

An Economic Analysis of the Ukrainian Crisis

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According to Ukrainian economist V. Vakhitov, the analyses of the Ukrainian political crisis overstate the importance of the Russian tutelage. The country is not as divided as it is said to be, between Pro-European West and pro-Russian East. Today's revolts against authorities should be seen as a larger protest against a corrupted regime.

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Books&Ideas: The current events in Ukraine, and especially in Kiev, give the impression of a country deeply divided, politically, economically, socially, geographically, and even culturally. To what extent does this image correspond to reality?

I would agree that there is an economic and political divide. If you track how Ukraine voted over the last twenty years, you will see a rough divide over the Dniper River: pro-Communists vs. “nationalists,” Yuschenko vs. Yanukovych, the Party of Regions vs. Motherland, Timoshenko vs. Yanukovych, etc. This is where the feeling of a political divide may come from. However, if you take a map of 18th century Rzeczpospolita and superimpose it over modern Ukraine, you will see that this imaginary border roughly coincides with the Eastern frontier of Rzeczpospolita (with exception of Trans-Carpathian region and Crimea). The divide, however, is not geographical, economical, or social. It is rather mental, between “pro-Western” and “pro-Russian” zones of influence.

The East of Ukraine has always been more abundant in natural resources, especially coal and ores, and thus the Russian Empire and later the USSR invested a lot into its development. The East has become more industrialized, urbanized, more densely populated, with a majority of people employed in large factories dealing with heavy industries. One should note that the Soviet industrial doctrine was heavily based on the economy of scale and massive cross-country ties. In many cities in Eastern Ukraine, a majority of people used to be employed by a single giant manufacture on

location. After the collapse of USSR and the tearing up of economic ties with the former Soviet republics and the Socialist Bloc countries, the production of many firms became obsolete. At the same time, the development of important institutions, such as the protection of property rights, lagged well behind the privatization and liberalization of prices. As a result, it became possible to run illegal privatization schemes, and as a consequence to redistribute wealth into the hands of the most risk-taking, audacious, and cunning people, who, by coincidence, happened to be leaders of the Communist party (“the red directors”), Komsomol (young communists), and criminal gang leaders.

At the end of the 1990s, owners of large, local plants sold them out for scraps, used them as warehouses, or lost them in hostile M&A deals to competitors from foreign countries (mainly from Russia), which led to their ultimate closure. Over this period, the number of full-time jobs was almost halved. This has resulted in a deep problem of unemployment and wage arrears in the entire region, in the dissolution of human capital and the creation of dependency on the single employer in the area. Consequently, incomes have fallen, whereas the tendency to fight for workers’ rights was impeded by factory owners who controlled the workers by paying them just subsistence wages. The extensive use of brain-washing (through ownership of all local media by the same business owners), combined with a focus on “workers’ pride”, “stability”, “ties with Russian friends”, being “the industrial core of Ukraine”, has led to the genesis of a particular type of people: poor, dependent on the local employer, poorly educated, many with a criminal past, but however very loyal to their local leaders, no matter what moral characteristics they possessed, and many of them not perceptive (to the point of aggressiveness) of any alternative opinions.

The West and, to some degree the South of Ukraine, have traditionally been more agricultural, with fewer large plants. While the major asset in the East was physical capital, in the West it was – and still is – mostly land. Land has always been banned from privatization, which never prevented the creation of large agroholdings and huge land ownerships through long-term rent. When agricultural production decreased (mostly due to a lack of large investments in the 1990s), people were not given even subsistence incomes and many of them decided to seek better opportunities abroad. Western regions have become more migration-intensive, with a large share of family incomes coming from remittances from the migrants. The proximity of Europe and, thus, of European values, has also played a role in the way people perceive the world. Nonetheless, income-wise, residents of Western Ukraine are even poorer than their Eastern counterparts. They are less dependent on a single employer in the city, but still a majority of these regions receive public transfers. Many people are thus dependent on local officials and managers of the budgetary institutions.

Having said this about the economic divide, I would not agree with the existence of a cultural or linguistic divide. Even though the Soviet influence is more acclaimed in the East, still, according to the last 2001 Census, a majority of people in all regions but Crimea perceive themselves as ethnical Ukrainians. Given the natural evolution of generations, younger people across the country are increasingly more likely to identify themselves as Ukrainians. Despite clear linguistic preferences – with Russian dominating in the East and Ukrainian dominating in the West – even the overwhelming

influence of the Russian cultural space cannot change this trend. History divides, but the feeling of belonging to a unique country unites. At least, sociology shows that the idea of EU accession is growing in popularity over years, and now the number of supporters is well beyond the number of opponents. One can hope that the new generations will help close the gap or, at least, make it much smaller.

Books&Ideas: Ukraine seems to be both a somewhat rich country (resources, industries, etc.) and a poor one (debt, deficit, poverty rate, etc.). How do you explain this contradiction?

The only reason for this gap between rich and poor is corruption. Corruption is everywhere, and is widespread because the state (and the set of mind of a majority of people) is paternalistic. The Constitution of Ukraine proclaims that the country is “socially oriented”. It looks as if a majority of Ukrainians still perceived the state as the source of most goods and services, even where the market would do much better. From kindergartens to schools and universities, from birth houses to hospitals, hospices and funeral homes, courts, civil services, the police, house maintenance – basically everywhere – the state is still highly involved. The supply of kindergartens is shrinking below demand, and the fastest and easiest way to set a child into a kindergarten is by bribing the principal. Universities propose free places to the most “able” students, and the easiest way to get a high test score is to bribe a school principal or a specific teacher. In universities, the state heavily regulates the curriculum, which has the effect of creating a great number of obsolete and unnecessary courses; it is so much easier to bribe a professor to pass a course than study something you will never need in your life. Schools and universities are well financed compared to other developed countries (in percentage of GDP), but the education system is quite inefficient. A school teacher and even a university professor, together with the medical personnel, are among the least paid specialists. In large cities, such as Kyiv, it is next to impossible to get a place at the cemetery without bribing the official in charge. In some cases, bribery becomes something almost official when compulsory payments to a special “Charitable foundation” are required.

What is even of greater concern is the avalanche of bribery. The higher the level of officials, the broader the trickle of bribes they collect from their subordinates. Teachers have to collect a certain amount for principals, professors for rectors, road police officers for their supervisors. Journalists have gathered dozens of stories about daily revenue plans set up by supervisors for their subordinates. Drivers sometimes meet police officers hidden behind bushes or behind a corner checking speed limit: it is then easier and cheaper to pay on the spot than to take the case through court. Firemen, tax inspectors, sanitary inspectors may visit offices with unexpected check-ups; since rules and regulations are complex and often less than straightforward, there is always a place for minor misdemeanors, which can be solved on the spot. Prisoners may obtain a whole list of banned items if the guard is bribed.

Courts, which are supposed to regulate such relationships, are not operational either. Not only is the legal system cumbersome, but even the laws which are there are not respected. In court trials, it is very often the most affluent person who will obtain a favorable verdict. The court system is designed in such a way that one given region may pass on a decision to another region hundreds of kilometers away, without requiring the physical presence of the people involved. In many opinion polls, the court system has the lowest level of trust from all state institutions.

When it comes to obtaining any type of permit or state service, there is always either an official payment to a company which is owned by some high-ranked official, or just an unofficial and immediate payment to a public servant. One of the most blatant cases of corruption is the system of state tenders, i.e. auctions for services to the government. Very often the auctions are set up in such a way that only very specific companies can win. Most of the time, the cost of services exceeds the market costs, sometimes by a factor of ten. There seems to be no responsibility for rigged auctions, legal or financial, whatsoever.

Over the last several years, there were many attempts to break the system. In several cities (such as Lviv or Vinnytsia), the system of municipal permits operates without an immediate contact between citizens and officials, through electronic queues and the system of “single window”, when the entire package of documents is accepted by a small clerk. Attempts to clarify the tax and customs codes have also been made since 2010. WTO accession required passing several laws which instilled competition in the service sector and increased the efficiency of services competing with those provided by the state (postal services, communications, finances). However, by and large, these attempts are not systematic and do not seem to have any effect on the overall relationships between economic agents and the state. This situation creates great inequality between the few people connected to officials and the majority of lay people.

The system still has a number of specialists who refuse to take bribes and still perform their duties. What is more worrisome is the perception that these people are “old school”, and that once they are gone, education, medicine, maintenance, services, everything will be left in the hands of the newly educated specialists. Still, it is possible to spend one’s whole life in Ukraine without encountering any case of corruption. Corruption is fed by ignorance and poverty; once you have reached a certain level of education or income you can find less straightforward, but more honest ways to get what you want.

Nonetheless, the overall system has a detrimental effect on the quality of the human capital in our country. The problem is not only poor health care and inefficient educational systems. It appears that the level of trust between society and the state is running low. Also, the system itself perpetuates a negative form of selection, since it is not the most able, but the most loyal and those with lowest moral principles who climb up the social ladder. The entire outrage of Euromaidan was directed to break up this system, which suggests that the call for change in society is salient.

Books&Ideas: From France, it seems that the main issue is still, for Ukraine, to get rid of the Russian tutelage, as if the Soviet Union had never ceased to exist. Is this perception relevant, or is it hiding the real problems?

The effect of the Russian influence is overwhelming. The absolute majority of Ukrainians (I would say, way over 75%) freely speak or understand Russian. Despite official norms limiting the use of Russian in the media, a majority of TV channels, magazines, books, and popular music use this language. In a way, this happened because Russia has greater resources to create all types of mass media products and protect them economically. For example, until recently, book printing in Russia was excluded from VAT, whereas Ukrainian books were denied the same privilege. Even with transportation costs, the price of Russian printed materials was lower, and far more varied. Here is another example: Russia produces an incomparable amount of TV programs, which do not need to be translated into Ukrainian (only subtitles are required if a Ukrainian channel buys the rights to broadcast it). Only a fraction of the total TV production is created in Ukrainian initially. A lot of cultural products recall the Soviet past (such as popular songs, movies, traditions, cliché, quotes, etc.). Ukrainian translations are sometimes not economically justified or even possible.

In order to illustrate this point about the past, here is a map (from texty.org.ua) showing the names of the main streets of 20,000 settlements in Ukraine. Only streets where the local Council is located are represented. The red dot denotes a “Soviet” name (Lenin St, Soviet St, Communists St., etc). The grey dots show “neutral” names and blue dots show names connected with the Ukrainian independence. Lenin is still pervasive in Ukrainian cities: almost every major city (with the exception of Western Ukraine) with a population over 20,000 residents still has at least one monument to Lenin or to some other leader of the former USSR.

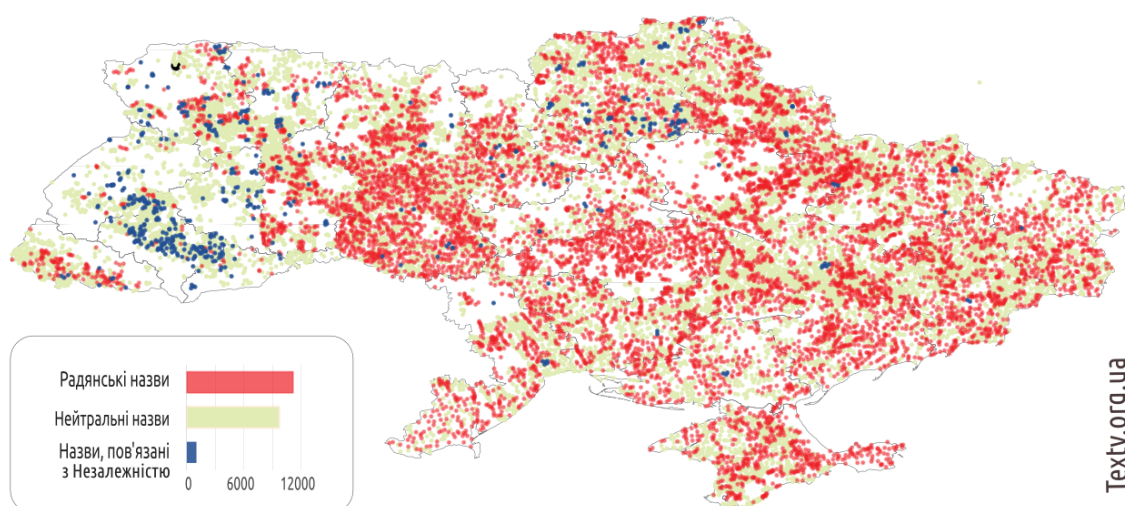
Nonetheless, I would not agree that the “Russian tutelage” is the main issue. Ukraine and Russia were parts of one country, which implies complex social, historical, economic, family, and cultural ties. Creating the Commonwealth of Independent States in 1991 was the way for a “civilized divorce”. The process has not been an easy one, but it is gaining speed. A majority of schools and universities in the country provide education in Ukrainian. Young people choose to speak Ukrainian, or, at least, do not have problems with switching between the two languages. Currently, most people in Ukraine perceive Russia as a foreign country, especially those who travel to Russia and have to deal with border crossing, passports, customs, sometimes residence or job permits. The Russian (or, rather, Soviet) past is still important, but there’s a growing understanding that it is the past.

However, what concerns most people is not the language they should speak or the name of their street. Major concerns are of purely economic nature. Recent events in Kyiv – when tens of thousands of employees of budgetary institutions were brought to Kyiv to “show their support to the President” – have revealed a complete lack of enthusiasm. Some of them were forced to come under the threat of being laid off, others came with the hope to obtain a small amount of money (about 20 EUR per day). What’s more, their opponents on Maidan square never had the intention to promote an anti-

Russian agenda. The Russian issue, as well as the issues of language, history, or even ideology, are thus not among the top ten priorities of an average Ukrainian. Economic issues are much more important.

Україна-2012: назви головних вулиць

На мапі для кожного населеного пункту кольором позначена лише назва тієї вулиці, на якій знаходиться місцева рада



Джерела: <http://rada.gov.ua>, <http://openstreetmap.org>, використані дані по 20 тисячам населених пунктів України

Books&Ideas: What is the influence of “European values” on an average Ukrainian?

Basically, there is none. Compared with the massive influence, even intrusion, of Russia in the Ukrainian cultural space – TV, books, ideas to create a common history textbook for schools and direct propaganda – Europe does virtually nothing in the public space to inform Ukrainians about its existence, to say nothing about promoting its lifestyle and virtues. All possible educational seminars, weeks of French or British movies, Europe days and even student exchange programs reach an extremely small and selective audience. The activities of the British Council, the Goethe Institute, the French House, the Polish House and the Sweden SIDA are visible and highly welcome, but not quite sufficient and again, limited to a small targeted audience of mostly young people. Unfortunately, the absolute majority of Ukrainians do not speak any foreign language, and many can't afford to study them.

There is no “European” TV channel that simply informs people about European everyday affairs in Ukrainian or Russian (Russian would even be better). There are no “European” newspapers in Ukraine which could be interesting to anyone, apart from a thin cohort of economic and political experts. French, Polish or Italian movies are much less frequent on TV screen and in movie theaters compared to Russian or Hollywood production. The most popular French sitcom used to be “Helene et les garçons”, which

is as old as independent Ukraine itself. Very strict visa policies, with tremendous list of required documents (such as full verifiable information about banking accounts, incomes, family structure, property, working status, etc.) make Europe a closed and “scary” *terra incognita*. In this respect, Russia has always been much more open for Ukrainians, and it is not surprising that many people still perceive themselves as part of the Russian World.

It is not surprising therefore that many people have extremely biased stereotypes about Europe as a territory struck by a severe crisis, little consent between countries, open gay and sex propaganda, open marijuana use, closed markets for Ukrainian goods, a place where Ukrainians are employed almost as slaves for low-paid jobs. It is not surprising as well, that Europe should not be perceived as the center of values which might be attractive to Ukrainians, since no such values are articulated in our public space. Soft power has long been the strength of Europe, but the lack of any common “Eastern” policy in Europe is hardly compensated by scattered and mostly political efforts of friendly countries, such as Poland or Sweden. Massive cultural expansion of Europe into Ukraine is long wanted. A 45 million people market is waiting for new ideas. A more proactive policy in this direction would be an important long-term investment rather than immediate “cultural expenditures”, and this investment would have a very large rate of return in the near future.

Books&Ideas: Does the dependency on Russian energy supply act as a constraint limiting the possibility of political change?

No, gas dependency is a fact that all Ukrainian elites will have to deal with. Most of the natural gas consumed in Ukraine comes from Russia. Gas is used not only for heating, but also in metallurgy and the chemical industry as an essential input. Since the outputs of these two industries constitute a large share of Ukrainian exports, gas dependency will be an issue for many years to come. It is difficult to expect that tycoons would be willing to give up their profits for unpredicted political change. Essentially, after the Orange revolution in 2004, there was a change in elites, which was followed by a drastic change in the gas supply scheme, and not vice versa. Still, some members of the Parliament simply changed their political affiliation and became members of the party that supported a new President-elect.

Most of the wealthy people in Ukraine became wealthy thanks to gas deals, manipulating the price differences and tariffs of the natural gas coming from Ukraine or Russia, as well as the price of the gas transportation system. The deals have never been fully transparent. For example, according to a very strange deal signed by Yulia Tymoshenko in 2009, Ukraine currently pays more than Germany for Russian gas. Despite the fact that Ukraine is the largest client of Russian Gazprom, it has no important discounts. The deal was strange because it regulated a minimum amount of gas Ukraine had to buy every year at a price tied to the oil price, while no minimum amounts of gas transportation volumes were fixed. The transportation price was also fixed quite low, with no regard to external market conditions. On the surface, the deal

was not beneficial for Ukraine, and my guess is that it included some unclosed additional agreements settled between Putin and Timoshenko, which were not respected after Timoshenko lost the Presidential election in 2010 and was sent to prison.

At the same time, Russia is no less dependent on the Ukrainian gas transportation system, first of all due to the large gas storage reservoirs that Ukraine possesses. The reservoirs help smooth gas consumption in Europe during peak periods. The fact that the Russians do not control them completely is the reason why they constructed highly expensive gas transportation systems around Ukraine.

Ukraine is one of the least efficient consumers of natural gas in the structure of the economy (as measured by the amount of gas consumed per unit of GDP). Higher prices could bring necessary energy-savings technologies (which actually started to happen over the last couple of years), while any price discounts will further postpone any need for restructuration. The issue is extremely political: since prices for the population are subsidized, tying them to the market would have enormous electoral cost. But without this measure, Ukraine occupies a vulnerable position in all the negotiations with international institutions such as the IMF.

I will not comment on oil and electricity, as these sectors are more transparent and operate within adequate market conditions. Internal inefficiency and huge energy losses in the electric transmission grid is an acute problem, but it is also an issue Ukraine has to deal with internally.

I hope that the European Energy Charter will bring more transparency into Ukrainian gas deals with Russia, as well as reduce the power of gas tycoons, thereby decreasing their ability to support current elites. Transparency and competition may bring about some changes in the political system, but will not decrease Ukrainian dependency on Russian gas.

Books&Ideas: From a French point of view, it seems that joining the EU would bring numerous benefits to Ukraine, both politically and economically, but that the Ukrainian government underscores the possibly heavy costs of a EU integration. Could you clarify this?

EU accession can provide long-term benefits, but it was not clear what the immediate consequences would be. Besides, I doubt there were more than a dozen people in the country who had read the entire 900-page document of the accession. It was very easy to start anti-European propaganda in the media, with huge support from Russia. There was no European response to this, as the European position has always been very mild: “We can propose you the deal and you should decide whether it is good for you or not”. But even such a mild view was not vocalized enough. The Russian propaganda was crystal clear: “You will pay a huge price, markets for your goods will be closed, both European, as you are not competitive, and Russian, as EU regulations are not compatible with those of the Customs Union; you will lose you labor force – just look at Latvia, Litva and Greece, you will become the source of cheap labor force for

European pensioners.” I guess Europe has lost this battle of ideologies (if it ever started it).

I also believe that the true reason is more cynical. Apparently, the rhetoric of Ukrainian government has changed after one of the meetings of President Yanukovich with President Putin. The Party of Regions, which has the majority in Parliament and fully supports the President, had the EU accession as one of the slogans of their election campaign. Last year soccer championship was presented as “one more step bringing Ukraine closer to Europe”. Until the end of summer 2013, it seemed that the only obstacle for signing the deal was the tension around Yulia Timoshenko, and it even seemed that European politicians ultimately agreed on a compromise. However, there was immense pressure from Russia, both internally and externally, which ultimately appeared to be stronger than the European unprecedented pull.

Ukraine is entering a new Presidential campaign this year, with elections to be scheduled for the beginning of 2015. The governance of President Yanukovich has brought the country on the brim of bankruptcy, with huge external debt, big public debt, budget deficit, huge Pension Fund debt, deteriorated investment climate, the absence of the rule of law, and a lack of trust in the state. His level of support even in his home regions is low, and he has very dim chances to be reelected in honest and transparent elections. That is why he urgently needs free funds to cover the most vivid deficits (in the Pension fund and the state budget), that is why he tried to discuss with the EU, Russia and China. It looks like he was not successful to strike any favorable deal with the IMF (which requires increasing internal gas tariffs for the population as the part of the package) and China (it looks as if China was considering him as a lame duck and decided to wait till the election results). Russia has proposed quick money, about 3 billion USD immediately and an additional 12 billion USD as gas price discount over the next several quarters. It is not clear what the long-term cost of this deal was.

Hence, the decision to postpone the European integration is a very short-sighted decision of a single person who put his personal electoral prospects ahead of the interests of the nation which elected him as President.

Books&Ideas: How do Ukrainians consider the examples of Poland or the Baltic state, and in particular their relationship with the EU and the euro?

Baltic countries are not relevant examples for Ukraine. They are much smaller (the population of each of these countries is comparable to the population of Kyiv alone), they don't have as many resources as Ukraine (such as soils, shale gas, coal, ores, fresh water, etc.), and they are far less similar to Russia mentally.

I guess that Ukrainians supported their aspiration to independence, but many dubious nationalistic actions are perceived with suspicion. Currently, all Baltic states are far away, and are as far as Germany in terms of travel cost (distance and visa requirements). They are cold and expensive for the summer vacation and not too attractive in the winter. Some Baltic banks operated in Ukraine, but they lost their

presence after 2008 crisis; no substantial Baltic business interests has been present in Ukraine since. Their voice in Europe is considered quite weak, despite the open and sincere efforts of Litva's President to personally support Ukrainian eurointegration. Currently, Baltic states are used as counter-examples of the benefits of a EU accession by numerous opponents (and rightfully so). However I doubt that most people in Ukraine think too much about them at all, or, at least, more than about any other former Soviet republic.

Poland is a more interesting case. Ukraine has long historical ties with Poland. Poland is quite similar to Ukraine in territory, mentality, and language. Polish is much more similar to Ukrainian than English, German or French. Parts of Ukraine used to be under Polish rule several hundred years ago. It was the war with the Poles that made it possible to sign a war treaty between the Cossak state and Russia in 1654, that further resulted into de-facto accession of Ukrainian territories by Russia (and Polish split-ups later). The last visible conflict with Poland was over seventy years ago. Poland has no open territorial claims to Ukraine (unlike Romania or Hungary). The Polish government proposes hundreds of scholarship for Ukrainian students who want to study in Polish universities. The last year soccer championship organized jointly with Poland was an absolute success. The Polish economic reforms led by Balcerowicz in the 1990s are studied as examples of successful post-communist transformation. It is hard to find any other nation in Europe which is so much preferred over Ukraine and so supportive of the Ukrainian EU aspirations. It looks as if the Polish economy were quite strong, and Poland one of the few newly accepted countries not touched too severely by the crisis (this fact, however, is not well-known in Ukraine in contrast to a massive labour force shortage due to emigration). If Europe decides on any pro-Ukrainian policy, Poland could thus be the best vehicle for that.

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