civil-service posts should be required to undergo a vetting process designed to scrutinize their levels of competence and decency. If carried out properly, this process should lead to a large share of the current public employees being relieved of their duties.

The European Union and its Association Agreement (AA) with Ukraine can work as important levers for the reform of the Ukrainian state. Yanukovych's November 2013 decision to forgo signing the AA was what led to his downfall. By reversing that choice and signing the AA on 21 March 2014, his successors have committed Ukraine to adopting hundreds of reform laws, while the EU has vowed to help draw up new laws and reorganize state agencies. As of this writing in May 2014, no fewer than sixty state agencies in various EU countries have made "twinning agreements" with Ukrainian counterparts for the sake of aiding the latter in their reform. These EU state agencies know how to combat corruption in the field: They have ample experience gleaned from their work in other countries that have joined the EU in recent years.

The EU would not approve the AA until Ukraine adopted a score of laws transforming its entire system for enforcing laws and administering justice. Yanukovych had balked at this, refusing to accept the new EU-designed law on prosecutions. Presumably, he realized that giving up control in this area would likely mean that he and his lieutenants would face indictments for their financial misdeeds, which indeed they now do. The EU's help in building a strong and independent Ukrainian judicial system should extend to assistance with the vetting of all current judges, most of whom deserve to be sacked for corruption.

Ukraine has a vibrant civil society and lots of young, well-educated people. Tens of thousands of young Ukrainians have graduated from European universities in recent years, but they have preferred to stay abroad. These forces should be mobilized for the reform of the Ukrainian state. These people are many and strong. They need to be prepared to stand up and fight for their ideals inside the halls of government.

Estonia in the early 1990s and Georgia after its Rose Revolution carried out the most successful reforms of state agencies in serious disrepair. Their governments dealt with corruption-riddled state agencies by firing entire staffs, reorganizing the agency in question, then hiring new staffers to run the new-model organization under much stricter legal rules. The abysmal quality of governance in Ukraine suggests that this is the approach to use. Nearby Georgia is well placed to provide plenty of excellent former ministers who can act as consultants to show how this is done.

How to Rebuild the Economy

As corruption's political machinery is being dismantled, its economic machinery needs to be destroyed. The Ukrainian opposition, civil society, the EU, and the IMF must carry out a full audit of public finances under Yanukovych in order to gain a thorough and precise understanding of how the embezzlement schemes and other misdealings worked. Once assessed and investigated, such malpractices can be rooted out in sector after sector through the new laws that the EU and the IMF are demanding.

As usual, the IMF has taken an early lead on economic reform. A new acting government was formed on February 27, and the IMF's fact-finding mission arrived just one week later, on March 4. By March 27, a two-year standby agreement with the Ukrainian government had been concluded. The IMF Executive Board adopted that agreement on April 30, and instantly disbursed the first $3.2 billion out of a total credit of $17 billion. Additional financing of $10 billion from other creditors is expected, providing Ukraine with the necessary international financial support. Before receiving this financing, the Ukrainian government had already undertaken the first reforms, which are both improving the nation's finances and reducing corruption.

The first IMF condition is a reduction of the budget deficit. Rather than raising more revenues, the government should cut public spending—which currently and outlandishly equals nearly half of GDP—in order to balance the budget in the medium term. A huge chunk of this inflated expenditure is being used to pay for corrupt subsidies of one sort or another. These must end. When corrupt benefits form such a large share of public outlays, it is socially beneficial to slash them fast. To cut them slowly would be tantamount to preserving corruption.

The new government has taken an important positive step by abolishing four-dozen state programs that amounted to little but corruption and were costing slightly more than 3 percent of GDP. But undoubtedly many other programs are also financing corruption. In particular, the large energy subsidies should be eliminated up front. They are nothing but channels for rent-seeking; if they remain, new beneficiaries will arise to fill them—and to make sure that reforms stall.

Specifically, in March 2014 natural-gas prices for households amounted to only 15 percent of the cost-recovery level. The only way to banish the perennial gas-trade rent-seeking is to let these prices rise sixfold till they reach cost-recovery level. The reform recently adopted (at IMF prompting) hikes household gas prices by 56 percent, keeping them far below the cost-recovery level, which they would only reach in 2017. Unfortunately, this will not be enough. The risk is great that a new rent-seeker will enter the power structure and seize upon the old arbitrage between low state-controlled prices and high free prices. It would have been better to liberalize the gas sector, while offering corresponding social compensation in cash.

The EU represented democracy and the struggle against corruption, while the Kremlin allowed Yanukovych to be as corrupt as he wanted and encouraged him to become even more authoritarian.

Ordinary Ukrainians need not suffer from rising gas and utility prices, since half the withdrawn gas subsidies could be handed back to them in the form of targeted cash compensation. In Latin America, the World Bank has proven that it knows how to design such a giveback program and actually lower inequality. With normal gas prices, Ukraine will have finally received sound incentives to expand its domestic gas production while reducing its outsized gas consumption. The country could achieve natural-gas self-sufficiency in five to seven years. The liberalization of coal prices and elimination of coal subsidies could proceed in similar fashion, and the corruption in the electricity arena could be cleaned up at the same time.

The 2010 tax code needs revision. Tax rates themselves are reasonable, but Ukraine's tax system is far too complex with too many taxes and an excessive number of tax payments. By imposing so much tax-related complexity on small entrepreneurs, the tax code drove millions of them out of business. Simplified taxation needs to be restored. The code also aggravated the already extensive transfer pricing of large, well-connected companies that paid neither profit taxes nor dividends to minority shareholders because all their profits were transferred to tax-free offshore havens. Refunds of value-added taxes to exporters should be made automatic so as to end the racket in which tax officials withhold refunds pending the payment to them of a "commission." A simplification of the tax system will also allow the abolition of the tax police, who too often subject citizens to lawless persecution.

Another key to reducing corruption is the adoption of a public-procurement law that will allow foreign as well as Ukrainian companies to make open tenders in pursuit of state contracts, which was one of the prior actions that the IMF demanded and parliament has already adopted. This measure alone should save 1 to 2 percent of GDP. Along with the other measures outlined, it will put Ukraine's state finances on a sustainable footing.

Many of the top officials responsible for the recent thefts from the public coffers have fled the country, predominantly to Russia, or gone into hiding; only a few have been arrested. Anyone who benefited from these larcenies should face prosecution and be forced to pay back what they extracted unlawfully from the Ukrainian government. As of this writing, two score of the miscreants have been made subject to international asset freezes, which suggests that the state has a fair chance to recover more stolen assets than is usually the case.

Meanwhile, the National Bank of Ukraine (NBU) has moved to let the exchange rate float, which should eliminate the overvaluation of the national currency and with it the large current-account deficit. The NBU has been able to preserve sizeable reserves totaling $17 billion. Having depreciated the exchange rate, the Bank has put itself in a position to gradually ease the rather extreme currency regulations that are hampering trade and investment while engendering corruption.

On March 27, the IMF announced that it had agreed to furnish Ukraine with $27 billion over two years. Some of the funds ($14 to $18 billion) will come from the Fund itself, while the remainder will come from the World Bank, the EU, and various bilateral creditors.

The Ukrainian drama has been framed as a choice between integration with Europe and integration with Russia. It is true that the EU offered a deep, beneficial, and comprehensive free-trade agreement, whereas a decision by Ukraine to join the Moscow-led customs union would have reduced Ukrainian GDP. Foreign-policy considerations and regionalism did play some role, but the funds offered by each side were irrelevant. What was of the essence was that the EU represented democracy and the struggle against corruption, while the Kremlin allowed Yanukovych to be as corrupt as he wanted and encouraged him to become even more authoritarian.

The Ukrainian people have now made a choice for Europe. Let us hope that they will stick with it. If they do, they will have their best chance to clean out the Augean stables of a long-corrupt economy and political realm. It will not be easy. The hotbeds of corruption must be ruthlessly flushed out, while in each sector that comes in for reform, the new system and more transparent ways must be imposed at once and as a package, never introduced piecemeal (with opportunities for resistance arising at each step of the process).

The EU, the IMF, and the United States have important roles to play in this process as bearers of legal standards, contributors of assistance, and also as monitors on the lookout for corrupt monetary flows. When corruption is the chief problem, its mechanisms must be uprooted fully. Otherwise, new actors will yield to the temptation to make money the old-fashioned way, as has already happened far too often in Ukraine.