

### Who you gonna call?: oligarchic clans as a bottom-up force of neighborhood Europeanization in Ukraine

Melnykovska, Inna; Schweickert, Rainer

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Inna Melnykovska, Rainer Schweickert

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**67** /2008

**Freie Universität Berlin**

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## Who you gonna call? – Oligarchic Clans as a Bottom-up Force of Neighborhood Europeanization in Ukraine

Inna Melnykovska<sup>1</sup> and Rainer Schweickert<sup>2</sup>

### Abstract<sup>3</sup>

This paper argues that, in the absence of a strong membership incentive within the European Neighborhood Policy (ENP), a top-down institutional convergence of CIS countries towards European standards – i.e. democracy and market economy – is unlikely to be successful. However, due to enlargement fatigue within the EU, the membership incentive is off the agenda for the CIS. Hence, the ENP has to initiate or to speed up a bottom-up institutional convergence by identifying bottom-up domestic forces that are willing and able to drive the convergence in a particular country. Ukraine, whose oligarchic clans are the main bottom-up forces behind institution building, is a case in point. After having supported the first wave of institutional reforms during the Orange Revolution, these bottom-up forces are facing great difficulties in forming sustainable coalitions for further institutional reforms. The paper shows that the EU could, by providing economic incentives rather than the membership incentive, exploit the strong business interests of the oligarchic clans in the EU markets and EU investment to motivate them to jointly drive institutional convergence from the bottom-up.

Key words: Europeanization, institutional convergence, institution building, Orange revolution, oligarchic clans

JEL-Classification: B15, D02, D72, F15, F20, P33, P36

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<sup>1</sup> Inna Melnykovska, Otto-Suhr-Institut für Politikwissenschaft, FU Berlin/Kiel Institute for the World Economy; [melinna@gmx.de](mailto:melinna@gmx.de).

<sup>2</sup> Rainer Schweickert, Kiel Institute for the World Economy; [rainer.schweickert@ifw-kiel.de](mailto:rainer.schweickert@ifw-kiel.de).

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## 1. Introduction

Institutional convergence towards European standards/values, i.e. building EU-style institutions, in any particular post-communist country can theoretically run two ways: bottom-up and top-down. Democratic governments may implement institutional reforms in a top-down way without wide domestic support in the population or the elite. A top-down convergence would be less complex, as governments would not have to spend time and effort finding domestic support. However, such convergence would be highly risky, especially if institution building causes high social costs. Hence, top-down institution building might be easier if the strong external incentive of EU membership were provided, which would make the bitter pill of convergence easier to swallow for those who stand to lose by balancing social pressure with other, e.g. geo-political, benefits. Alternatively, the wide support of some institutional change by the population or by the elite can induce governments to achieve institutional convergence in a bottom-up way. Such convergence would be more sustainable, as the resulting European-style institutions would be home grown. Convergence in a bottom-up way would proceed slowly, but could be speeded up by providing some external incentives for the population or for the elite.

Indeed, the success of the Central and Eastern European countries (CEECs) in the top-down building of European-style institutions is often attributed to EU membership incentive these countries enjoyed. The concept of convergence – not only, but also of institutions – is tightly integrated in the process of EU enlargement (Schweickert 2004). The institutional convergence of the CEECs, often labeled “Enlargement Europeanization”, has resulted in the most massive transfer of European institutions in recent history (Schimmelfennig and Sedelmaier 2005; Pop-Eleches 2007).<sup>1</sup> When accepting ten CEECs as new members, the EU established the Copenhagen Criteria for membership, including standards of criteria on institutional quality, and provided financial and technical assistance to bring down the social costs of institutional convergence towards these common standards (Gawrich and Schweickert 2004; Raik 2005; Roland 2005). To fulfill EU institutional standards, the candidate countries must demonstrate political stability, including maintaining of human rights and protection of minorities (political criteria); implement the *aquis communautaire* into national legislation and adopt the goals of the political, economic and monetary union (legal criteria); and have a fully functioning market economy (economic criteria). Truly, the EU has been successful until now in its enlargement strategy, as there is a large consensus on the favorable role of the EU in promoting democracy and economic development by fostering a top-down institution building in most CEECs (Gawrich and Schweickert 2004; Raik 2005; Roland 2006).

In the Commonwealth of Independent States (CIS), the top-down institutional convergence towards European standards and values has lagged behind. Unlike in the CEECs, comparable Europeanization mechanisms – incentives, compensations, linkages, direct financial support, etc. – to implement European institutions have not been available in the CIS.. The EU did not give these countries a membership incentive and concentrated more on economic cooperation than on institutional convergence. Furthermore, the other international organizations acting in the CIS targeted macroeconomic stability and expected institutions to be built as by-product of the macroeconomic reforms. Only in the second half of the 1990s did the disappointing outcomes of political reforms, as well as the economic stagnation and crises in the CIS and in developing countries, give rise to a great number of studies on the reasons for the mistakes made in the design of the reforms (Hellmann 1998; Unmüsig and Walther 1999; Rodrik 2000, 2003, 2006; Schweickert und Thiele 2004).<sup>2</sup> These studies conclude that building

European-style institutions is crucial to successful political reforms and sustainable economic growth in the CIS and lead international lending organizations, governments and investors to rethink the importance of institutions.

It is obvious that the EU as one of the influential international actors in institution building in the region would speed up top-down institutional convergence towards European values and standards in the CIS by offering a membership perspective for the neighboring CIS countries. However, after Eastern enlargement has been completed with the recent accession of Bulgaria and Romania in 2007, the “carrot” of membership to push for institutional development in transition countries is currently reserved for the Western Balkan states exclusively. For the post-Soviet space as well as for Mediterranean countries, the EU has created a new instrument, the European Neighborhood Policy (ENP).

The ENP clearly demonstrates the EU’s interest in “the ring of well-governed states”<sup>3</sup> that would respect European democratic, market and legal institutions, but has limited potential to push for institutional convergence towards European standards in a top-down way. In the absence of a strong membership incentive, a top-down institutional convergence is unlikely to be successful. “Neighborhood Europeanization” has to rely on the European Neighborhood Policy Action Plans (ENP APs) together with financial assistance to cut the social costs of institution building under the new European Neighborhood Policy Instrument (ENPI). As argued in Gawrich et al. (2008), the incentives and compensations provided by the ENP are well-suited to a top-down approach, but a top-down approach could only work in the CIS if the membership incentive were provided, as it was to the CEECs, which have successfully converged as a result.

In the absence a strong membership incentive, democratic institutions and a stable market economy have to be bottom-up to survive changes in the political and economic sphere (Rumer 2005). The so-called color revolutions in Ukraine, Georgia and the Kyrgyz Republic exemplified the potential of these countries to converge towards European standards in a bottom-up way. The wide support for institutional convergence by the population and by the elite has induced the government to introduce formal legislative standards and to narrow the institutional gap between the EU and these countries. Such a bottom-up convergence proceeds slowly, but could be speeded up by the EU.

This paper argues that, the EU’s external incentives for institutional development in the CIS can only work if there is a net benefit for domestic forces to converge in a bottom-up way towards EU standards. Hence, the ENP has to rely more on appropriate incentives and mechanisms to push for a bottom-up convergence by identifying the domestic bottom-up forces that are willing and able to drive institution building in a particular country. The EU should design ENP incentives and mechanisms such that they exploit the political and economic preferences of these domestic forces to bring about institutional convergence. Because the strength of the EU is its position as a global economic player, economic incentives have to play the most important role in this regard.<sup>4</sup>

Ukraine, which has expressed a keen interest in becoming member of the EU, but which is not being considered for membership by the EU, is a case in point. The Orange Revolution clearly revealed Ukraine’s potential to adopt the fundamental European values of democracy, market economy, human rights and the *Acquis communautaire*, a potential that can be exploited by the ENP (Vinhas de Souza et al. 2006). However, the unified domestic forces that ended Kuchma’s repressive regime failed to build any consistent coalition after the common goal of overcoming reform gridlock and building minimal institutional standards was achieved and the EU did not offer Ukraine the strong incentive of membership. As a consequence,

Ukraine's reform capacity to converge in a top-down way that would go hand in hand with enthusiastic expectations that EU membership would be granted in the aftermath of the Orange Revolution has decreased considerably (Fischer et al. 2008, White et al. 2008). However, the EU still has the possibilities to push for a bottom-up institutional convergence in Ukraine. It can use economic incentives to motivate the oligarchic clans that are the main bottom-up forces behind institution building in Ukraine to jointly drive institutional convergence, since these clans are strongly interested in EU markets and its investment.

We proceed by showing that the oligarchic clans have been and are still the main (potential) internal drivers of a bottom-up institutional convergence in Ukraine (Section 2). Combining the theories of Oleh Havrylyshyn (2006a) and Mancur Olson (2000), Section 3 takes a closer look at the political and economic preferences of the oligarchic clans and the way they are changing under the influence of globalization. Section 4 concentrates on Ukraine's trade with and investment from the EU, thereby identifying the EU's potential leverage to exploit the changing preferences of the rent-seeking oligarchic clans in Ukraine and to engender the bottom-up convergence of Ukraine's institutions towards EU standards. Finally, Section 5 summarizes and draws conclusions for "Neighborhood Europeanization" under ENP.

## **2. Oligarchic Structures as Domestic Forces behind Institution Building in Ukraine**

The population or the elite are the domestic forces that drive a bottom-up institutional convergence. The population may participate in "intermediary" non-state organizations, such as professional associations, religious groups, labor unions and citizen advocacy organizations to articulate their preferences for better institutions and push democratic governments for institutional convergence. A population organized in such a way is often referred to as a civil society. In their turn, the elite in such a society may found lobby organizations or create networks with politicians (often part of elite) to push for institution building. Theoretically, civil society is assumed to be even more important for a bottom-up convergence than the elite.

Civil society, however, has not been the main bottom-up force in Ukraine. Public choice was neither a driving nor constraining force of institution building during the early transition years (Howard 2002; McFaul 2002). CIS countries had the least participatory civil societies in the world (Howard 2002; World Values Survey 2004) and their civil societies were regarded as weak and passive (this was also true for Ukraine).<sup>5</sup> The studies on the civil society in Ukraine define the mass demonstrations during the Orange Revolution in 2004-2005 as spontaneous popular protests based upon social dissatisfaction with the incumbent political regime, but not the activities of a developed and established civil society (Stepanenko 2006). While these studies differ on the importance of the mass demonstrations for the outcome of the Orange Revolution, they agree that the popular protests were "the birth" of a civil society that has now undergone an elementary stage in its development, but is still nascent in nature (McFaul 2005; Kudelia 2007; Gelman 2008). Ukraine's civil society is, therefore, a weak bottom-up force.

Hence, the elite are the only domestic forces capable of building institutions in Ukraine. Among the various elite groups, the oligarchic clans are the most powerful bottom-up forces, "capturing" the state authorities and controlling the enforcement and implementation of institutional reforms (Hellman 1998; Zimmer 2006; Pleines 2005, 2008). During the early

stages of transition, the oligarchic clans were responsible for the gridlock in institutional convergence with the EU. By 2004, they had changed their political and economic preferences, supported the Orange Revolution and the following bottom-up institutional convergence and managed to maintain their immense influence in Ukraine's politics and in its economy.<sup>6</sup> Thus, we concentrate exclusively on oligarchic clans as the most powerful bottom-up force of institutional change in Ukraine.

The oligarchic clans are a special hybrid of the political and business elite, which is a major actor in both Ukraine's politics and its economy. They are not groups of relatives or systems of kinship, as are the classic European and Asian clans, but rather business entities.<sup>7</sup> Thus, they are mainly interested in accumulating wealth and capturing new markets. However, the oligarchic clans also are different from a classic business entity in the way they use the strategy "power-money-power" for wealth accumulation. Namely, access to state power enables the oligarchic clans to secure their economic interests and make profits, which they use to broaden their political power. A symbiosis of politics and business does not involve just a simple patronage connection. Besides lobbying, networking and bribing to influence politics, the oligarchic clans aim at assimilating the political elite. The assimilation of clan's members in politics and vice versa is a common phenomenon in Ukraine.

The Ukrainian clans exhibit hierarchical levels. The top position is held by a chieftain who is surrounded by a core, i.e. the most trustworthy group of business partners, relatives and friends. The chieftain and members of a core are often called oligarchs. Lower positions in a clan's hierarchy are held by professionals and ordinary employees who work in the enterprises under the clan's control. Agents of influence or patrons in politics hold a special position. Officially, they are not members of a particular clan, but their mutual support and cooperation are vital for the clan's fortune.<sup>8</sup> State officials supply the clans with valuable information about state policy plans and ensure them a privileged economic position and profits by providing licenses, tax exemptions and subsidies.

In the political framework of Ukraine's "defective democracy"<sup>9</sup> (Merkel et al. 2003), oligarchic clans capture the state and directly access political power through the executive, the legislative or judicial branches.<sup>10</sup> Yet, the value of having access to a particular state branch varies over time. In the early 1990s, a direct connection to the president was of the highest value.<sup>11</sup> Thus, the Ukrainian clans concentrated their attention on building up their connections in the executive. They secured their enterprises through contacts to the president, the presidential administration and the government in general. In the late 1990s, connections to parliamentary representatives or - even better - obtaining a personal mandate increasingly gained more importance. Some oligarchs founded or captured political parties, or simply bought slots on party lists. Others used one-man constituencies in Ukraine's mixed majoritarian and proportional representation system to become members of the *Verkhovna Rada* (the Ukrainian parliament). The oligarchs became independent from national politics and transformed themselves into state actors that translated their interests into public policy, passing "made-for-oligarch" laws.<sup>12</sup> Such laws ensured, for instance, preferable trade conditions or tax relief for specific economic sectors, regions or enterprises. In addition, the oligarchs received full personal immunity for their term of office, which helped them to avoid criminal responsibility. They could thus use their privileges secure their illegal wealth and avoid persecution or punishment by the tax administration. As a result, oligarchic clans have been able to expand their influence disproportionately and accumulate a great amount of wealth.

During the privatization of state enterprises, the oligarchic clans exploited their connections in politics to acquire those state enterprises that promised the large profits.

Representatives of a particular oligarchic clan in politics provided reliable information on the financial situation and production capacities of the state enterprises to be privatized, ensured their clan a privileged position, and the possibility to buy the state enterprises at low prices during the privatization auctions. As a result, oligarchic wealth became concentrated in the most profitable sectors of Ukraine's economy, such as gas and oil, metal, food-proceeding, and machinery sectors.

Because oligarchic capital is spread across various sectors, it was difficult to say which clan dominated which sector. The only exceptions were with the agrarian and coal mining clans, who were interested in sectoral benefits (Kubicek 2000; Pleines 2005, 2008).<sup>13</sup> In the early years of transition, clans mostly covered a region, but, with greater diversification and an increasing number of clans, their regional dominance also became less clear-cut (Wittkowsky 2001; Kowall and Zimmer 2002; Zimmer 2006). Often, clans coming from the same region rivaled each other in doing business or influencing politics.<sup>14</sup> Hence, a particular oligarchic clan did not push for sectoral or regional preferences, but rather for preferences for particular enterprises in which the clan was involved. The particularly low level of trust between the oligarchic clans in Ukraine accelerated rivalry and made their collective actions difficult (Aslund 2005). As they often conducted their day-to-day business in the same economic sectors and in the same regions, the Ukrainian oligarchic clans were often rivals.

The rivalry between the oligarchic clans was reflected in the political regime of Ukraine, which suffered from the syndrome of “feckless pluralism” (Carothers 2002). The clans used their political connections to the state branches instrumentally and transmitted their conflicts into politics, thereby making the political system highly competitive, its institutions inefficient, and the political regime largely unstable. Ukraine's state authorities represented the preferences of the rival oligarchic clans and conflicted with each other, passing contradictory and opaque laws. Moreover, president Leonid Kuchma's “divide and rule” strategy even strengthened the syndrome of “feckless pluralism”. He appointed representatives of rival oligarchic clans to offices with similar levels of power,<sup>15</sup> in order to prevent the rise of possible internal rivals and even reinforced the rivalry among the clans.

By the end of Kuchma's second and last constitutionally possible term in office, it looked like the Ukrainian clans had reached the equilibrium of institutional development and power distribution. A particular clan was either satisfied with or did not have sufficient power to change the status quo of Ukraine's “defective democracy” with its partial reforms, in which some democratic and market economy principles, e.g. elections and private property, were implemented, but the rule of law and large-scale macroeconomic reforms failed (Hellmann 1998). This status quo was advantageous to accumulate wealth. However, it was disadvantageous to ensure property rights and the security of the accumulated wealth. Due to the large number of oligarchic clans, Kuchma's “divide and rule” strategy also led to the regular rotation of persons and also meant high instability and insecurity for those who had already accumulated a great amount of wealth. Such a strategy also gave fewer incentives for the oligarchic clans to invest in and to modernize their enterprises. New persons in office could withdraw their beneficial budget compensations and privileges in Ukraine's markets. Furthermore, with a new person in office, previous office holders and their oligarchic clan with illegally accumulated wealth ran the danger of being prosecuted by the state.

The president was the most powerful force in Ukraine's political system. Thus, the presidential election of 2004 was especially important for the security of illegally accumulated wealth. By becoming the president, a representative of a particular clan could destroy the financial imperia of the other clans. As a result, in the “defective democracy”, the presidential

election became an Achilles' heel for the oligarchic clans (Hale 2005). Due to the lack of transparency in and the frequent abuse of institutional mechanisms of election and consequent power transfer, any clan powerful enough to manipulate election outcomes was able to push its representative for the presidency. The uncertainty among the oligarchic clans about the fate of their wealth, if a representative of a rival clan were to win the presidential elections, was high. The designated successor of Kuchma, Viktor Yanukovych, had to admit his inability to unite all the clans behind his candidature. Part of the reason for this was his support for one particular clan (of the Doneck region) during his years as the prime minister before the election in 2004. It was not credible that he could become a dominating arbiter, who could act in the interest of all the clans. Despite the rivalry in their day-to-day business, the oligarchic clans joined forces to secure their wealth in the run-up to the presidential elections in 2004. Because Ukraine's "defective" democracy did not provide an institutional framework for actors to settle disputes and realize the potential gains, the various oligarchic clans built a coalition to confront with the incumbent president and his designated successor (North 1990).

Hence, most oligarchs directly or indirectly supported the Orange Revolution of 2004 and the subsequent institution building in the political and economic system of Ukraine (Malynkovych 2006, Melnykovska 2008). They participated in the Orange Revolution personally or provided media space for the "orange" candidate for the presidency, Viktor Yushchenko, and for his proponents, to report about election fraud and to organize the mass demonstrations (Mr. Yushchenko's opponent was Yanukovych, the "white-and-blue" candidate).<sup>16</sup> The uncertainty about their wealth security united all the clans under the common goal of overthrowing the presidential regime and pushing for some minimal convergence towards European standards. They eliminated the possibility that anyone oligarchic clan could monopolize state authorities and they supported the new institutional framework of the political system to ensure that a "pluralism" of the clans' influence in the politics was established.

Given the very low trust between the Ukrainian clans, transforming Ukraine from a presidential into a parliamentary republic, where no force was able to monopolize state power, was the second best choice for all oligarchic clans. During round table negotiations in November-December 2004, "orange" and "white-and-blue" leaders agreed on a package of laws, known as the "package deal". With the support of the Ukrainian oligarchic clans, this package was approved by the *Verkhovna Rada* by an overwhelming vote of 402 to 21. It changed the division of powers between the president and the parliament that was specified in the constitution of 1996 and amended electoral law. The constitutional change transformed the Ukrainian political system of a presidential republic by adopting a number of features necessary to establish parliamentarianism. It reduced the presidential powers and strengthened the powers of the parliament. The amendment of the electoral law guaranteed fair competition in the run-off of the presidential election that had to be repeated in December 2004. To calm mass demonstrations against election fraud, and taking reference to the newly amended electoral law, the central electoral commission was reshuffled and the possibilities for fraud stemming from home voting and absentee ballots were substantially reduced. The candidate of the "orange" forces, Yushchenko, obtained the chance to win the repeated run-off of the presidential election, but this time under fair competition. In return, the "orange" forces agreed that the newly elected president would lose some of his powers in favor of the parliament. As a result, Yushchenko won the election and became the president. Because the constitutional change was not to enter into force until after the parliamentary election in 2006, he still enjoyed the framework of the presidential republic and appointed the first "orange" government (January-September 2005), headed by his ally Yulia Tymoshenko. However, a new equilibrium of power distribution among the elite was not established.

In the following months after the Orange Revolution, the parliamentary elections intensified the rivalry either between the politicians or between the clans and made establishing a new equilibrium difficult. In the struggle for votes and seats in the future parliament, the members of the “orange” coalition started to blame each other for the failures of the first “orange” government.<sup>17</sup> The coalition fell apart, soon opening the door for a comeback of the “white-and-blue” forces. As a result of the parliamentary election in 2006, the “white-and-blue” coalition led by the Party of Regions came back to political power. Supported by the Communist and the Socialist Parties, Viktor Yanukovich became prime minister again. The struggle for political dominance and control over state authorities between the “orange” presidency and the “white-and-blue” government and the legislative led to a deadlock in state governance. As a consequence, the Ukrainian parliament was dissolved in September 2007 and Ukraine held pre-term parliamentary elections. This time, the parliamentary elections resulted in the resurrection of the “orange” coalition, headed again by Tymoshenko as prime minister. However, recent political disputes about privatization, dismissal and appointment of heads of regional, district, and local administrations, as well as control over the State Property Fund and authorities of the National Security and Defense Council (Boltushkina et al. 2008) have raised doubts about the sustainability of this second “orange” coalition.

Since 2006, the position of the parliament has strengthened and the number of powerful veto-players in Ukraine’s politics has consequently increased. The president can no longer dominate politics. In contrast, the elite (also the oligarchic clans), which are present in the parliament, have gained more influence, but need to negotiate any political decision with each other or with the president. The oligarchic clans, whose prosperity depends on having a stake of their parties in the government, have become involved in the political struggles. The oligarchic clans have got their representatives into the new parliament (which is more influential than the old parliament) using the party lists. The day-to-day preferences of rival business clans have prevailed over striving for political stability. After the Orange Revolution, the “feckless pluralism” of the political system has become even more pronounced and, until now, prevented the establishment of a new equilibrium of power distribution.

However, the oligarchic clans may become the bottom-up force to consolidate the state power. Basically, the political elite could not replace the oligarchic clans as a driver of institutional reforms. The clans are present in all the major political parties and control the executive and judicial branches. Moreover, they depend less on short-term electoral periods and public opinion than the political elite. Thus, the oligarchic clans can pursue a goal of institutional convergence with the EU which promises them long-term benefits of sustainable growth, even if the achievement of this goal causes social costs in a short-term perspective.

However, unlike in Russia, the oligarchic clans find it difficult to conduct the “collective actions”. “Collective actions” are difficult, because of their great number, sectoral and regional diversification and the low level of trust between clans, but they are not impossible (Melnykovska 2008). Attaining minimum institutional standards for their business has been an incentive strong enough to make them join forces to push for institutional convergence, as was exemplified by their successful negotiations with the WTO completed in 2008. Despite the political crises, the “white-and-blue” and “orange” forces in the parliament passed the laws necessary to complete the negotiations on WTO accession and the “orange” president did not use his veto. Depending on the preferences of the Ukrainian oligarchic clans, the EU may provide them well-targeted incentives other than a membership perspective to accelerate a bottom-up institutional building. Therefore, the political and economic preferences of

Ukraine's oligarchic clans, as well as the determinants that create and change these preferences, are need to be identified.

### 3. Transforming Oligarchic Clans into Global Players

Two theoretical approaches to institutional change explain why oligarchic clans supported by external incentives could change their political and economic preferences and become the driving forces of a bottom-up institutional convergence in CIS countries. A prominent theory on internal drivers of institutional change and the evolution of rent-seeking societies is Olson's theory (2000) of the evolution of state rulers and the exploitation of rents, which either hinders or supports institution building.<sup>18</sup> Olson distinguishes between "roving" and "stationary bandits". Translated into a CIS framework, "roving" oligarchic clans concentrate on exploiting short-term rents like those stemming from non-renewable resources. After getting sufficiently rich and reaching the limits of wealth accumulation and control, "roving" clans transform into "stationary" clans and begin to care about securing their wealth. While "roving" clans can rely on informal institutions, "stationary" clans need and demand formal institutions, which implies that they begin to support institutional development. In terms of Olson's theory it is important that clans become stationary in order to change their preferences and demand better (formal) institutions.

While this process may be rather slow, or even painfully slow in resource dependent economies, according to the other theory of institutional change in rent-seeking societies, opening up a country to globalization,<sup>19</sup> i.e. to trade and investment flows, may work as a catalyst for transforming the preferences of oligarchic clans (Havrylyshyn 2006a). With hindsight, the popular debate about an appropriate sequencing of opening up and institution building seems to be misleading. In the early 1990s, institutional reforms were a by-product of other high priority policies on macroeconomic stabilization, trade liberalization and enterprise restructuring (Hare 2001). Follow-up institutional reforms either did not take place or lacked implementation effort. Arguably, structural policies like opening up a country to the world market and institution building at home have to reinforce each other in order to be successful.

As argued by Havrylyshyn (2006a), the majority of CIS countries, which have been closed economies, reformed and changed their institutions moderately. They have also experienced the greatest social pain. Vested interests in these countries have been working towards the creation of "capitalism for the few" and concentrating ownership in the hands of the selected elite. He calls such states the "oligarchic societies". By comparison, the CEECs countries have been more successful at reforming their institutions because they have been more open. The results of Havrylyshyn's research suggest that openness ensures economic recovery and democratic institutions. Thus, the establishment of an open market economy and institution building complement rather than exclude each other. Replying to debates between "shock therapy" supporters and gradualists, Havrylyshyn comes to the conclusion that a more useful view of sequencing should begin with a basic and simplified legal-regulatory institutional framework that is comprehensive but not deep, thereby opening up a country, and should then follow-up with refinements of these institutions over time (Havrylyshyn 2006b).

This is exactly why oligarchic interests matter in the context of institution building in transition countries like Ukraine. Opening up a country can work as a catalyst for otherwise

rather slow processes of changing the political and economic preferences of the oligarchic clans, assuming that they have an interest in reaping the potential benefits from trade and foreign investment. Clearly, the success of institution building depends on the interests of the powerful elite in the first place (Keohane 1984). Therefore, the political and economic costs and benefits to these elite are key to explaining the nature and scope of change (Feeny 1988:168). Opening up may well change the cost-benefit calculation of “roving” clans. While the impact of legacies (resource endowment, access to power) is constant, openness is a conditional variable which ensures that “changes in relative prices – and therefore changes in the cost-benefit calculations – are the most important source of institutional change” driven by the bottom-up domestic elite (North 1990:84). It can be shown for the case of Ukraine that the oligarchic clans actually have this kind of incentives to change their preferences and to demand better institutions and institutional convergence towards European standards.<sup>20</sup>

Combining the theories on rent-seeking limits and openness, rent-seekers should be subject to limits when seeking to accumulate wealth with informal institutions in a closed economy and should transform from domestic into global players that demand formal institutions in order to reap the benefits of interacting with global markets. Changes in sources of rents can result in such limits to rent-seeking. It is evident from Table 1 that the sources of rents have changed over time and thereby increased competitive pressures for Ukraine’s oligarchic clans. In the early 1990s, fuel and metal product exports were the most attractive sources of rents. In addition, large-scale credits from government in combination with hyperinflation resulted in huge subsidies for the clans (Prizel 2002). Finally, the oligarchic clans benefited from exporting highly subsidized gas and oil imports from Russia. In the Soviet era, Russia subsidized Ukraine by supplying around 50 million tons of oil and substantial amounts of gas each year at prices at roughly 35-40% of world market prices. After the collapse of the Soviet Union, Russia and other energy-rich CIS countries did not intend to continue subsidization of the Ukrainian oligarchic clans. The prices for imported energy to Ukraine increased continuously, but were still under world price level.<sup>21</sup>

In the mid-1990s, rents stemming from hyperinflation disappeared, but the clans continued to benefit from the political patronage that supplied them with indirect subsidies, special treatment and tax incentives (Van Zon 2000). Until the financial crisis in 1998, the international community was more concerned with the political stability of Ukraine, because it possessed nuclear weapons, than with its progress on institutional reform. Hence, during the initial transition years, the preferences of the oligarchic clans were dominated by domestic developments.

Following the financial crisis, the most important source of economic rents in Ukraine still stemmed from imports of gas and oil from Russia and other energy-rich CIS countries.<sup>22</sup> However, the limits of such economic rents became more and more evident. Finally, the termination of possibilities to reap economic rents was marked by the latest developments in the gas market. According to the agreements signed in the spring of 2004, Ukraine covered its energy debts to Gazprom with Eurobonds and transit charges for Russian gas up to 2009. For the Ukrainian oligarchic companies, it meant no gas for transit from 2005 on. At the same time, Gazprom revealed its intent to raise the gas prices to the world levels (Stern 2006). After the 2006 crisis, Gazprom sold gas to Ukraine via the joint company RosUkrEnergO at a price of \$230/mcm (Gazprom Press Release 2006).<sup>23</sup>

Table 1. The sources of oligarchic rents in Ukraine

		→			
		early 1990s	middle 1990s	late 1990s	early 2000s
<b>Domestic</b>	* credits from state's bank with negative real interest rates due to inflation		* indirect subsidies * tax incentives * separate treatments	* tax incentives * separate treatments	* tax incentives * separate treatments
	* arbitrage opportunities		* shadow privatization		
	* market monopolies				
<b>International</b>	* cheap fuel resources from Russia		* external demand for Ukrainian metal and chemical products	* strong international pressure for reforms	* external demand for Ukrainian metal and chemical products
	* external demand for Ukrainian metal and chemical products		* weak international request for reforms		* strong international pressure for reforms
	* weak international request for reforms		* international focus on political stability		* focus on corporate governance
	* international focus on political stability		* soft financial aid		
	* soft financial aid		* Russia's toleration of Ukrainian debts and illegal siphoning of gas		

Source: Aslund (2005); Prizel (2002); Zimmer (2006); own illustration.

Generally, even before the Orange Revolution, the possibilities for oligarchic clans to profit from cheap Russian energy imports had almost disappeared. In addition, the requirements of good corporate governance and transparency became essential for Ukraine's oligarchic groups to do business in international markets. Indeed, Table 2 shows that oligarchic clans in Ukraine have increased their wealth considerably and become more transparent during recent years. Due to rapid economic growth since the end of 1990s, most oligarchs at least doubled their wealth. The Wprost rating of the 100 richest Europeans for 2007 includes 24 Ukrainians, with fortunes as large as \$18,700 million. For comparison, in 2002 only 3 Ukrainians were listed among the richest Europeans, with fortunes as large as \$1,700 million. These numbers show not only a rising accumulation of wealth due to increased business activities, but also show that there were transfers of wealth from the shadow into the official economy. By 2007, several of the major oligarchs had become fully legal and legitimate, were paying taxes, had declared their ownership and were spending substantial amounts for charity. The case studies on the Ukrainian energy, metal and chemical sectors confirm the ongoing implementation of corporate governance norms. In these sectors, the business and ownership structure became more transparent, international bookkeeping norms were launched, and companies and corporations began to develop long-term strategies (Heinrich 2004; Zheka 2006; Pleines 2008). Making one's business transparent under informal institutions is highly risky and therefore makes better formal institutions necessary. Transparency and good corporate governance also meant that illegal "shadow" resources used to ensure wealth and market benefits by means of state capture or corruption were scaled back.

Table 2. The wealth of Ukrainian oligarchs, 2002-2007

Year	<i>Wprost</i>		<i>Ukraine</i>	
	Total number	Total number	Total number	max Wealth, in million \$US
2002	25	3		1 700
2003	50	6		1 900
2004	50	5		3 500
2005	100	7		2 800
2006	100	15		7 200
2007	100	24		18 700

Source: *Lista 100 Najbogatszych Europy, Wprost*; own calculations.

Obtaining investment for modernization has also become a big challenge for Ukraine. Current growth has an extensive character, based on the old capital stock with exports of intermediary, semi-finished and low-quality goods. The efficiency of the basic exporting sectors – e.g. the metal sector – is low, while the energy wastage is high. At the same time, Ukraine’s exporting sectors are aging.<sup>24</sup> Thus, the modernization – i.e. replacement of the old capital stock and increase of their efficiency – that is needed to make economic growth sustainable has become the priority of the Ukrainian oligarchic clans whose assets are concentrated mostly in the exporting sectors. In addition, the clans have improved their access to international capital markets and increased the capitalization and diversification of their assets, which has led to more financial openness, the disappearance of transfer pricing, the transparency of taxable profits and demand for better institutions.

Overall, after the financial crisis in 1998, the sources of economic rents for the Ukrainian clans have either disappeared or became more limited. The oligarchic clans, whose business became more and more internationalized, were forced to implement international standards of transparency and corporate governance. In addition, to be competitive in international markets, they needed and still need to modernize their energy-intensive companies, especially in the energy, metal, and chemical sectors. The modernization, however, requires large financial investment, which in turn depends on political stability and quality of institutions. Hence, increasing trade and investment relations can be treated as an exogenous force, limiting the sources of rents and challenging oligarchic clans in Ukraine to improve institutions and converge with the EU standards.

Initially, the political system in Ukraine did not react to the changing political and economic preferences of the oligarchic clans. As can be seen in Figure 1, there was no clear trend in institution building after the 1998 crisis. Only after the Orange Revolution the impact of institutional reforms leads to the progress in building institutions as measured by the World Bank Governance Indicators (WBI) (Figure 1). Quite unusually, the progress in building economic-administrative and legal institutions is even stronger than the progress in building political institutions. The usual pattern of institution building in CIS countries is rather that follow-up economic-administrative and legal reforms are more difficult to implement than political reforms (Hammermann et al. 2005). Given the political turmoil following the Orange Revolution, it is far from clear whether or not this progress in building institutions implying an increased convergence of Ukraine towards European institutional standards can be sustained.

Figure 1 shows a slight slow-down in the development of economic –administrative and legal institutions in 2006-2007, but strong improvement in building political institutions. Further steps towards the integration of Ukraine into the EU would be clearly in the interest of Ukraine oligarchic clans because this would imply that trade and investment relations could be expanded.

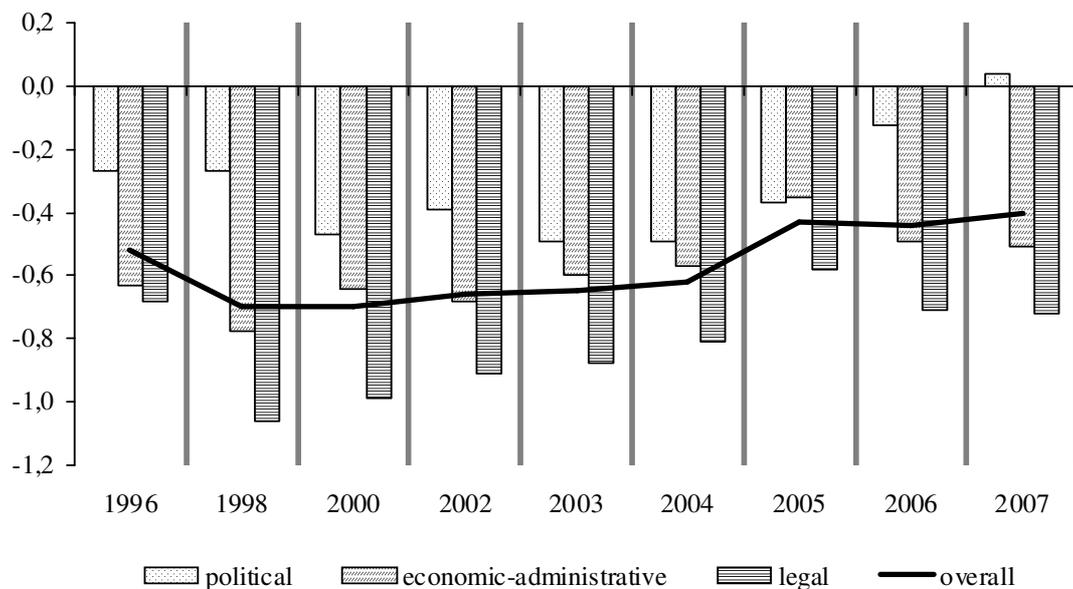


Figure 1. Progress in institution building in Ukraine, 1996-2004  
 Source: World Bank Governance Indicators; own calculations.

#### 4. Ukrainian Business Interests and EU Leverage for Better Institutions

Trade and foreign direct investment (FDI) figures reveal that Ukraine’s regional and global integration is on the rise. Its level of trade openness has increased considerably. Imports and exports are equivalent to 90% of GDP and are now comparable to other countries in the region. As has been argued above, Ukrainian oligarchic clans have become increasingly export-oriented and have profited from external trade, but they urgently need new technologies and investment to become more competitive on EU and global markets.

The importance of the EU as Ukraine’s main trading partner and investor is increasing. The EU has even become more important than CIS countries, although energy imports from the latter region still figure prominently (Figure 2). In 2006, EU-Ukraine trade surpassed €27 billion due to a strong increase in imports, but was on a steady rise even before (Table 3). Despite this significant reorientation of exports toward the EU, the extent of Ukraine’s trade with the EU is still lagging behind that of new EU members. To some extent, Ukraine’s trade pattern reflects the trade policies of the past and Ukraine’s difficulty in deciding on priorities for international integration. Being sandwiched between Russia and the EU, Ukraine has tried to integrate in both directions (Vinhas de Souza et al. 2006). As a consequence, Ukraine depends on Russian fuels and EU machinery and equipment. Its dependency on Russian fuels

is a carryover/legacy from the Soviet era, which left it with an extremely inefficient energy sector. It is now not only a net importer of gas and oil, but is also the economy in the region that consumes the most energy. Prices for the Russian gas and oil have increased, leading to the introduction of energy-saving technologies and the diversification of energy suppliers and the types of energy used. Thus, it is to be expected Ukraine will reduce its dependence upon Russia.

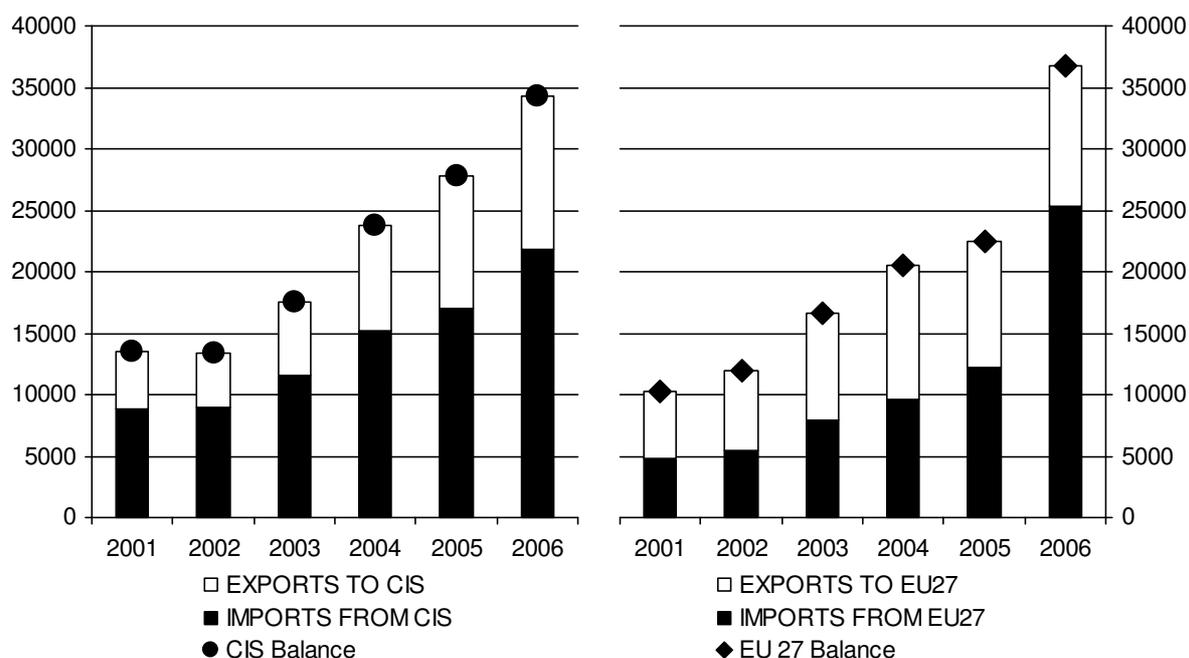


Figure 2. Ukraine's trade with EU and CIS, 2001-2005 (\$ million)

Source: *Direction of Trade Statistics, International Monetary Fund.*

Table 3. Ukraine's trade with the EU 2002-2006

Year	Imports, € million	Yearly % change	EU Share of total imports	Exports, € million	Yearly % change	EU Share of total exports	Balance, € million	Imports+ Exports, € million
2002	5.729		<b>31,97</b>	6.105		<b>32,60</b>	376	11.835
2003	6.859	19,7	<b>32,27</b>	6.972	14,2	<b>32,70</b>	112	13.831
2004	7.536	9,9	<b>32,40</b>	7.876	13,0	<b>30,22</b>	340	15.412
2005	9.543	26,6	<b>32,93</b>	7.400	-6,0	<b>27,21</b>	-2.143	16.943
2006	19.605	105,4	<b>42,65</b>	8.007	8,2	<b>25,57</b>	-11.597	27.612
Average annual growth, %		36,0			7,0			23,6

Source: *EU EUROSTAT, External Trade Statistics.*

Up to now, however, the structure of Ukraine’s trade with the EU and Russia still reveal the traditional pattern, with the westward movement of raw materials and semi-processed goods, and the eastward (opposite) movement of final products, primarily investment goods. Looking at trade with the EU, Figure 3 reveals that, although total trade figures increased especially for EU trade, the structure of Ukraine exports and imports remained rather stable. Iron and steel clearly dominate Ukrainian exports. In 2005, they had a share of 24% in Ukraine’s total exports to the EU-27. Other exports to the EU mainly consisted of primary products which made up for about 35% of total exports. This picture clearly reveals the high dependence of Ukraine exports on a few commodities and products. So far, the international business cycle and China’s new role in the world market have provided favorable conditions for Ukraine’s exports and its economic recovery. At the same time, Ukraine exports are highly dependent on these developments and diversification is needed in order to provide a broader basis for export expansion (World Bank 2004). Thus, diversification is of high priority for Ukraine’s oligarchic clans, who are trying to secure and expand their position in the society.

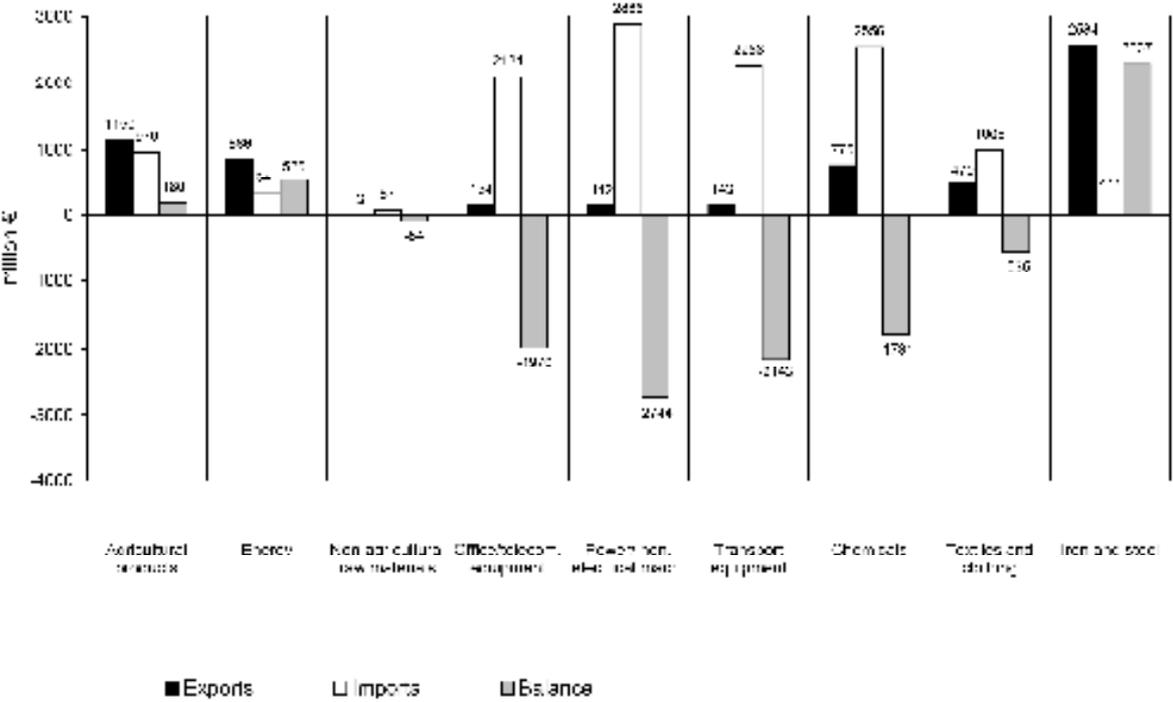


Figure 3. Ukraine’s trade with the EU by product, 2006 (€ million)

Source: EU EUROSTAT, External Trade Statistics.

Besides being an important trade partner, the EU is also an important investor in Ukraine’s economy. Although Ukraine initially failed to attract a significant amount of capital from abroad and from the EU in particular, FDI inflows to Ukraine increased considerably from \$3,8 billion in 2004 to almost \$16 billion in 2007. Considering the origin of foreign investors present in Ukraine, the EU is by far the largest investor. The share of EU FDI in total FDI jumped from 56% in 2004 to 75% in 2007.<sup>25</sup> It is followed by the United States, a set of so-called “offshore zones” and CIS countries, mainly Russia.

However, capital coming to Ukraine from the west and from the east differs not only by volumes, but also by investment motives and distribution of funds across economic sectors. Recipients of investment from Europe are mostly companies operating in the food, chemical and machine building sectors (Emerson et al. 2006). The wholesale and retail trade sectors have also received a significant amount of investment from the EU. At the same time, Russian investment is concentrated in the fuel and energy sector. Russian oil companies have acquired almost all Ukrainian oil-refineries, which in Soviet Union times were constructed specifically for processing Russian oil. Another object of interest for investors from the “northern neighbour” was healthcare complexes in the region of Crimea.

More generally, however, FDI in Ukraine seems to follow Ukraine’s trade patterns and reflect its production links. While stronger production links between Ukrainian and Russian enterprises in certain sectors would be beneficial for both countries, capital from the more advanced economies of the EU could bring benefits – such as generating new production, management, and marketing technologies, better labor skills, improvement in risk management – that are more relevant for the long-run growth and development of the Ukrainian economy. Another important benefit is that western companies also tend to “export” to Ukraine European institutional standards.

In its turn, institutional development, especially the absence of corruption and improvement in the business environment, attracts FDI. According to survey results, the main motive for western companies operating in Ukraine was the possibility to access a large domestic market (International Centre for Policy Studies 2000). Indeed, with its 48 million inhabitants, Ukraine represents one of the biggest national markets in Europe, which, in addition, has a good potential for growth in terms of purchasing power. Relatively low labor costs are also reported as one of the motives for investment; however, this advantage is diminished by low productivity. At the same time, the poor quality of the business environment and institutions is often quoted as a reason why Ukraine has attracted only small amounts of FDI, though it has considerable comparative advantages over CEECs (Mayhew 2006).

While Ukraine’s problems are home-made to a large extent, the Ukrainian business interests of the oligarchic clans also have to overcome substantial obstacles when trying to enter foreign markets which are closely related to institutional convergence. At the same time, the incentives provided by market access have already helped institutional convergence. Again, this is an example of how the interests of the clans have been united and succeeded in pushing reforms in a considerably short time. The Ukrainian oligarchic clans strived for better access to the European Market as long as their commodities were hampered by the antidumping measures that the EU applies to third countries. On the European steel market, Ukrainian oligarchic clans exporting metal products competed against Russian and Rumanian steel producers which benefited from the status of a full-fledged market of their economies and, at the same time, provided the yardstick for evaluating Ukrainian exports. Furthermore, Ukrainian metal sector has attracted less foreign direct investment (FDI) than the Russian metal sector, as Ukraine’s metal exports have permanently been under EU antidumping investigations and subject to EU antidumping penalties (Eremenko and Lisenkova 2004).<sup>26</sup> The penalties for Ukraine’s metal exports ranged from 24% to 64%, raised the price and reduced the competitiveness of the Ukrainian goods. These penalties depend on whether, according to EU calculations, a particular export product is sold at dumping prices. While calculating dumping prices, the EU takes into account the economic status that the EU grants a country of origin. Exports from a country without the status of a full-fledged market economy are more vulnerable to antidumping penalties, than a country enjoying this status.<sup>27</sup> Thus, institutional

building is very important, as the EU uses the level of institutional quality in a particular country as the main criteria to grant the status of a full-fledged market economy to a particular country. Thus, to escape high antidumping penalties, the Ukrainian oligarchic clans have strived for this status for their individual enterprises as well as for Ukraine's economy in general and have pushed for the improvement of Ukraine's poor institutional quality.

The negotiations with the EU about obtaining the status of a full-fledged market economy started in 2000. However, the European Union Council of Ministers initially granted Ukraine only the status of a transitional quasi-market economy, but did offer the status of a full-fledged market economy to certain Ukrainian companies. By 2005, two Ukrainian companies - Azot and Gorlovka Stirol - obtained this status. However, given the lack of institutional reforms that could provide safeguards by implementing formal rules, the political risks of expropriation for Ukrainian producers when making their business more transparent were very high. Therefore, the Ukrainian oligarchic clans used their political influence to implement the institutional reforms required for achieving the status of a full-fledged market economy for the whole country and to accelerate negotiations with the EU (Honcharuk 2006). Finally, in the aftermath of the Orange Revolution (in 2005) and due to the progress in building institutions, Ukraine obtained the status of a full-fledged market economy.

Generally, Ukraine when trying to penetrate foreign markets and to attract foreign investment faces by far more problems at home than abroad. The greatest internal barriers to international trade in the country, as perceived by traders, are the following: the general complexity of regulations and their unfair enforcement, including a multitude of pre-customs permits, registrations, licenses, technical regulations, and, related to this, corruption, delays, and high compliance costs, the slow and costly process of VAT reimbursements to exporters, which continues to receive highly negative grades in business surveys, and the unpredictability of and corruption in customs (World Bank 2004). Hence, some of the main limitations to expanding trade and investment relations are domestic and relate to institutional development. Convergence with the EU (import of EU company legislation, EU rules on standardization and certification, EU competition rules, EU customs procedures, etc.) would not only help eliminate these internal barriers but would also strongly support Ukraine's integration with the EU (Vinhas de Souza et al. 2006).

WTO membership is an imperfect substitute for EU integration as regards finding who might support Ukraine in becoming a competitive market economy with democratic structures.<sup>28</sup> An assumption present in some studies is that the process of obtaining WTO membership – Ukraine announced its intention to join the WTO as early as 1993 – can be a stepping-stone for EU membership given that some of the requirements are similar for both processes (Blue Ribbon Commission for Ukraine 2004; World Bank 2004) and that WTO membership should, therefore, precede EU membership. Although it is true in the sense that no country has ever entered the EU without having first entered the WTO, the connection between these two “options” is not very strong. As the experience of the last enlargement round shows, most of the applications for EU membership preceded WTO membership, and frequently by several years.<sup>29</sup> The Baltic countries, whose economic problems most resemble the sort of problems faced by Ukraine, did join the WTO until as late as 1999. For most of the former EU candidate countries, the causality was actually the *reverse*: the fulfillment of WTO membership conditions came about as a *by-product* of the EU Accession process. Additionally, the assumption that the WTO is an effective framework provider that will enhance *domestic* reforms – especially on the scale necessary for EU Accession – seems to overestimate the “minimum common denominator” negotiation process that actually leads to WTO membership

(which, among other things, is responsible for the usually disappointing trade increases a country experiences after joining the WTO).<sup>30</sup>

EU accession and, to a lesser extent, cooperation would clearly be a great deal more effective to Ukraine in exporting a much more robust and comprehensive regulatory framework than WTO membership. If one assumes EU accession is the main objective, the EU integration process includes all the necessary reforms for WTO entry. This is especially true within the framework of pre-accession free trade agreements, as was the case in the last round of enlargement. For Ukraine, which is far from EU accession and free deep trade agreements with the EU, it implies that membership in the WTO may provide some intermediate target with, however, limited additional impact on the willingness of Ukrainian oligarchic clans to support further institutional convergence.

Accordingly, the second government of Tymoshenko (since December 2007) made Europeanization an explicit goal of domestic reforms rather than treating it as a foreign policy goal. Tymoshenko declared that Europeanization is one of her government's priorities. The negotiations on a free trade area, simplification of the visa requirements, participation in EU programs and agencies and development of energy cooperation are the main tasks on her government's agenda. Furthermore, Tymoshenko has supported her political declaration by implementing wide-ranging reform programs. Launching the government program "Ukrainian breakthrough: not for politicians, but for the people", Tymoshenko stressed that her Transparency Initiative is based on understanding of the necessity for changes and reforms in Ukraine that are in accordance with key European values and the demands of Ukrainian civil society.<sup>31</sup>

However, the political declarations are difficult to implement without bottom-up support. According to *Razumkov Zentrum* (Razumkov Center 2008), 224 of 227 governments' reforms (both of Yanukovych and of Tymoshenko) were in line with the AP priorities for 2007.<sup>32</sup> Only one third of the government reforms, however, were fully implemented. Almost 40% of the implemented reforms dealt with AP priorities regarding economic and regulatory policy, trade and the new perspective of economic cooperation with the EU. The political crises were the main obstacle to better implementation. Similarly, the effectiveness of current government activities is rather low due to the ongoing struggles for power between the government, the parliament, the president, and the oligarchic clans (Boltushkina et al. 2008).

However, there is no deep commitment on the part of the EU for any deep free trade agreement (FTA+). Already the Partnership and Cooperation Agreement (PCA), the bilateral agreement which governed EU-Ukraine relations until 2008, was more a declaration of intentions to cooperate in different areas (political cultural, scientific cooperation, trade, investment, etc.) than anything else. It does not offer any specified mechanisms or benefits for achieving cooperation. The new ENP framework is not very different (Afanasyeva et al. 2008). There is still no specified mechanisms that provides a roadmap as well as benefits, and, in addition, it is based on the intention of the EU to prolong top-down "Enlargement Europeanization" as "Neighborhood Europeanization", i.e. it details what the EU wants without offering a reasonable "carrot" as an incentive for domestic forces like the oligarchic clans to support necessary reforms.

Ukraine entered the ENP framework in 2004. The first EU-Ukraine AP was drafted in late 2004—before the Orange Revolution—and was signed with slight changes in February 2005 after the new Ukrainian government protested about some of its draft's provisions. It defined the priorities of cooperation in different policy areas and the mechanism of their

implementation for three years. Further, it targeted the following: promotion of Ukraine's accession to the WTO, removal of non-tariff barriers, improvement of the investment climate and tax reform and approximation of legislation to EU standards. In December 2005 and March 2008, the European Commission evaluated the implementation of the AP positively (Joint Report 2005; 2008). Nevertheless, the mode of operation of the AP is not too distinct from the former PCA. The institutional framework and tools used in the relationships between Ukraine and the EU remain the same.<sup>33</sup>

What the EU could do to offer a reasonable incentive for countries that are not on the list of potential accession countries is clearly to provide a FTA+, which could be expected to boost trade and investment relations through substantial trade liberalization and regulatory harmonization (Emerson et al. 2006). In order to achieve this, the FTA+ would have to build on the liberalization undertaken as part of WTO membership and work towards "deep convergence" – not just cutting tariffs but addressing red tape for exporters by aiming for similar regulatory standards and norms in both economies. The significance of such an FTA+ would, however, depend on the range of products covered by the agreement. The major Ukrainian trade items, such as heavy industry products and agricultural products, belong to the "sensitive" sector for the EU and are, therefore, not included in agreements with the EU. Furthermore, a large range of Ukrainian products fails to fulfill European standards and is, therefore, barred from EU markets by using non-tariff barriers. Nevertheless, a kind of FTA+ as a kind of operation scheme with neighboring countries and offering a reasonable incentive for cooperation in exchange for the creation of a ring of well-governed countries at the periphery of the EU, as is the intention of the EU, should be a realistic target for European politics.

A further step, i.e. offering a stake in the Common Market, would of course be more of an incentive for Ukraine's oligarchic clans to push for further institutional convergence with the EU in all the parties but, at the same time, is currently less realistic. It would involve participation in the areas of free movement of goods, services, and factors of production. A stake in the Common Market has not been offered to non-accession countries but is mentioned in the ENP APs for Ukraine and for Moldova.<sup>34</sup> While this is clearly expected to have high benefits in terms of growth (Brenton and Manchin 2003) and FDI inflows that promote technological transfer and efficiency improvements (Levine 1997; Francois and Schuknecht 1999), the ENP APs are rather wake at this point. Even if it were to become reality, important topics for Ukraine, like agriculture and steel markets, could still be excluded from negotiations (Milcher and Slay 2005).

All in all, the stylized facts about trade and FDI as well as the policy discussion should have made clear that tying up with the EU is of clear advantage for the oligarchic clans in Ukraine. Doing business with the EU could constitute a common denominator that they might otherwise lack in order to unite the Ukrainian elite under the goal of improving institutions and governance. EU markets, being the largest neighbour markets both in terms of population and GDP, are the most attractive market for the Ukrainian oligarchic clans and provide the relevant yardstick for meeting high institutional standards. The FTA+ should provide significant incentives for re-kindling bottom-up demand for institutional reforms in Ukraine. However, given the present design of ENP AP for Ukraine, in which the FTA+ is defined vaguely, one can not be overly optimistic.

## 5. Conclusions

The preceding has shown that Ukraine provides a case in point supporting the argument that opening it up and integrating it internationally may speed up the change in political and economic preferences of the oligarchic clans in favor of formal institutions that otherwise might be established only very slowly. In the absence of strong incentives of EU membership to initiate top-down institution building, the oligarchic clans that are the most influential part of the domestic elite and therefore also the most important bottom-up force to drive the institutional convergence of Ukraine towards European standards. The oligarchic clans have changed their political and economic preferences from wealth accumulation toward its security and a consolidation of their position by means of establishing formal institutional safeguards. They needed a minimum of formal institutions in order to meet international standards of doing business, and these institutions had not been provided by Kuchma's regime. Hence, most of the oligarchic clans directly or indirectly supported the Orange Revolution of 2004 and the consequent institutional change in the political and economic system of Ukraine.

In the course of the Orange Revolution, Ukraine was transformed into a parliamentary-presidential republic. Thereby, the probability that any domestic force can monopolize state authorities has been diminished, but the number of veto-players in Ukraine's politics has increased. The political crises that have occurred since the end of the Orange Revolutions in 2005 demonstrate that post-revolutionary institutional reform is a tricky business in Ukraine's political system of "feckless pluralism". The first Orange coalition, consisting of Our Ukraine Party, Bloc Yulia Tymoshenko, and the Socialist Party was dissolved after having lost the sight of their common goal of overturning Kuchma's regime. The Party of Regions won the parliamentary election of 2006 and created a wide parliamentary majority with the Communist and the Socialist Parties. Having returned to power, the Party of Regions attempted to regain its old influence in the new more democratic regime. Obviously, the new democracy passed its first test because these attempts failed. However, this led to a political deadlock. The results of the recent pre-term parliamentary election of 2007 gave the "orange" forces a new chance to promote democratic and market-oriented reforms in Ukraine. However, there seems to be no end to Ukraine's political instability in sight. The second Orange coalition has been short-lived; the new parliamentary elections are on horizon. And the situation is worsened by the fact that the oligarchic clans, who ensure their wealth through their connections to politics, are also involved in the political struggles between the executive and the legislative.

This implies that there would be an important role to play for the EU as an external driver for institution building in Ukraine. Trade and investment flows have increased in recent years, providing the EU with the leverage to support bottom-up demand for further reforms in Ukraine. With civil society still in its early stage of establishment, such demand has to be based on business interests. As shown in the paper, the oligarchic clans found it hard to form a coalition for the day-to-day business. An important reason for this is that, contrary to the situation in Russia, oligarchic clans are sectoral and regional rivals. Access to EU markets is likely to promote further convergence of Ukraine's legislation with EU standards by providing significant external incentives, like a free trade agreement or a stake in the Common Market, to the Ukrainian oligarchic clans to push for further institutional convergence. Taking into account the presence of the oligarchic clans in the parliament and the executive, these economic incentives could be very effective

However, the ENP framework does not provide a firm commitment on the part of the EU, and the AP provides possibilities rather than concrete mechanisms and benefits. It is unlikely

that this will be sufficient to create a momentum for institutional convergence with the EU, as was the case with “Enlargement Europeanization”. External incentives supporting the domestic drivers of institutional reforms would be highly welcome in the present situation in Ukraine. While it is doubtful whether or not stable political conditions favoring reforms may be established in Ukraine by Tymoshenko’s government, a new enhanced agreement to replace the expiring PCA and new ENP AP are to be negotiated. Moreover, Ukraine has not only successfully completed the negotiations on WTO membership, it has begun negotiations with the EU on the FTA+. The challenge in these negotiations is that the incentives the EU provides are rather small compared to the accession process and thus have to be well targeted in order to be effective and generate some optimism that the bottom-up forces for institutional reform in Ukraine will be strengthened and that the current stalemate can be overcome.

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<sup>1</sup> Europeanization is “a process in which states adopts EU rules” (Schimmelfennig and Sedelmaier 2005).

<sup>2</sup> A growing empirical literature stresses that “institutions matter” for sustainable economic growth (Rodrik 2003; Kaufmann, Kraay and Mastruzzi 2005; Chhibber et al. 2006; Acemoglu and Johnson 2003).

<sup>3</sup> Solana, Javier: A secure Europe in a better world. European Security Strategy, Brussels 2003, p.14.

<sup>4</sup> Apart from economic incentives, regional security may be an additional or even increasingly important incentive for institutional building. Thus, NATO membership also provides incentives. Empirical results confirm that apart from EU incentives, NATO membership has a positive impact on institution building in transition countries (Drautzburg, Melnykovska and Schweickert 2008).

<sup>5</sup> Although it is difficult to measure the extent to which a civil society exists, the number of registered organizations and associations, and the percentage of citizens who are members of voluntary organizations and associations, are commonly used as a yardstick.

<sup>6</sup> The rankings of the most influential persons in Ukraine’s politics and economy are periodically published by a few national journals and newspapers. Representatives of business groups have held the leading position in these ratings since before the Orange Revolution. See, *Ranking of The Most Influential People of the Country. Hvardiya, Halyski Kontrakty*, 2002-2005; Rating of the 200 Most Influential Ukrainians 2007, in: Focus 51(64), 21 December 2007.

<sup>7</sup> Relatives could be included in a clan, but relative relationships play a secondary role.

<sup>8</sup> The patronage relationship between Pavlo Lazarenko, the former prime minister of Ukraine, and Yulia Tymoshenko, the former president of the United Energy Systems of Ukraine (UESU), ensured the monopoly position of this company on Ukraine’s gas market.

<sup>9</sup> Defective democracies are political regimes, also categorized as “semi-authoritarian regimes” or “electoral authoritarian regimes” (Olcott and Ottaway 1999), in which limited forms of pluralism (i.e. elections, civil society) exist, but in which the other elements of democracy (i.e. accountability, checks and balances between state branches) do not function properly.

<sup>10</sup> The judicial branch can not be considered an independent branch of state power because it is strongly influenced by the executive.

<sup>11</sup> In Ukraine, the position of presidential advisor was held for a long time by oligarchs Vadym Volkov and Oleksandr Rabylovich. Businessman Andriy Derkach is also an example. In 1996, he was appointed presidential advisor on foreign trade and two years later he became the manager of Kuchma’s election team.

<sup>12</sup> According to Kerstin Zimmer (2006), in the late 1990s, Ukrainian enterprises bought legislative laws (44 percent of total), presidential decrees (37 percent of total), credits and preferences of the National Bank (approx. 37 percent of total) and adjudications (21-26 percent of total).

<sup>13</sup> The agrarian oligarchic clans had already existed in Soviet times and still influenced Ukraine’s politics through its own ‘Agrarian Party’ (*Selyanska Partiya Ukrainy*). The coal mining oligarchic clans obtained subsidies and blocked restructuring reforms of the mining sector by means of networking with the executive. In the 1990s, the coal ministry and government were strongholds of the Donbas-based oligarchic clan. Its position was supported by the miners’ strikes and by the coal enterprise directors and the Donbas regional elites. However, the influence of the agrarian and coal mining clans began to diminish already in Kuchma’s era. Cross-sector oligarchic clans took over the agrarian and coal clans’ influence in politics.

<sup>14</sup> Such inner regional rivalry is exemplified by the rise and fall of the United Energy Systems of Ukraine (UESU), Tymoshenko’s clan stemming from the Dnipropetrovsk region. Flourishing during the period that Lazarenko was the prime minister, the company lost its monopoly in the Ukrainian gas market and its wealth after a new prime minister, Valeriy Pustovoitenko, a representative of another oligarchic clan that also came from the Dnipropetrovsk region, was appointed in 1997. The same regional origin of Pustovoitenko’s and Tymoshenko’s clans did not secure the financial imperia of UESU. Tymoshenko and the members of the executive board were accused of smuggling currency and natural gas, bribing, and the large-scale misappropriation of state property.

<sup>15</sup> Coming to power in 1994, president Kuchma awarded the presidential administration with governmental powers. Correspondently, the value of the position in this state body increased for the oligarchic clans radically. The positions in the presidential administration (as well as in the government) offered opportunities to obtain information about privatization plans, to negotiate subsidies for enterprises and to obtain credits and licenses. The presidential administration, or “shadow government” as it was since then called, had wide executive powers and competed with the government. The offices of the head of the presidential administration and prime minister were objects to exchange between the Kyiv, the Kharkov, the Doneck and the Dnipropetrovsk clans. During Kuchma’s

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presidency the governmental positions were filled by the representatives of the Dnipropetrovsk and the Doneck clans. The chieftains of the Kharkov (Jevheniy Kusnaryov) and the Kyiv (Viktor Medvedchuk) clans often became the heads of the presidential administration.

<sup>16</sup> The “5 channel” and “Era” the broadcasting companies - loyal to the Orange forces media - were owned by the Ukrainian oligarchs.

<sup>17</sup> The first “orange” coalition was created in the aftermath of the Orange Revolution in 2005 and consisted of Our Ukraine Party, Bloc Yulia Tymoshenko and the Socialist Party. The first “orange” government of Tymoshenko was blamed for corruption and dissolved in the autumn of 2005.

<sup>18</sup> Institutional convergence can be considered an institutional change to adjust institutions to certain institutional standards.

<sup>19</sup> By globalization we mean trade in goods, financial flows, and global harmonization of rules and norms.

<sup>20</sup> The type of rent might be another conditional variable. Connecting the ideas of Olson and Havrylyshyn implies that opening up a country may have different implications for rent seekers depending on the types of rents. Unlike non-renewable resources in isolated mining sectors, opening up has a direct impact on rents to be extracted from monopoly situations in the case of renewable resources or production sectors in general. The scarcity and worldwide demand for non-renewable resources limit the positive effects of globalization by pushing domestic rent-seekers to support institutional convergence towards global standards. In trade with non-renewable resources, openness has lost its power.

<sup>21</sup> The end prices were also lower than the world prices because compensation for transit charges was included in the payment for energy resources.

<sup>22</sup> The financial crisis in 1998 also marked the end of IMF “soft” credits. At the request of the IMF and because the Ukrainian government wanted to avoid financial full-fledge default, it undertook some market reforms and cancelled “soft budget constraints”. Thus, the most conservative part of the Ukrainian elite – the “red directors” - lost its rents in terms of subsidies and donations, and subsequently left the stage of the politics. “Red directors” were the former Communist party apparatchiks or directors of the Soviet state enterprises who actually ran state enterprises on a day-to-day basis. As products of the old system, these individuals kept control over their enterprises in the years of transition and were likely to attempt to frustrate any reform effort that limited their power. The external shock following the crisis of 1998 transmitted into successful economic and political reforms that squeezed their rent-seeking possibilities.

<sup>23</sup> The importance of two pipelines going through Ukraine as a “high-value card” in the bargaining position of Ukraine vis-à-vis Russia diminished. In 1999, the Yamal-pipeline began to transport the Russian gas across Belarus and Poland, circumventing Ukraine. By 2010, Ukraine’s loss of geopolitical advantage in the transit of energy will be intensified by the completion of a pipeline running through the Baltic Sea and connecting Russia directly with Germany.

<sup>24</sup> In 2004, Ukraine’s steel sector reached its highest level of capacity utilization: 95.4%, up from 52.1% in 1998.

<sup>25</sup> The figure for FDI flows from the EU-27 includes one very large off-shore zone, Cyprus, which accounts for a substantial part of FDI into Ukraine.

<sup>26</sup> From 1993 until 200, the EU lodged 43 anti-dumping cases against Ukrainian steel traders.

<sup>27</sup> The decision whether the Ukrainian steel prices were “dumping” prices or not was defined by comparing Ukrainian steel prices to the calculated unit production costs and steel prices in a third country “surrogate” that had the status of a full-fledged market economy. The calculated costs and prices were typically higher than Ukrainian ones. Thus, the EU introduced antidumping customs duty equal to the difference between the production costs of the third country and the production costs of the Ukrainian producers.

<sup>28</sup> The creation of any deep regional integration with Russia is both rather unlikely to occur and unlikely to be of great help. Ukraine’s trade regime is determined by both CIS-wide arrangements and bilateral agreements. Numerous CIS-wide agreements (like the CIS Economic Union, CIS Free Trade Zone, CIS Common Agricultural Market, etc.) have failed to be fully implemented. After Ukraine joins the WTO, it seems that the feasibility of CIS agreements is rather low and likely any activities related to these agreements will be limited to an attempt to create a free trade area between CIS countries. In addition, Russia’s markets are still relevant for Ukraine, but, as the trade regime of the EU towards Russia is rather liberal, there is no contradiction between bilateral Ukraine-Russian trade and EU integration.

<sup>29</sup> The same does not apply to achieving some sort of FTA with the EU: FTAs with the EU usually preceded both WTO entry and the official EU application membership by several years.

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<sup>30</sup> Andrew Rose (2004) estimated that WTO Accession has non-significant trade-creating effects, contrary to regional FTAs, which have strong significantly positive trade creating effects. That is probably the case due to the “lowest common denominator” constraints of the WTO Accession negotiation process, as opposed to regional/bilateral FTAs that usually go much deeper towards liberalization amongst their members. The EU is perhaps the most obvious example of the latter case. Igor Eremenko and Ekaterina Lisenkova (2004) share the same conclusion for Ukraine.

<sup>31</sup> Press release. 2007. Press office of the Cabinet of Ministers of Ukraine (CMU).

<sup>32</sup> The calculations take into account all governmental measures in 2007. During this period, Ukraine has two governments: one of Yanukovich (September 2006-December 2007) and the other of Tymoshenko (since December 2007). Thus, these achievements could not be endowed to Tymoshenko’s government only.

<sup>33</sup> The ENP tools to enhance reforms stemmed from the PCA and were sporadically complemented with Enlargement tools. Despite regime changes and transformation of Ukraine into a parliamentary-presidential republic, the EU institutional linkages are almost the presidency- and executive-oriented (Gawrich et al. 2008).

<sup>34</sup> The same unique character has the FTA incentive.