

Finding the Balance-
The Ukrainian Experience on the Road to
Freedom and Development

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Cape Town, April 2002

Signed by candidate

To Anatoli & Vladimir -

the most entertaining Ukrainian bus drivers one
could envisage

Abstract

The theme of this study is freedom and development. One of the crucial points is the relation of freedom and development to different degrees of regulation and to the provision of substantive rights in a given society. The importance of formal and informal institutions as constraints on individual freedom but also as a necessary condition for individual freedom and co-operation is illustrated.

The theoretical framework I am building on combines two distinct but reconcilable approaches to this topic: Amartya Sen's *Development as Freedom* and F.A. Hayek's *The Constitution of Liberty*. It is supplemented by Hernando De Soto's *The Mystery of Capital* and some ideas of the New Institutional Economists.

By applying this framework to developments within a transition economy – the Ukraine, and in particular to the agricultural sector of the country - I try to show both the basic challenges that transition economies face and how far theoretical approaches to freedom and development are actually applicable to practical issues. The problems the Ukraine is facing on its way to a free market economy, especially in the area of privatisation and liberalisation, are largely the result of arbitrary regulation and coercive state interference. Rent-seeking and corruption are a consequence of creeping administrative discretion and have impeded the development of the country tremendously. These problems are enforced by the neglect of substantial rights such as political freedoms, social opportunities and protective security. Thus both the regulatory environment - the rule of law - and the actual freedoms that people enjoy need to be improved. A stable institutional framework that avoids both over-regulation and under-regulation needs to be created. Within such a framework people will be able to act freely and lead a life they have reason to value.

The German Advisory Group on Economic Reform and members of the Department for Agricultural Economics of the University of Göttingen have largely provided the information about developments and policies in the Ukraine. Although I did not engage in proper empirical work myself – and as a philosopher I probably should not have done so – my visits to the Ukraine have helped me to process the variety of empirical data.

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Abbreviations:

AMC	Antimonopoly Committee
CAE	Collective Agricultural Enterprise
CIS	Commonwealth of Independent States (includes as full or associate members all countries of the former Soviet Union, except the Baltic states)
DUAP	Deutsch-Ukrainisches Agrarentwicklungs- und Investitionsprojekt
EBRD	European Bank for Reconstruction and Development
EC	European Community
EU	European Union
FDI	Foreign Direct Investment
FSU	Former Soviet Union
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GNP	Gross National Product
GDR	German Democratic Republic
IER	Institute for Economic Research and Policy Consulting
IFC	International Finance Corporation

IMF	International Monetary Fund
NGOs	Non-Governmental Organisations
OECD	Organisation for Economic Cooperation and Development
SMEs	Small and Medium-sized Enterprises
SPF	State Property Fund
Tacis	Technical Assistance for CIS Countries (EU)
USAID	United States Agency for International Development
UAH	Ukrainian Hryvnia
VAT	Value Added Tax
WTO	World Trade Organisation

Introduction

Back to the Rough Ground!

“We have got on to slippery ice where there is no friction and so in a certain sense the conditions are ideal, but also, just because of that, we are unable to walk. We want to walk: so we need friction. Back to the rough ground!”

(Ludwig Wittgenstein, *Philosophical Investigations*, § 107)

October 2001 – I am travelling with forty young agrarians through the Western part of the Ukraine. Our trip leads us to Lviv, Ternopil, Vinnycia, Cherkassy and Kiev. We are visiting various agricultural enterprises, slaughterhouses, dairies, an academy for agriculture and an agricultural research institute.

Not surprisingly, I am the only philosophy student in this group of agricultural economists, eager to find out something about the nature of the relation between freedom and development in a so-called transition economy. For the first time in my university career I am trying to open the purely conceptual perspective on an issue to the rough ground of empirical facts, deeply convinced that only these facts can give meaning to any conceptual framework.

The framework I am going to use and to fill with facts is a net woven around two cornerstones: Freedom and Development. In the following I aim to fill some gaps in this network, very aware of the fact that I will not establish a complete system. If I should be successful in contributing towards the understanding of the concept

of freedom, of the role that freedom plays for development and in encouraging some discussion, I would be rather pleased.

Setting the Stage

When you start talking about the Ukraine, most people in Western Europe or even further afield will be hard-pressed to add something profound to the conversation. Although situated right between central Europe and Russia and thus of strategic importance, the country remains virtually unknown throughout most of the world. This relative ignorance was only interrupted in 1986, the year when the Chernobyl accident shattered our confidence in nuclear power.

“Ukraina” means borderland, and indeed for much of the last millennium the Ukraine has been a frontier zone remaining at the intersection of the continually shifting borders of the Grand Duchy of Lithuania, the Ottoman Empire, the Polish-Lithuanian Commonwealth, the Crimean Tatar Khanate and Muscovy. The different parts of the area have belonged to a range of different peoples and countries.

An exception to the status of a politically undefined territory was the so-called “Golden Age” of the Kievan Rus. It lasted from the early tenth to mid-thirteenth century. Under Yaroslav the Wise (1036-1054) laws were codified and a stable administration was established. Thus Kiev grew to be a political, economical and cultural centre that was able to compete with Constantinople.

Yaroslav strengthened the state's ties with Europe by marrying his daughters to the kings of France, Hungary and Norway.

Unfortunately, the glory could not be maintained – and never really returned. The Mongols under Tshingis Khan took over in mid-thirteenth century. The area around Kiev and the north and the south of the empire become tributary to the Mongols, while the principalities of Nowgorod and Polotzk remained relatively independent. This division explains the different political, cultural and religious developments of both the Mongolian and the more western orientated parts of the previous Kievan empire in the middle ages. These differences remain significant until today. After two and a half centuries of Mongolian oppression the chain of different rulers continues for centuries afterwards: Lithunians, Poles, Austrian-Hungarians – and last but not least – the Russians. It is not the purpose of this work to give a detailed historical overview, but whoever is interested in the Ukraine will find it worthwhile to put some time into researching the different historical periods.

All these peoples and systems left their marks – some more, some less. In cities such as Lviv one clearly recognises the Western European influence. A certain Viennese flair has resisted even 70 years of SU totalitarianism. On the other hand, the further east one ventures, the more one feels the closeness to Russia. Greek Catholic Unitate Churches give way to Russian Orthodox ones. You can trust your nose: the further east you go, the more incense

is used as a haze for the senses. If one were a bit sarcastic, one might claim that people further east would need additional portions of incense. The well-known and often abused Marx-insight that religion is the opium for the people, makes perfect sense under these conditions: the quality of roads and infrastructure in general and the degree of hope in people's minds seem to decrease with every city one passes. More and more road blocks emerge and you get used to having to bribe your way for you and your vehicle past "police men", who seemingly have taken the current call for privatisation a bit too seriously and work independently of state and law. You see potato fields protected by ex-soldiers who lean on their rifles. Thus, nobody really minds an extra-portion of incense as a means of comfort – indeed, that's by far preferable to the common place alcoholism terrorising society!

Admittedly, these last remarks must sound somewhat sarcastic to the reader. Of course, they are meant rather to be snapshots and do not claim any scientific validity – but they might help the reader to get in touch with the atmosphere one can experience while travelling the Ukraine.

However, there is more to the country than Chernobyl, alcoholism and corruption. Post-independence Ukraine has a chance. It is a country of impressive physical size, economic potential, resource endowment and great people. And even if the country might not return to the glory of the Kievan Rus – the days of "Golden Ages"

seem to be over anyway – its people can change it into a country where they can lead free and responsible lives according to their values. That’s not going to be an easy path – but one worth travelling.

By far the most inspiring theoretical input for this project is Amartya Sen’s book “Development as Freedom”. His analysis of the concept of freedom and the relation between freedom and development is the departure point for my considerations.

Moreover, I found the work of F.A. Hayek (*The Constitution of Liberty*), Hernando De Soto (*The Mystery of Capital*) and Jon Elster (*The Cement of Society*) to be outstandingly instructive.

Furthermore and most importantly, I am very grateful for all the material concerning recent developments in the agricultural sector of the Ukraine that I received from the Department of Agricultural Economics of the University of Göttingen (Germany). In particular, I am grateful to Ludwig Striewe, one of the Department’s Research Associates¹, whose patience in answering many of my questions regularly left me with amazement. Without this support the informational base of this work would have been much poorer.

A. Exposition-The Theoretical Framework

Free Agency

“The argument for liberty is not an argument against organization, which is one of the most powerful means that human reason can employ, but an argument against all exclusive, privileged, monopolistic organization, against the use of coercion to prevent others from trying to do better”²

Discussions on freedom often turn out to be rather puzzling. When I asked Natalia, our translator in the Ukraine, about the acquired freedom in her country, she just smiled mildly at me and said, “there is no freedom, only many sorts of unfreedom”. After the first euphoria had passed, people saw themselves confronted with a high degree of uncertainty in most areas of social life. The country had gained independence from Soviet rule, but it was far from clear where this freedom would lead.

When we talk about free agency we seem to find ourselves in some kind of a paradox. On the one hand, freedom seems to presuppose a systematic relation between our expectations concerning the outcomes of our actions and the outcomes themselves. This in turn is only possible with a reliable level of information and certainty about the environment within which we act and interact, comprising both our physical and societal surroundings. That is why free action presupposes certain constraints such as rules and

norms that structure our behaviour and help us to rationalise the world.³

On the other hand, we would be reluctant to call a scenario of perfect information facilitated by an exceedingly high level of regulation the right playground for free agency. Understandably, under such circumstances our expectations would always match with the outcomes of our “actions”. But would this kind of “agency” be valuable to us?

What would be the point of playing the game of life when the outcome is clear right from the beginning? Where would development and progress fit into such a picture? The whole novel of one’s life would have been written before one were to start with it. Thus, the state of affairs where everything is regulated, where everything is perfectly certain, is not what is needed for free action. Finally, we are also not looking for some kind of metaphysical freedom á la Hegel that would be characterised by complete certainty and the absence of any constraints from others.

We are looking for psychologically significant freedom; a kind of freedom the individual can experience and that allows her to invent herself within certain boundaries. These boundaries are real but not unchangeable. Since the context of individual freedom is society, the constraints I am focusing on are constraints resulting from the presence and activity of other people in society rather than natural forces. Thus I am concerned merely with constraints that fall into the category of regulation and state coercion. These constraints include both the formal legal framework under which a society

operates, such as the rule of law and the social norms and values, which support this formal framework. So where is the appropriate space for freedom then?

I would suggest the following ways of thinking about the matter.

Firstly, we can picture an *increasing level of certainty* on the x-axis and a *decreasing degree of constraints from others* on the y-axis of a Cartesian system. If we divide both axes into ten equal segments (0-10) respectively, we can say the following: Neither the point described by the co-ordinates (x=0; y=0) nor the point described by the co-ordinates (x=10; y=10) would satisfy the conditions for psychologically significant freedom. The former would describe a scenario of severe uncertainty and an extreme degree of constraints from others. The latter describes the kind of Hegelian metaphysical freedom characterised by perfect information and the absence of any constraints from others.

Secondly, we can change the designation of the axes as follows: an *increasing level of certainty* remains depicted on the x-axis and *increasing degree of constraints from others* is now depicted on the y-axis. The segmentation of the receptive axes remains the same.

Again, neither the point described by the co-ordinates (x=0; y=0) nor the point described by the co-ordinates (x=10; y=10) fulfils the conditions for psychologically significant freedom: (x=0; y=0) describes an anarchic scenario characterised by severe uncertainty and absence of constraints from others and (x=10; y=10) describes a quasi-deterministic scenario of perfect information and an extreme degree of constraints from others.

Note that these scenarios do not describe real states of the world.

They help us rather to think about reality.

What I am assuming is that different degrees of psychologically significant freedom can be found in an *area* between these extremes; I am not claiming that we can locate this kind of freedom at a single fixed spot in the system.

From these remarks one can already draw two conclusions:

- a) Freedom and free agency must neither be confused with the absence of rules/constraints or with complete regulation.
- b) Freedom is not unidimensional; it makes sense to talk about different degrees of freedom or about a variety of possible equilibria.

The social constraints that psychologically significant freedom and free agency presuppose, I would like to call institutions.⁴

Institutions can be seen as the rules of the game of social life.

In the broad sense they build the informational basis for any rational action by providing agents with a sufficient level of information about their environment. Only when I know that certain rules prevail for all players in the game can I, at least to an acceptable extent, predict the outcomes of people's actions. Only when I can be fairly certain that other people adhere to certain societal norms, that prevent them from defecting, will I enter into

co-operation with them without having to guard too extensively against their likely opportunistic behaviour.

Viewed from a slightly different angle, one could say that institutions prevent negative externalities caused by one agent from infringing on the freedoms another agent enjoys.

This explanation of institutions can well be made in terms of pareto optimality. From a certain point onward, any additional unit of freedom utilised by one agent might subtract from the freedom another agent can enjoy. When one accepts that interpersonal utility comparisons are difficult, then the problem of optimising freedom within society can only be solved by negotiation. This also implies that freedom rather demands than denies the necessity of co-operation and the ability to compromise.

However, the institutional network that on the one hand helps us to rationalise our environment and to plan our actions, and on the other hand prevents the negative externalities caused by one agent from restricting the free agency of another agent, is not made of iron. Although we are acting within a given institutional framework, this framework leaves us space and even provides us with the very opportunity to make choices and to influence and change the institutional infrastructure in accordance with our current conception of a fair society. Thus it is not only the institutional web of formal and informal rules that shape the behaviour of agents within society, but also the choices agents

make and the actions they perform that can and do shape the institutional constraints of any society.

As Hayek puts it for the matter of state interference in human life:

“Organization is [...] likely to be beneficial and effective so long as it is voluntary and is embedded in a free sphere and will either have to adjust itself to circumstances not taken into account in its conception or fail”⁵

What is important for social integration and stability, I presume, is that the members of the respective society accept and recognise these rules as fair, that they consider them to be legitimate. That is probably most obvious when it comes to formal property and contract rights. For this acceptance to prevail, it is crucial that formal regulations and informal arrangements, and in a similar manner one set of formal rules and another one, do not contradict each other.

Furthermore, arbitrary regulation, including both over-regulation and under-regulation, is the perfect breeding ground for all sorts of opportunistic behaviour that undermines co-operative equilibria in society and makes it less free. The opaqueness and non-transparency of arbitrary regulation, e.g. the frequent and retroactive change of rules, cause a high level of uncertainty and distrust in society that prevents free agency and development.

In the course of this thesis I am going to illustrate these rather abstract remarks by describing some of the recent developments and policies in the Ukraine and especially in the agricultural sector of the country. For this transition country it is of vital importance to get onto an equilibrium path that is characterised by the rule of law. It must wind its way between both over- and under-regulation, to create a stable but non-coercive framework that allows its citizens to act as free agents. Setting the issue of freedom and development in a context where institutional arrangements are still highly fragile will hopefully open our eyes to the significance of a well-established institutional environment that enhances people's personal freedoms and contributes to the development and growth of a country.

Amartya Sen argues in *Development as Freedom* for the need for an integrated analysis of economic, social and political freedoms and the various interconnections among them that enable every member of the respective society to lead a life *she has reason to value*.⁶ At the same time he views development as an integrated process of expansion of these interconnecting freedoms.

"Societal arrangements, involving many institutions (the state, the market, the legal system, political parties, the media, public interest groups and public discussion forums, [...]) are investigated in terms of their contribution to enhancing and guaranteeing the substantive freedoms of individuals, seen as active agents of change [...]"(p. xiii)

In the following section I shall review Sen's *capabilities approach* in some detail.

Sen's Capabilities Approach

Development economics has often been accused of focusing exclusively on the role of markets and the generation of wealth with reliance on income as the prime indicator, using only the traditional measuring devices of GNP or GDP, economic growth and cost benefit analysis and often ignoring wider social and political factors.

In all his considerations Amartya Sen does not contest the importance of markets and material wealth creation. Instead he tries to establish a different perspective on development in which political freedoms (free speech, a free press and free elections) help to promote economic security, social opportunities (education, equal status of women, etc.) facilitate economic participation and economic facilities help to generate personal abundance as well as public resources for social activities.

Sen's *capabilities approach* "measures" development by the extent to which a range of diverse human capabilities or freedoms are realised. The freedoms individuals enjoy are both treated as the basic building blocks of development and as the appropriate elements of optimisation that constitute the idea of development itself.

According to Sen development is the process of expanding the real freedoms or capabilities that people enjoy so that they can *choose a life they have reason to value*. It requires the removal of major sources of unfreedom such as poverty, neglect of public facilities, intolerance and over-activity of a repressive state, etc.

It is crucial for Sen's argument that freedom entails not only the *processes* that allow freedom of actions and decisions but also the *actual opportunities* that people have, given their personal and social circumstances. Both components are essential parts of the definition of freedom.

Freedom is at once the goal of development and the principal means of development. This interdependency between freedom and development implies for Sen firstly that the assessment of development has to be done in terms of whether the freedoms that people enjoy are enhanced, and secondly, that development is thoroughly dependent on the free agency of people.⁷ For development to take place social institutions must aim at expanding individual freedoms. But simultaneously, individual freedoms must be used to improve the standard of life and to make social arrangements more effective.

Thus individual freedom is viewed as a social product and the success of society is evaluated by the substantive freedoms that its

members enjoy. Freedom enables people to help themselves and to influence the world. Thus it is both the necessary and sufficient condition for individual responsibility.

The concept of informed choice is central to Sen's approach. The capabilities approach focuses on the creation of conditions that provide people with real opportunities (capabilities) to judge the kind of lives they would like to lead and that allow them to choose between alternative functioning combinations or different lifestyles. Substantive public support in the provision of basic health care and essential education is crucial in that respect, but so are basic political and civil rights that prevail under democracy, including the opportunity of open public discussion and debate. The latter are not only among the basic human freedoms and thus important in themselves, but they also play an instrumental role in enhancing the hearing that people attain in expressing their claims to political attention. Furthermore, they are crucial for the conceptualisation of economic needs and the formation of shared values and preferences.

Public consensus on certain values and rules of conduct is essential for sustainable development. These informal institutions are desperately needed to supplement formal institutions such as the market. They may be strengthened by ethical consideration but they are also instrumentally important for economic and political success. Trust and responsibility are necessary ingredients for the

long-term sustainability and success of any economic and political system.

Instrumental Freedoms

The emphasis in Sen's capability approach to freedom is on the development of the responsible agent, capable of changing her environment and able to help herself and others. Sen lists five instrumental freedoms that essentially contribute to the general capability of the individual to act and choose freely:

- 1) Political freedoms
- 2) Economic facilities
- 3) Social opportunities
- 4) Transparency guarantees
- 5) Protective security

Political freedoms include civil rights. They provide people with the opportunity to determine who is going to govern them and on what principles. They provide citizens with the right to scrutinise and criticise authorities and are intimately linked to the freedom of political expression, association and participation and the freedom of the press.

Under *economic facilities* Sen subsumes the opportunities citizens have to utilise economic resources for the purpose of consumption, production or exchange. Economic entitlements depend on the resources owned by the individual or available to her, on the

conditions of exchange, relative prices and the working of the market. Another important aspect with respect to economic entitlements is the availability and access to finance.

Social opportunities include the arrangements society makes for the availability of basic public goods like health care, education and housing. These opportunities enable citizens to participate both in economic and political activities.

Transparency guarantees are important due to the agents' need for openness and certainty. They are expected to enhance the predictability of people's actions, thereby facilitating all kinds of social and economic interaction and co-operation. Transparency guarantees are a basic means to create trust and they work as a disincentive for corruption and other forms of opportunistic behaviour.

By *protective security* Sen means the establishment of a functioning social safety net, which should include certain fixed institutional arrangements like unemployment benefits and obligatory insurance schemes.

Each set of these freedoms is important in itself. For example, we do not need to justify the significance of civil rights by referring to their positive impact on the development of the market or individual prosperity; they are valuable in themselves. So even if a person would not suffer from any economic disadvantage we would still find that a lack of political rights subtracts substantially from her overall freedom to choose a life she has reason to value.

Equally, economic freedom is a goal in its own right. The denial of opportunities of transaction, through arbitrary controls for instance, is a source of unfreedom in itself independently of the fact that arbitrary restrictions of the market reduce people's real opportunities in other areas.

Nevertheless, all these instrumental freedoms reinforce each other, and improvements in one area will often lead to improvements in other areas. For example, the provision of basic education will help people both to stand up for their political rights and to participate in economic activities. A telling example, which Sen provides us with, is that of an enhanced level of literacy and education of young women in developing countries, such as India, which contributes essentially to the decrease of birth rates in these regions. This helps to deal both with the problem of overpopulation and the improvement of women's health in underdeveloped areas, enabling these women to take their stand in society.

The Practicality of Sen's Approach

However intuitively appealing this approach may be, it is necessary to point out some reservations concerning the workability of Sen's concept of human flourishing and development. I agree that his approach provides us with a much broader view on development than narrower, income-focused, measurement approaches do and that it has great analytical power. But how far can this broader concept be applied practically?

Sen admits that there is no way of attaching a specific weight to each capability. It is impossible to say that education is worth x , economic security y , and a free press z . There is no simple formula for measuring development. That implies that the capabilities approach is more difficult to apply than the narrower income-focused approaches it is intended to extend.

However, this does not mean that it is impractical. Although it might be hard to record Sen's concept of development in a quantitative way and equally hard to evaluate the trade-offs between the various development goals⁸, they *can* provide clear criteria for development policies, which can complement more quantitative economic indicators.

Reaching consensus about the priorities of certain goals might be thought of as problematic as well, but I suppose that this is not an unmanageable task as long as one does not lose track of the broader picture. Some options will always be more feasible to pursue now than others will. Government investment in health care and basic education, for instance, is not very costly in many developing countries due to low labour costs and can therefore be initiated even before economic growth kicks in. The development of these sectors is going to improve people's standard of life and is likely to have a positive impact on other development goals.

However, the main problem is the following: if we agree that we have to take into account many dimensions when it comes to

measuring the quality of development policies, one could object that governments would then have opportunities to fudge about important issues. Government officials could always claim to act in the interest of this or that “development aspect”, preventing its citizens and foreign countries from holding it accountable to clear and comprehensive standards. The more complex the targets of political action are, the more complicated and obscure the policies that can evolve. If they did, transparency would be threatened and that in turn opens the door (or keeps it open) for all kinds of irresponsible behaviour.

The non-transparency that might arise with the attempt to maximise a complex development function, is likely to incentivate the different bureaucrats concerned with different development objectives to misuse their discretionary powers. Sen does not tell us who would be responsible for constraining this administrative discretion. He points out that under the institutional infrastructure of instrumental freedoms development standards cannot simply be invented as it suits certain governmental or non-governmental interest groups. They have to be *formed* by democratic debate. People arguing about them are expected to create clear standards of behaviour and social values. (Of course, a basic set of common beliefs and the willingness to debate are needed for any conversation or discussion to start.)

However, we must not be over-optimistic. It is not clear whether democratic debate and public discussion will always lead to consistent standards. Certain interests within society are simply

opposed to each other. The mobility of capital, for instance, is hardly reconcilable with concerns about equality and certain efficiency measures might contradict other social issues.

Democratic debate alone does not inoculate society against rent-seeking and other forms of power abuse.

Thus, one might argue that a narrower optimisation focus could provide stricter and more consistent standards to which a government or state can be held accountable. But despite the reservations I have made above, development goals such as the establishment of legal certainty, an efficient social safety network, an independent and diverse media and the supply of educational facilities are important and *can*, under certain conditions, be pursued without sliding into non-transparency and opportunism.

Sen does point out that government officials must be accountable to their citizens and citizens must remain vigilant and exercise their rights of free expression and political participation. However – as mentioned already - this is not sufficient. There also needs to be some general constraint on the discretionary powers of government officials. It is a severe weakness of Sen's approach that he does not address this concern sufficiently.

Hayek's Constitution of Liberty

F.A. Hayek has given one of the most comprehensive accounts of liberalism in *The Constitution of Liberty*. In his work Hayek defends the chief values of classical liberalism such as the dignity of the human individual, the moral primacy of her freedom, the

benefits of free markets and the necessity of limited government under the rule of law.

Hayek defines liberty as the independence of the arbitrary will of another or the absence of coercion by other men. Coercion is characterised as eliminating an individual as a thinking and valuing person and making her a bare tool in the achievement of the ends of another person.

The main argument in Hayek's account of liberty is that a free society must be governed by the rule of law. Here it necessary to point out what he means by the *rule of law*.

*"The rule of law is [...] not a rule of the law, but a rule concerning what the law ought to be, a metaphysical doctrine or a political ideal."*⁹ It is something like a meta-constitutional doctrine about what an actual constitution ought to be.

The rule of law is characterised by three essential attributes.¹⁰

Firstly, its rules must be general and abstract. Laws should be long-term measures that refer to yet unknown cases, never to particular persons, places or objects. They must be prospective rather than retrospective in their outlook.

Secondly, the rules of the law must be known and certain. There must exist a set of judicial procedures, such that decisions of courts, which articulate these laws, become predictable.

Finally, the rules of the law must respect individual equality before the law.

On page 154 of *The Constitution of Liberty* Hayek gives a truly beautiful characterisation of the rule of law: *“The true contrast to a reign of status is the reign of general and equal laws, of the rules which are the same for all, or, we might say, of the rule of leges, in the original meaning of the Latin word for laws – leges that is, as opposed to the privi-leges”*

The “rule of status”, which Hayek opposes would be a state in which the rules are not fully general but single out particular persons or groups and confer upon them special rights or duties. His characterisation of the rule of law implies that rules must apply to those who lay them down and those who apply them – to both the government and to the governed, independent of their position – and that nobody has the right or power to grant exemptions. For all these demands to be fulfilled the law must have largely formal character, stipulating terms under which people pursue their chosen activities.

One of Hayek’s basic premises is the limitation of human reason. The individual lives in a complicated world of change and uncertainty, in which complete foresight is a matter of impossibility. The abstract and general rules of the law (as well as the rules of nature) help to restrict the scope of this uncertainty and only through the knowledge of these rules is the individual able to predict the consequences of her actions and to make plans with confidence. That is the precondition for free agency. The rules of the law provide the framework within which the individual can

confidently calculate risk. The law defines variable side constraints, which both constitute individual freedom and draw its boundaries. These side constraints or rights identify protected domains by imposing limits on all individual action. The definition of property, for instance, is one of the crucial achievements of the law and essential for the functioning of a market economy. It frames the protected domain of each individual – a domain that is respected by her fellow citizens (and the government!) and in which decisions and choices are hers. The recognition of private property is considered to be an essential condition for the prevention of coercion. Moreover, it provides individuals with the necessary knowledge about who owns what. Without that kind of knowledge the benefits of co-operation would be less clear and thus co-operation would be less likely to occur. Thus the stable juridical framework of liberty under the rule of law provides people with the greatest opportunity to make voluntary exchanges that are to their mutual benefit.

In accordance with his theory of spontaneous formation of order in society, Hayek formulates the task of the lawgiver as the creation of conditions in which an orderly arrangement can evolve and ever renew itself. This idea of the “evolution” of order and rules restricts the possibility of *designing* social institutions considerably.

All these ideas convey Hayek’s theory of procedural justice. In his view rules of justice guide individuals by defining the range of permissible actions and making her environment more predictable.

Justice is the means of securing social co-operation and is not directly concerned with the question of distribution. In a free and just society all major institutions, aside from those bound up with sustaining its framework, should be privatised. There would be competing types of education, welfare provision, medical care, etc. Thus coercion by a monopoly supplier of such services would be less likely and their effectiveness would be significantly increased. The framework that is established by the rule of law is the precondition for the attainment of general welfare – if we conceive of welfare in terms of maximising the chances of an unknown individual to achieve her ends. These ends need to be discovered. Procedural justice rather than justice of substantive outcomes is meant to give individuals the maximum opportunities to obtain their unknown purposes within certain defined boundaries.

Progress is only possible if individuals are free to experiment and to learn. Liberty under the rule of law is the necessary and sufficient condition for progress. Hayek speaks about the *“process of formation and modification of the human intellect, the process of adaptation and learning in which not only the possibilities known to us but also our values and desires continually change”*.¹¹

Some critical remarks

Hayek's approach has often been criticised because it does not provide a more substantive view on justice and rights. The Kantian requirements of abstraction and generality, which he applies to law,

are not recognised as a sufficient condition for a liberal legal framework and often not even as a necessary condition for a stable and predictable legal code by many. His critics point out that he inadequately specifies individual rights in almost entirely procedural terms. Hayek is accused of having conflated individual freedom with the rule of law while ignoring the demand for substantive freedoms and rights.

In order to understand Hayek's reluctance to specify substantive freedoms and rights further, we have to consider his social theory and his ideas about knowledge. For Hayek rules of the law (and therefore rules of justice) embody not only explicit laws but also an enormous amount of social knowledge: they entail what is considered to be a duty in the respective society, they express social norms, values and conventions that have been agreed upon. Note that this kind of knowledge is for the greatest part not articulated. It is embodied in action. Consent on norms and values does not need to be reached by any kind of verbal debate or discussion. It often arises when individuals adopt or reject certain practices according to their observations of success and failure. The reason for Hayek's reluctance to specify too many rules of justice originates from this epistemology. A great deal of our social knowledge cannot be articulated but must remain in procedures, which express it. What we regard as just today can differ widely from what we considered just a while ago.

In Hayek's approach the rule of law provides individuals with the framework within which they can act independently of the arbitrary will of another agent. Agents have a right to take action that is not "forbidden" by one of the abstract and general rules created by the rule of law. Hayek applies the Kantian test of universalisability to the rules of the law. This test includes the demand for consistency between similar cases and non-discrimination and the demand for impartiality between different agents. The maxims that meet these demands must be integrated into a system of non-conflicting rules. But then Hayek goes on to combine this Kantian and obviously reason-based approach with his idea of the spontaneous order of society. Individuals act within their "self-imposed" constraints as long as the latter are successful in co-ordinating interaction and facilitating co-operation. When they fail to meet these objectives due to a change in circumstances, they will be supplanted by new rules. But would that be a deliberative or an evolutionary process or a combination of both? Will the new rules pass the test of universalisability? And if they did, would that be a sufficient condition for liberty? Admittedly this combination of ideas is somewhat confusing.

The evolutionary view on the establishment and change of the social contract does not have to build on moral arguments, but it does not exclude them either. Moral principles and rights are bound to change, but of course that should not prevent us from moral reasoning and the formulation and implementation of rights.

Here I agree with Sen that in studying evolutionary selection within a broad framework, there is no need to confine the admission of norms and values to evolutionary selection without allowing a role for rational deliberation. Evolutionary selection does not exclude rational deliberation.

Hayek is rather sceptical about the roles that public discourse can play in society. He points to the fact that the political process often strongly favours existing, powerful and well-entrenched groups, which are able to use the arena of public discourse to defend their interests more effectively than groups that lack such skills and resources. Rather than focusing on opportunities that would allow the latter to increase their bargaining power, he denies the beneficial role that political participation and public discourse can play in the formulation of norms, values and political programmes. Furthermore, he does not seem to see that these processes do not contradict the fact that the long-run survival of norms and values can scarcely be independent of their consequences and the selection processes that may come into play. This reluctance is all the more striking in view of his risky attempt to combine his evolutionary account of the processes in society with the rather rationalist test of universalisability to the rules of the law.

Hayek's conception of the limited role of human reasoning and its deliberate influence on society at times seems to suggest that all deliberative attempts to reform society are in vain. However,

despite the importance of being aware of the difficulties that will arise when we try to reform society and of the time consuming and gradual character of the process, this does not mean that reform is impossible or undesirable. For any successful reform attempt clear development criteria need to be *formulated*, criteria to which policy makers can be held accountable. Neither the appeal to evolution nor to some metaphysical ideal will be very helpful. That is all the more obvious when we turn our attention from the stable democracies of the West to developments of transition countries in the East.

However, if we compare Hayek's work to Sen, his approach has at least one significant advantage. Sen puts enormous trust in the powers of democratic debate and the reinforcement of instrumental freedoms to ensure a free society. Yet – as pointed out before – this optimism does not seem to be justified. Different groups in society care about different things to different extents. Conflicts of interest are inevitable and a consensus cannot always be reached. In some cases distortive outcomes seem to be unavoidable. So what is going to restrain the consequences of either of the interest groups winning to the detriment of the freedom of other agents?

Furthermore, who can guarantee that government officials and bureaucrats, while claiming to act in the interest of the population, do not abuse their discretionary powers? Who guarantees the just implementation of developmental objectives?

Hayek can be accused of paying insufficient attention to the role of democratic debate and the formulation of norms and values. But he clearly designates the rule of law as the fundamental principle that all interest groups in society must respect. He is opposed to all forms of creeping administrative discretion that threaten liberty. He is not only against central planning itself but also against the kind of accidental socialism characterised by too much bureaucratic discretion and non-transparency, which can surface everywhere when people forget to be vigilant. The rule of law is meant to provide a constraint on such discretionary powers and arbitrary coercion. Thus it needs to be embodied in the institutional framework of any free society. This is going to be of utmost importance in the Ukrainian context.

Interlude

Dealing with freedom and development, the necessity of transparent regulation, trust and responsibility creation and the importance of political and economic competition are going to play a major role in this work. The negative effects that a lack of transparency, trust, responsibility and competition among economic agents has, will be made apparent by giving several examples of opportunistic behaviour (rent-seeking, asset-stripping, moral hazard, etc.) as they occur in the Ukraine, which subtract substantially from the overall freedom of society and its developmental potential.

In trying to pull the different components that are decisive for substantive freedom and sustainable development together, I will have recourse to some insights made by the advocates of the *New Institutional Economics*. I am going to focus on problems such as information asymmetry, transaction costs and the principal-agent model. In relation to these issues I will also deal with the role of such fundamental institutions as a well-established formal property system and enforceable contract rights. Furthermore, I will try to give some indication of the significance of informal institutions over which policy makers have less influence (e.g. social norms and values) and the need to integrate them with formal rules. Finally, I am going to discuss the role that international lending institutions and other foreign donors can play for progress in transition.

In my considerations I will emphasise the importance of economic development and economic growth. In doing so, I am treating these aspects of development predominantly as a means for enhancing the standard of living people enjoy and their capability to choose a life according to their values and perception of the good, and less as ends in themselves.

B. Development

Ukraine as a Rent-Seeking Society

In order to sketch an impression of the Ukrainian economy's situation after independence in 1991, I would like to provide the reader with a couple of telling figures.

On the Index of economic Freedom established by the Fraser Institute, Ukraine reserves place 106 out of 114 countries in 1997 (Russia: 102).

The Index of economic Freedom of the Heritage Foundation ranks Ukraine on position 124 out of 161 countries in 1999 (Russia: 106).

Transparency International put the country in position 87 (together with Azerbaijan) in its September 2000 report (ranking from 1 = least corrupt: Finland, to 90 = most corrupt: Nigeria)

Last, but not least, in the report on competitiveness issued by the World Economic Forum in Geneva on 7 September 2000, Ukraine, Bulgaria, Zimbabwe and the Russian Federation tied for place 58 out of 59 places.

I take it to be a fact that non-competitiveness is a major obstacle to freedom, facilitating opportunistic behaviour like rent-seeking and corruption. Certain influential groups pursuing their own narrow vested interests have an incentive to prevent free competition in order to extract as many rents as possible for themselves from the state. Given that state resources are limited this rent-seeking

behaviour subtracts from the welfare of the majority of the population and has a negative impact on the development of the respective country. Moreover, rent-seeking typically produces horrendous inefficiencies in the use of assets even when managers are unsuccessful in stealing or asset-stripping.

If, on the other hand, free competition is allowed, then the various interests within society can compete, compromises can be reached informed by public discussion, which in turn is essential for the creation and maintenance of common norms and values. The latter are the informal institutions, without which the bare net of formal regulation would collapse. Under such conditions, which should prevail under democracy, narrow vested interests are less likely to survive for long.

Anders Aslund describes the Ukraine in his 1999 paper “Why has Ukraine failed to achieve economic growth?” as a full-fledged rent-seeking society, which is construed to benefit a small elite, living off monopoly rents that are costly to society at large. The economy is characterised by an *amalgam of dominant insider ownership* combined with a lack of enterprise restructuring, slow deregulation and ubiquitous and arbitrary state intervention. The state administration is extensive and intrusive; incoherent decision making renders legislation unstable and causes a huge amount of uncertainty and distrust among economic agents. In the Ukraine the old elite remained powerful in the sense that it managed to use its influence over politics to gain material benefit. The continuous

development of new and often arbitrary regulation by the government helped them to maintain control and to maximise their rents consisting mainly of state subsidies and monopoly rents. Therefore, in the first years after independence deregulation in the Ukraine was very slow and incomplete. Economic and bureaucratic agents profited from informal property rights acquired in the past. They steered the institutional change of the administrative market in a direction that secured and formalised their privileges and simultaneously prevented external competition. Agents had the bargaining power necessary to enforce only partial reforms because they were still effectively organised via the old networks established under communism and because the newly developed democratic state was still weak. Due to this networking, government and business were living in mutual dependence. Businessmen were often in favour of all kinds of regulations applying to others but not to themselves¹² (including high taxes) that would increase their monopoly rents. In order to be re-elected, politicians would need the support of top-businessmen, but politicians could also oust the tycoons if they turned against political leaders. Members of government were earning a significant part of their revenues from bribes and were consequently opposed to any deregulation.¹³ Parliament had the dominant tendency to pass numerous laws on tax exemptions and additional regulations, while major draft reform laws were postponed for years.

In a nutshell, government, parliament and businessmen were all promoting a maximum of regulation and state interference in order to maximise their rents. The population was of little consequence since it was partly co-opted and compromised by the rent-seeking system as well. Many people were and remain unable to stand up for their rights due to the poor economic situation, the dependence on the underground economy, the lack of social security, and reasonable distrust in political institutions.

Rent-Seeking behaviour has taken different forms, depending on changing circumstances. In 1993 and 1994 four forms of rent-seeking were predominant:

- 1) Due to persistent price regulation it was quite convenient to buy cheap metals and chemicals in the Ukraine and sell them abroad at world market prices. For this to work, access to metals and export permits were required. In 1992 the total export rent gained in such a way amounted to \$ 4.1 billion or 20 per cent of GDP.
- 2) Another strategy employed was the import of certain commodities such as natural gas from Russia, at a low subsidised exchange rate in order to resell it at a higher price. The rents obtained increased, if one simply would not pay for the deliveries and let the government pay on the basis of state guarantees for gas imports.

- 3) Most famously, subsidised credits were an important breeding ground for rent-seeking. In 1993 Ukraine struggled with a 10,155 per cent inflation rate. However, huge state credits were issued at an interest rate of 20 per cent and, thus essentially represented gifts to those who could quickly convert them into hard currency or tradable commodities.
- 4) Finally, budget subsidies amounted to 8.1 per cent of GDP in 1992 and 10.8 per cent of GDP in 1993. These subsidies were concentrated on agriculture and the energy sector. The distortions caused by state subsidies to the agricultural sector will be discussed later.

On the whole, a small rent-seeking insider elite usurped a huge share of GDP in the early years of transition and thereby became even more powerful. As rent-seeking interests became entrenched, market oriented reforms became less and less likely. The only significant threat to this remarkably stable rent-seeking system was that of the collapse caused by macroeconomic instability.

Some time later, notably in 1996 macroeconomic stabilisation was taking hold and inflationary rents were largely abolished.¹⁴

However, structural reforms were not pursued over this period.

Consequently, macro-economic stabilisation remained fragile and vulnerable to exogenous shocks such as the Asian crisis.

Rent-seeking behaviour changed slightly in this period. Recourse to ordinary monopoly rents became more widespread and attempts to stop unwanted competition via arbitrary regulation and over-

regulation became even stronger. Moreover, managers started to expropriate the enterprises they ran for themselves (cold privatisation, asset-stripping). Insider privatisation using a voucher system often had very negative effects. Firstly, vouchers were frequently not properly linked to enforceable property rights and secondly, managers had incentives to keep a considerable amount of the yield an enterprise earned for themselves or to engage in asset-stripping.

Such situations can be best described using the principal-agent-model applied by the New Institutional Economists. The basic point that is illustrated by this model is information-asymmetry. According to the model, an agent is working on behalf of the principal. However, the principal has difficulties in supervising and controlling all actions of the agent; he only sees the final results. If the principal were the owner of an enterprise in which the agent is the manager, the final results would be the yields earned within a year, for instance. If we exclude exogenous disturbance, the principal could directly infer the actions of her agent from the perceived results at the end of the year. However, if we allow for the possibility that exogenous disturbances might have influenced the final yields, the agent/manager can “invent” various excuses for bad results, while the principal cannot be completely sure what caused these results.¹⁵ The problem of information-asymmetry described by this model is inherent in all forms of rent-seeking behaviour. The model also shows clearly what difficulties the separation of property and control within an enterprise can cause

and explains the need for comprehensive privatisation¹⁶ and the introduction of good corporate governance for enterprises.

Information-asymmetry is aggravated in situations in which the basis on which people hold assets is not formalised. What is lacking in many transition economies, and especially in the Ukraine, is a well-established integrated formal property system together with enforceable contract rights.

Within a regulatory framework of a functioning market economy, the “invisible hand” is said to co-ordinate the market participants’ activities in such a way that their personal pursuit of profit results in higher prosperity for the community. In the Ukraine, at least until recently, all market conditions were set in a way that anybody who acted rationally would not act towards the common good.

To my mind, the creation of a transparent legal property system and the strengthening of ownership rights are the cornerstones of healthy economic and, by extension, societal development, since they are working as disincentives for rent-seeking behaviour. Only by establishing these basic institutions, confidence in the reforms and in the market economy can be created. Thereby, agents will be incentivated to act towards each other in more co-operative ways as has been required for freedom in the introduction of this work.

Excursus: De Soto's Property Effects¹⁷

It is impossible to have a well-functioning market economy unless clearly defined ownership rights are established and unless those who assume obligations are held liable for the full extent of their assets. In a free society ownership-based rights and obligations must apply equally to all economic agents, whether they be the state, consumers, or producers.

In former communist countries nobody really knows who owns what or where, who is accountable for the performance of obligations, who is responsible for losses and fraud, or what mechanisms are available to enforce payment for delivered services and goods. De Soto describes the scenario of the undercapitalised sector of a developing country in a way that also applies to the bulk of the Ukrainian economy:

- a) The ownership of assets is difficult to trace and to validate.
- b) The economic environment is (*largely*) governed by a set of rules that is not legally recognised.
- c) Assets cannot be used in the most efficient way due to their unfixed nature and a huge amount of uncertainty leaving too much room for misunderstanding, reversal of agreement, etc.

Note that De Soto is concerned mainly with the problem of shadow economies. I am going to deal with this issue a little bit later.

What is decisive now is that for him the creation of an integrated formal property system is the central political task. Let me summarise the main advantages he expects a formal property system to entail. All of these advantages are closely related to the issue of transaction cost reduction.¹⁸

- 1) The institution of formal property is a means to secure the interests of other parties and to create accountability by providing all the necessary information, references, rules, and enforcement mechanisms. For instance, formal property can be used as collateral for a loan, as equity exchanged for investment, etc.
- 2) A well-established formal property system incorporates all the loose and isolated data about property into *one* integrated system, providing a transaction cost reducing rationalisation device. In former communist countries, on the contrary, there are dozens of property arrangements, managed by all sorts of organisations, some legal, some illegal.
- 3) The integration of assets into a formal property system makes economic agents accountable for their decisions and actions. Through the institution of formal property people become linked to real estate and business in such a manner that people who, for instance, do not pay for goods or services received can be easily identified and charged. Authorities can learn about legal infractions and dishonoured contracts, can suspend services, place liens against property, etc. Legal

property functions as commitment and leads to a more sensitive perception of potential rewards and dangers since people will be cautious not to risk their stakes in the capitalist game.

- 4) A formal property system provides standards for the description of assets and thereby reduces transaction costs.
- 5) Due to all the factors described above formal property systems convert the citizens of a given society into a network of individually identifiable and accountable business agents. The institution of formalised property radically improves the flow of communication about assets and their potential. Moreover, it enhances the status of their owners, who then become economic agents able to transform assets within a broader network.
- 6) A formal property system protects the security of ownership and produces trust in transactions. In doing so it allows economic agents to act without having to guard too extensively against other agents' opportunistic behaviour.

What does prevent people in former communist countries from using modern formal property systems is often enough an opaque legal and administrative system. Therefore, property is frequently protected by all sorts of extralegal arrangements. These extralegal arrangements cannot be ignored when politicians want to create a formal property system.

Although informal institutions have not been manifested in statute books, they can be extremely forceful. If they undermine formal arrangements then the success of the latter is highly questionable; in extreme cases this might lead to a covered or even open civil war. The integration of informal rules into an acceptable formal property system is the ultimate prerequisite for social integration and stability. Only if the people of a country acknowledge the established property relations, the mass of the population will respect the law and will act so as to preserve the status quo. In transition economies the process of establishing such a system is bound to take time, since norms of behaviour, conventions and self-imposed codes of conduct only adapt slowly to the new order. Furthermore, policy changes are less likely to have an impact on them. Therefore a pure transfer of a foreign institutional structure to one of these countries without paying attention to the informal rules still shaped by the previous system, is not likely to work well. Equally, trust in a new institutional framework and particularly in a new formal property system has to *evolve*. Apart from the necessary legal arrangements this process presupposes the formation of shared values (social consensus that can be reached by open and informed public discussion, education, etc.) and the adjustment of values to the new conditions and circumstances. The development of institutions does not happen in a vacuum – history counts.

Excursus: Gradual reform versus Big Bang?

“The first phase after the political breakthrough is a very important one. [...] There’s a special atmosphere and much euphoria. People are willing to accept radical changes. [...] This first period is precious, because it can be used to launch as many painful changes as possible. Whenever there’s a window of opportunity, one should use it, because later it may be very difficult or impossible” (Balcerowicz, 2000)¹⁹

An important argument against hesitant reforms and partial liberalisation and privatisation efforts is that in many CIS countries the winners of these processes have often been able to block further progress in reform and to preserve the advantages for themselves. Especially in Russia and in the Ukraine, the partial level of reform generated significant income for those who had benefited from the initial allocation of property.

Moreover, the more time passes, so the argument goes, *“the more likely it is that resistance to reform will build as “losers” will become aware of the stakes, rent-seekers “learn the ropes”, and politicians become attuned to the interests of both groups. This suggests that reforms should be implemented quickly.”²⁰*

However, supporters of this school of thought do not have to deny that some gradualism in reform is needed anyhow. 40 to 70 years of communist rule cannot be wiped out overnight. Reforming markets without providing appropriate institutions at the same time may prevent the materialisation of the benefits of transition, both in

economic and political terms. Moreover, a consequent path of reforms does not contradict the fact that different countries have to deal with different initial conditions and that there is no “one suits all” path for all countries. Peculiarities have to be taken into account. Surely, time plays a decisive role in transition as the introductory quotation of this section suggests. But one should not insist that the more is pushed through the narrow window of opportunity, the better the political and economical outcome will be without qualifying the respective policy measures. The idea of “shock-therapy” seems to make only sense when the “shock“ is really accompanied by some therapy. Within a climate of uncertainty, which is characteristic for transition, some certainty and confidence needs to be created by establishing institutions like the rule of law, adequate protection of property rights and effective corporate governance. Furthermore, far-reaching reforms and structural change require the establishment of a social safety net, which often has to be developed from scratch. Without such a safety net no country could sustain a massive reallocation of labour across sectors, since workers would lack incentives to leave inefficient enterprises and face a period of unemployment. This, unavoidably, leads to a lack of support for reforms. Thus, the whole issue of a good transition policy is not predominantly concerned with the speed of the reform process itself but rather with its quality and transparency. Privatisation and liberalisation are not ends in themselves. In order to facilitate sustained development and freedom, they need to be realised together with the development of

a stable institutional framework. The quality of this institutional framework can be measured by the strength of the legal environment, the certainty of contract enforcement and the actual respect for the law.

Policies and Agricultural Development in the Ukraine

The Ukraine has a considerable agricultural potential. It combines a large area (33.3 million hectare of cropland and 7.5 million hectare of permanent pasture) with fertile soils (roughly 40 per cent of the world's black soils). It has year-round ice-free ports and is situated close enough to key import markets such as the Middle East, Northern Africa and the EU.

Despite these comparative advantages agricultural performance has been poor relative to expectations. The decline in agricultural production has been stronger than the decline in overall economic activity. Nevertheless, the agricultural sector remains one of the key sectors of the country. It employs one third of the labour force of the country and generates 11 to 12 per cent of GDP.

Under central planning the agricultural sector of the SU was highly inefficient. Farms were large and characterised by high labour-land ratios. That led to problems in motivating and monitoring workers. Cost-plus pricing and the fact that subsidies were directed preferentially towards poor performers imply that there were only few penalties and even some rewards for waste. Moreover, farms

had to maintain a large social sphere including infrastructure maintenance, schools, cultural programmes, etc.

After independence in 1991 market-oriented restructuring would have been the appropriate thing to do. However, the path of agricultural *reforms* was, and sometimes still is, characterised by arbitrary and inconsequent regulations and an artificially high degree of state intervention. These features support all kinds of opportunistic behaviour.

Until 1992 the original sovkhoses and kolkhozes were transformed into collective agricultural enterprises (CAEs) and land was denationalised.²¹ Farmland was passed on to collective ownership of the CAE members so that it could be shared and, at request of members, divided into plots with private land status. However, this transformation had been merely a formal change without any real restructuring taking place. Basically, physical plots of land and physical assets were given only to people leaving the farm in order to set up their own independent farms. Those remaining in the collective farm could “choose” to recommit their shares to the new CAE. Thus, most people received only entitlement certificates and not actual land plots or assets.

Many important aspects within CAEs were not sufficiently regulated. Norms of management, the redistribution of property and withdrawal procedures remained highly ambiguous. Furthermore, farm managers did not bear any responsibility for the financial results of their enterprises. Moreover they were usually elected

from the ranks of and by CAE members. That often encouraged them to postpone restructuring in order to be re-elected.

Taking all that into consideration it is not surprising that CAEs remained highly inefficient.

In 1991 a law had made private farming possible. By 1994, 32,000 private farms had emerged (in 2001: 38,400). But the private farms remained mostly small (average of 56 hectare) and were less potent in shaping agricultural policies than the roughly 12,000 CAEs and their successor enterprises.

In 1993 export quotas and licensing procedures were implemented.

In this first period hardly any restructuring of enterprises took place. At the macro level fiscal and monetary imbalances led to hyperinflation (10,155 per cent in 1993). Therefore, the environment for any type of decent economic activity was less than encouraging.

In 1994 Leonid Kuchma became president and some important steps were taken like the creation of the legal basis that allows for the distribution of land shares to CAE members.

By 1996 most quotas and licensing restrictions on exports had been eliminated.

Unfortunately, many of the positive developments were reversed in the years between 1997 and 1999. It became apparent that only minimal changes had taken place behind the formally new facade of the CAEs. While members theoretically had the right to

individual land shares, they were often lacking the practical means of exercising this right. Land sale and rental were forbidden and individual land parcels were not demarcated.²²

Although quotas and licenses were abolished in 1996 in order to comply with IMF and World Bank conditions, those who already had benefited from the old techniques quickly invented alternative restrictions. So-called “indicative” and “recommended”²³ prices had no legal basis, but custom-officials would insist on their strict application. In order to avoid costly delays, traders would either have to resolve arising disputes on the spot with the custom-official, or they were well advised to cultivate high-ranking contracts in Kiev, which could guarantee immunity.

After the 1996 harvest, some oblast authorities managed to declare bans on grain exports, claiming to secure repayments for inputs that had been delivered in spring and assorted tax debts. In fact, they had no right to do so, but the central government hardly intervened. From 1997 to 1999 regional export bans and confiscation of grain and oil seeds were employed. Again the need to collect payments for earlier input supplies and debts was said to be the reason for introducing these measures.

The Ukrainian President’s Decree of 3 December 1999²⁴ created considerable confidence in the reform process. It prescribed the restructuring of all CAEs that did not work profitably into enterprises based on private ownership. Furthermore, it granted the right to all members of CAEs to leave these enterprises freely and to withdraw their land and property shares. It also stipulated that

members would obtain their plots according to a defined procedure. If they chose to do so, they could use their plot to expand their private household plots or to rent it to agricultural enterprises. Finally, it prescribed that rent-payments for the use of a land plot must not be lower than 1 per cent of its value.

By the second quarter of 2000, CAEs had mostly disappeared. In December 2000, 10,800 non-state agricultural enterprises had been transformed into 14,700 entities based on private ownership of land and property. In the same year, the government announced that it would withdraw from input supply and cancelled or restructured all farm debt to the state. However, the amount of optimism created by these announcements decreased considerably after subsequent government decisions have raised the spectre of export certification again and have introduced mandatory crop insurance (June 2000, January 2001). Moreover, by the beginning of 2001, only 400,000 persons (out of 6,453,300, who had obtained land certificates) had actually received deeds that define a specific demarcated plot.

In the food processing industry, a privatisation mechanism that gives supplying farms and the state 51 and 25 per cent of the shares respectively and allocates the rest to employees and sales, was introduced in 1996. It is remarkable, that in so-called “strategic” cases like grain marketing, the share remaining in state hands is larger and several key enterprises have been exempted from privatisation. Consequently, much of the food processing and

marketing sector remained monopolistic and inefficient. This in turn led to depressed farm-gate prices since many agricultural products are tradable and one has to take transportation and storage costs into account.

The combination of the lack of restructuring and implicit taxation of agricultural prices over the years explains why most CAEs and their successors remained and remain unprofitable.

Additionally it must be said that at least until October 2001 farms were not able to secure commercial loans by using land and other assets as collateral. Moreover, there remains a moratorium on the initiation of bankruptcy procedures in agriculture until 2004.

Combined with the fact that regular debt write-offs for farms in Soviet times had fostered a relatively cavalier attitude towards debt repayment, it is not surprising that farms are still not regarded as creditworthy and have little access to finance. This, of course, poses an obstacle to investment.

One important reason for policy failures is that agricultural policy has been made by a variety of different bodies: Parliament, the Cabinet of Ministers (CMU), and the President pass laws, resolutions and decrees, while the Ministry of Agriculture, oblast authorities, custom officials and various state committees and state enterprises exercise a considerable amount of control over the practical implementation of the respective acts.

The co-ordination between all the different authorities is very weak and responsibilities are not clearly divided. The maintenance of

such parallel structures is almost bound to fragment the policy making process in a rather non-transparent and unhealthy way.

The Issue of Privatisation

Decisive shortcomings and impediments to agricultural development are unclear and insufficiently formalised property relations. As pointed out before, the institution of private property poses a disincentive for opportunistic behaviour and is the precondition for a functioning market economy.²⁵ Particularly in the farming sector, private ownership has three main functions:²⁶

- 1) Private ownership ensures that there are real owners of assets/resources including not only land but also means of production. Thereby it promotes the productive use of resources, which is a precondition for effective management.
- 2) Private ownership allows owners to use their assets as collateral.
- 3) The threat of losing their assets makes owners/managers refrain from unreasonably risky decisions. Owners and managers will manage their enterprises with the purpose of maximising profits. This again is crucial for the productive use of resources and efficient management.

Taking all this into account, the institution of private property not only provides proper incentives for increasing the profitability of enterprises, but also enhances individual freedom and responsibility. However, privatisation and restructuring efforts have

been unsatisfactory in the Ukraine for most of the time since independence.

The presidential decree “On immediate measures to accelerate reform of the agricultural sector of the economy” from 3 December 1999, has theoretically abolished collective ownership. CAEs have been reorganised into joint-stock companies, limited liability associations, co-operatives and private farms. However, farm-restructuring efforts have not radically changed the entrenched collective organisation of Ukrainian farms. Land shares have been distributed to the members of former CAEs, but mostly only in the form of paper certificates without any physical demarcation of land or an actual allocation of assets to individuals.

In a 1998 World Bank study, 70 per cent of farms reported that they retained a central management body patterned on the former collective farms, while only 30 per cent reported greater shifts of responsibility to autonomously operating entities. After eight years of reforms, individuals (private/family farms and household plots) cultivated only 15 per cent of agricultural land, while most of it remained collectivised.

In the processing and marketing sector most up-and down-stream enterprises are only nominally private. They continue to act as para-statal agencies in accordance with state instructions and tend to be headed by former officials. Many of these officials were very successful in converting their position into the acquisition of substantial wealth as property is transferred from state to private

ownership. Precise ownership structures and the degree of state independence in these firms are still subject to lots of speculation. Enterprises used to oppose comprehensive privatisation in order to prevent any effective control of their activities. Leaving property rights unclear as long as possible provided many officials and farm managers with the opportunity to acquire legal ownership of property for themselves or to strip all valuable assets before its final privatisation. Due to unclassified property relations and a lack of independent controlling agencies they did not even have to fear much sanctioning.²⁷ What supported this opportunistic behaviour was the fact that most residents of agricultural areas continued to see their major interest in obtaining a maximum of state support. The danger of unemployment combined with the lack of social security makes people afraid of structural change. This fear was nourished and exploited by those who benefited from the restructuring delay.

The Land Market

Although a new Land Code has been passed on 25 October 2001 (in spite of strong opposition by the Communist Party), trade of agricultural land is still not allowed until 2005.²⁸ It is assumed that a functioning land market would be of vital importance. Firstly, it would allow land to move from less to more efficient operators. Secondly, it would ensure that land could be used as collateral for farms, and finally it would permit land to serve as a source of

revenue for pensioners and others in rural areas that are otherwise deprived of sufficient income.²⁹

Without the firm legal guidelines that are now provided by the new Land Code, land transactions were always tainted by the possibility that they may be overturned by higher-level legislation in the future. Thus, the legal certainty the code provides is highly appreciated.

However, there are good reasons for the moratorium on the purchase of farmland. One of the strongest ones is the following. Currently the Ukrainian land market would not be competitive. If foreign subjects are not permitted to own farmland, only a relatively small number of wealthy and well-connected individuals who have access to a range of benefits and privileges would be able to purchase land in practice. Furthermore, most landowners are poorly informed about their rights. They often depend completely on farm managers as a source of information. Not surprisingly, the latter frequently happen to “filter” information for their private benefit. In exploiting the prevailing uncertainty they can also subject landowners, who are members of a collective farm, to considerable explicit coercion.³⁰

Another danger likely to arise is that of speculation. People who are influential and rich enough could buy land today at depressed prices due to the mentioned information disadvantage that peasant landowners face and the lack of competition on the demand side. This would render their chances of selling land later at a profit

artificially high. Thus, on the one side we would find a small group of wealthy, well-connected and well-informed buyers and on the other side a large group of poorly informed and dependent peasants. Such a severe asymmetry makes it likely that a land market without any provisions and restrictions would lead to the rapid concentration of land in the hand of only a few land barons. In order to prevent the creation of such a neo-feudal system, the public and especially the peasant landowners need to be educated about their rights. Public discussion, hopefully encouraged by the work of the media, should be one means of doing this.

Moreover, for the duration of the moratorium an independent commission should make regular public reports on the status of the market for farmland. This agency must have unrestricted access to all information on land transactions. Furthermore, both lessors/lessees and sellers/buyers of farmland need to be provided with the opportunity to access low-cost impartial legal advice.

Finally, it stands to reason that it is not really a good idea to prevent foreigners from purchasing agricultural land.³¹ If the land market were opened for foreigners this would increase competition and that in turn would be beneficial for Ukrainian land owners, since they would be able to sell their land for higher prices and under more favourable conditions.

Preventing foreigners from purchasing agricultural land in the Ukraine is an exception to the practice of competitive land sale stipulated in chapter 21, Article 134/135 of the Land Code, whose economic purpose is not quite clear.³²

Another perspective on the creation of a land market has not been considered much. Many people in former communist countries, especially in CIS countries, do not consider agricultural land to be a material factor that can be sold as any other.³³ Land and soil are experienced as given by “Mother Nature”, or in less poetic terms, as public goods.³⁴ Close emotional ties to the land seem to contradict the possibility of subjecting it to market forces. Much more than in Western economies, land is treated as a public good that must be owned and managed by the state for the benefit of all and that must be used for growing crops.³⁵ In accordance with this way of reasoning the Land Code stipulates that land which is suitable for agricultural needs shall be granted primarily for agricultural use. Thus the controversy about the land market in the Ukraine partly illustrates how important socially learnt values and conventions are. We cannot easily transform our Western concepts and laws concerning property and ownership to another country. The adaptation of new values that could support formal institutions will take time. A sense of social security and confidence in the developing economic and political system are essential for the success of this process.

Some goods like natural resources and land, which are explicitly considered to be public goods or at least goods that should only be owned by the citizens of the respective country, are often subject to greater restrictive measures due to their perceived social significance. The idea that property implies something like social

obligation towards society is nicely expressed in articles 13 and 41 of the Ukrainian constitution. The fact that these well-formulated and honourable premises are often in tension with the opportunistic behaviour of a fair number of Ukrainians in the rough world of transition, is of course unfortunate and shows that society has not arrived at a stable equilibrium yet.³⁶

Importance of a Land Registry

The transparency and efficiency of the Ukrainian land market is closely linked to the establishment of a sound land registry system. In the new Land Code the function of the State Land cadastre is defined as follows: *“The state land cadastre is a unified state system of land cadastral operations that establishes the procedure for recognising the fact of acquisition or termination of the right of ownership and the right of use of land plots and contains a totality of information and documents on the location and legal regime of those plots, their assessment and land classification, as well as quantitative and qualitative characteristics, the division among land owners and land users.”*³⁷

According to the Land Code the land cadastre is meant to provide economic agents (the state, bodies of local self-government, enterprises, organisations, citizens) with sufficient information in order to regulate land relations. It provides the necessary data to determine the value of land and to maintain an overview of the use of land, as well as assistance with measuring the ecological and economical soundness of business and land engineering plans.

With the introduction of such a unified system that includes full information on all land plots (a system of spatial co-ordinates and a system of identification of land plots), incentives for damaging speculation could be significantly reduced, opportunistic behaviour could be sanctioned more easily and a competitive land market with moderate transaction costs would be possible. A transparent land registry system therefore is essential for realising the positive property effects that De Soto illustrates: fixing the economic potential of assets, the integration of dispersed information into one system, enhanced accountability of economic agents, making assets fungible, social integration and the protection of transactions.

However, in the case of the land market the effectiveness and efficiency of such a system is not independent of the costs that are invested in its maintenance. If the bureaucratic costs are too high (due to over-regulation and parallel decision structures) the costs can offset the benefits. Thus, responsibility structures have to be clarified and an appropriate measure of regulation needs to be found. Moreover, if regulation and state interference were to restrict private initiative and entrepreneurship in a manner that goes beyond the prevention of negative externalities, the success of the land market and the freedom of economic agents would be endangered.

Excursus: Short-Term Effects of the New Land Code on Rural Finance³⁸

Although the new Land Code plays a decisive role in providing long-term benefits, in the short run its effects will be rather moderate. As mentioned above, in the long run it is likely to promote legal certainty (which is essential for investment), facilitate the development of a mortgage credit system and contribute to the social security of the rural population.

Article 90 of the Land Code stipulates that owners of land plots have the right to sell or alienate in any other way a land plot, lease it to others, mortgage it and pass it to their heirs. In section XI/6 it postulates that the Cabinet of Ministers of Ukraine shall establish a State Land (Mortgage) Bank with a corresponding infrastructure and introduce state registration of rights to land. However, mortgage crediting is not going to play a significant role in Ukrainian agriculture in the near future. The main reason for this is that usually the farmland is not owned by the agricultural enterprise, which cultivates it. Enterprises are leasing most of their land from a number of small landowners. Remember that in the course of restructuring approximately 6.5 million land certificates were issued. On this basis 5,615 million leasing contracts were completed by 2000. A typical agricultural enterprise today is cultivating an area of roughly 4000 hectare, but from this land only 100 hectare are usually owned by its founders. Now consider that the relative price for one hectare of farmland is 600 US\$. For an area of 100 hectare this amounts to 60,000 US\$. If we assume that

a mortgage can be raised on 60 per cent of this amount that leaves us with 36,000 US\$. However, the costs for a combine harvester, for example, would already amount to 200,000 US\$! Therefore, since enterprises are not allowed to acquire the ownership of more than 100 hectare of agricultural land until 2010 (Land Code, Section X/13), at least until this point in time they will have to finance themselves through their own profits.

WTO Accession and the Regulatory Environment

Frequent and retroactive changes and a non-transparent network of standardisation and certification procedures have poisoned the Ukrainian regulatory environment for a long time. This situation needs to be changed dramatically for the achievement of sustainable development and growth. The restructuring of trade barriers is an essential precondition for the country's accession to the World Trade Organisation.³⁹ The pressure resulting from the entrance conditions posed by the WTO is likely to strengthen agricultural policies and institutions in the Ukraine. Its rules prohibit a range of distortive policies such as export taxes and non-tariff barriers. Moreover, by requiring that trade policies be applied to all trading partners equally and by providing transparency and clear criteria for regulations, the prospective membership can also reduce the scope and incentives for rent-seeking and corruption. One starting point for that is that the GATT Working Party (WP) has demanded that the Ukraine supply more detailed information

about its system of government regulation and import restrictions and a more comprehensive description of the state support system for agricultural producers. So far, agricultural policy has been in a constant flux. What is needed now is the implementation of consistent measures. The fulfilment of the demands associated with WTO accession would serve to create trust in the Ukraine as a possible trading partner and a secure place for foreign investment.

Tariff and Non-Tariff Barriers

The application of import-tariffs in the Ukraine is highly opaque. Many exemptions such as import quotas at reduced tariff rates, are granted to specific firms at specific times in a non-competitive manner. The combination of import protection with the numerous exemptions to this system generates significant rents, which are sought by those cultivating connections to politicians in Kiev.

Although the Ukraine does not apply explicit export subsidies, the continuous government intervention in agricultural development has inhibited agricultural development enormously. Officials apply minimum export prices for hides and animal skins, sugar and oilseeds⁴⁰, although they deny this. There are also many reports that custom officials refuse to permit exports when the export contracts specify prices that are below the *recommended* level. These restrictions applied particularly to grain exports in 1999 and 2000. During this period traders were at least temporarily unable to obtain necessary certificates because of the uncertainty regarding the

status of official grain inspection requirements.⁴¹ Besides the mentioned export impediments, borders between oblasts often represent significant obstacles for intra-Ukrainian trade. Restricting measures employed by local authorities such as complicated and arbitrary checks at various oblast borders do increase the transaction costs producers and traders face.⁴² These enormous additional costs, which include the increased trading risk, are less than attractive to potential trading partners within the country and abroad. Both tariff and non-tariff barriers to trade are subject to frequent and often retroactive change. Therefore these measures, applied as they are, have the same effect as an explicit tax on trade. Traders attempt to compensate for the expected risk by demanding higher margins and by paying producers less for their products than they would have under more reliable conditions. The only beneficiaries of this system are those living by rent-seeking and corruption activities, which thrive on non-competitiveness and a certain amount of chaos. However, rent-seeking only works until resources are finished. This brings me to the next section: the issue of state subsidies.

Subsidies

“Providing subsidies to agriculture in the Ukraine is like doping an untrained athlete. The doping might help for a while (if side-effects are ignored), but it also reduces the incentives to train effectively”⁴³

To put the conclusion right in the beginning: subsidies in the form of credits and tax write-offs and preferential administrative treatment have helped many CAEs to avoid necessary restructuring such as cost-cutting, the reduction of the company workforce and the adjustment of production.

The Vicious Circle

If the number of new jobs rises slowly there is a tendency to delay restructuring by granting subsidies and a range of preferential administrative and legislative treatment to state-owned enterprises. These measures pose disadvantages for the private sector by subjecting it to a high tax burden to finance the respective subsidies and therefore inhibit proper competition. That, in turn, hampers the creation of new jobs in the private sector and often hampers the reform process. Subsidisation continues and competition becomes more and more distorted. The longer this process continues, the more it will erode the willingness of private entrepreneurs to set up new companies and to create new jobs within the country. Capital flight is the logical consequence.⁴⁴ It is important to realise that the delay of restructuring within a sector does not save jobs. On the contrary, when enterprises oppose transformation, they will remain unable to compete and consequently even more jobs will be lost. What the state should do to satisfy its responsibility towards the citizens is to set up a social security system that can ease the risk of unemployment by providing people with sufficient support.⁴⁵ If they are able to leave their work place in order to find employment

in another enterprise or even in a different sector of the economy, they will be less likely to oppose necessary restructuring.

Moreover, through a more efficient allocation of human capital, which is greatly dependent on the existence of a social safety net and the provision of education, productivity is going to increase considerably.

The absence of hard budget constraints

State subsidies have been quite helpful to managers who were interested in postponing reforms in order to acquire property at no costs to themselves (asset-stripping, cold privatisation). Moreover, they have fostered a highly irresponsible attitude towards debt repayment and have contributed to the large budget deficit and macroeconomic instability, which is strangling the country. The misuse of subsidies is possible because ownership rights within CAEs are poorly defined and managers cannot be held liable to the full extent of their assets and because the targeting of state support is highly deficient. The principle of profitability has not been taken into account sufficiently. This principle implies that hard budget constraints have to be applied and that a company operating at a loss should go bankrupt, otherwise it is a strain on the economy. Additionally, the introduction of uniform accounting and reporting standards for enterprises is necessary in order to monitor these budget constraints. Their application would make it harder for managers to hide information and thereby reduce their incentives to engage in rent-seeking activities, moral hazard and asset-

stripping.⁴⁶ But up to 1999/2000 the principle of profitability and the implementation of hard budget constraint have been considered to be politically unfeasible.

Input supply subsidies

The most important and most distortive measure of farm support prior to 2000 consisted of input supply advances to CAEs. Funds were transferred to suppliers, who in turn supplied farms with inputs. Oblast governors were responsible for collecting repayment in the form of agricultural commodities. In order to do that these officials often introduced bans on the shipment of grains and sunflower seeds from their oblasts until farms repaid their debts. Here the unfortunate link between subsidisation and the implementation of trade barriers becomes apparent. In 1998, for instance, government provided 1.8 billion UAH worth of input to the farms. Farmers only supplied one third of the value of this input, leaving a remaining debt of 1.176 billion UAH. In the same year 70 million UAH of farm tax debts were cancelled and a further 698 million UAH deferred.⁴⁷ In 1999, 41 million UAH of loans were written off and 533.4 million UAH were restructured.⁴⁸ Moreover, all farms have been exempted from paying VAT in the years from 1999 to 2004 and only have to pay 30 per cent of the Fixed Agricultural Tax. These tax privileges amounted to 208 million UAH of subsidies in 1999. In May 2000, all farm debts to the state (6.8 billion UAH accumulated between 1994 and 1999) were written off. This means that all budget loans disbursed and tax

arrears accumulated in 1998/99 have, with hindsight, to be considered as direct subsidies.

Regrettably, all these subsidies provided by the government did not increase the efficiency of CAEs. In 1999, 85 per cent of the CAEs, which were the main beneficiaries of the spending, were technically bankrupt. However, this outcome could have been anticipated. While financial flows were pumped into the maintenance of unprofitable enterprises without forcing them to restructure, almost nothing had been invested into the development of human capital and technology. Agricultural education, research and rural infrastructure development - the most important sources of medium and long-term growth - have been neglected tremendously. Finally, in 2000 the government stopped supplying inputs to farms in the form of zero-interest rate budget loans. Instead it started to encourage private suppliers and banks to finance the sector by providing 50 per cent interest rate subsidies on commercial loans. This mechanism of interest compensation has considerable advantages compared with other forms of subsidisation, since the creditworthiness of the applicant is assessed by a commercial bank interested in the correctness of this assessment and not by the state. Consequently, it is less likely that unprofitable enterprises will be supported.

Rural Finance – Risk and Trust

In the Ukraine it is not the lack of capital, but rather the lack of creditworthiness that poses an obstacle to establishing sound credit relationships. The shortage of financial liquidity is an expression of the extremely high risk posed by the uncertainty and non-enforceability of legal titles. The shortcomings of the institutional framework, which regulates the relationship between lenders and borrowers and problems related to the Ukrainian banking system, are a major development impediment.

What is preventing both foreigners and domestic agencies from supplying credit to farmers is the high risk of non-repayment caused by a high degree of information asymmetry. One reason for non-repayment is that many agricultural enterprises are highly inefficient. Labour productivity, for example, is very low due to the high amount of unemployment hidden on these farms.⁴⁹ Land and input productivity is very low as well. Inputs are often used in accordance with standards applied in the 1970s and 1980s. Well-educated managers, who could improve these shortcomings, are scarce.⁵⁰

Yet the key problem is that banks and other potential lenders are not in a position to enforce their claims on farms because the required legal instruments are missing. This provides farm managers with strong incentives not to repay loans although they might be perfectly able to do so.⁵¹ Banks and other lenders, on the other hand, are not able to judge whether borrowers will be both able and willing to pay⁵²; they cannot judge the creditworthiness of

potential borrowers. This information asymmetry⁵³ combined with the lack of legal certainty increases enormously the risk of providing credits and causes lenders to charge very high interest rates and to abstain from issuing long-term credits.⁵⁴ What is needed to lower this risk is trust.⁵⁵ One important way of creating trust is the development of a variety of institutions that can lower the costs of information asymmetry. One of the most important cornerstones would be the clarification of property relations within the enterprises, which are looking for credit. If managers could be held responsible for their actions with the full amount of their assets then they would act in more considered way. For this to work out, the existence and implementation of a bankruptcy law is decisive. Together with a couple of other laws which protect the rights of lenders, such as credit registries and transparent accounting systems, it would allow financial institutions to act in a more confident manner. By providing legal certainty and an enforcement device in the case of non-repayment, bankruptcy laws increase the willingness of lenders to provide loans. Therefore, they should be in the best interest of farmers, who are dependent on such financial flows.

If commercial banks and other financial institutions can work within a stable legal framework then they will have strong incentives to evaluate all potential investment projects carefully, especially when they face the competition of other lending institutions. Managers of agricultural enterprises will have to

demonstrate to them that they can revamp the organisational structure of farms, reduce the labour force and increase productivity before they get the chance to apply for a loan. Therefore, the financial support of genuinely unprofitable projects will become less likely and managers will be incentivated to initiate the necessary restructuring (unless they are able to squeeze more money out of the state budget). The risk is much higher when state lending institutions supply credits. They have to operate in the same environment as commercial banks do and are consequently also confronted with the problem of information asymmetry. However, in the case of state lending institutions, their situation is aggregated by the fact that they are often under considerable political pressure to provide loans to loss-making enterprises.

The significance of the presidential Decree “On urgent measures for accelerating agricultural reform” from 3 December 1999 has been mentioned above, but it is worth mentioning some of its implications for rural finance. By stipulating that all CAEs have to restructure to form new entities and to distribute land shares, the decree increased the creditworthiness of Ukrainian farms. It clarified the relationship between farm managers and farm members and it reduced members’ participation in the decision making process. Consequently, the decision making process became more transparent. This, in turn, has reduced farm managers’ incentives to steal from their farms.

As mentioned above, in early 2000 the government withdrew from its direct involvement in agricultural input supply and resorted to the implementation of a partial interest compensation mechanism. All these policy changes had a positive effect on the creditworthiness of Ukrainian farms. Due to restructuring, reduced government interference and the increased responsibility of farm managers the profitability of farms has increased.⁵⁶ Additionally, the business environment for banks improved due to stabilised macroeconomic conditions. This led to falling interest rates, less government intervention into the banking sector and improved expertise within banks for assessing the creditworthiness of agricultural enterprises.

The Social Security Network

The development of a social security system that provides basic and targeted support to those in need is not only of moral, but also of political and economic importance. Politically it is necessary to overcome resistance to reform. By creating new employment opportunities and social fallback options for those displaced by the sheer scope and pace of structural change, the implementation of a security network eases the effects of transition. Thereby, it is decisive in breaking the hold of vested interests over reform policies.

The present form of the social security system leaves the economy over-regulated and under heavy financial pressure without achieving even a minimum of income security above the poverty line for the sick, the old and the unemployed.⁵⁷ The very high social security contribution rate (49 per cent in 1999) is a disincentive for many to work and save in the official economy.⁵⁸ Despite the high social security contribution rate, no health insurance system based on contributions has been established. Although there are no official fees, people have to “bribe” their way to medical treatment.

In 1997, 49.8 per cent of the population had an income of less than 90 UAH per month, while the cost of a minimum food basket was approximately 64 UAH. As these low-income groups have to spend most of their money for food, they can hardly afford anything else (medical treatment, for instance).

One of the most vulnerable groups in the country is the group of pensioners. Due to the small size of their pensions and non-regular payments they are often not able to afford even a minimum food basket. The average life expectancy fell since 1990 from 65.4 to 61.1 years for men and from 74.0 to 72.8 for women. Instead of developing a sound social security system that could increase the income of the most vulnerable, the government has pumped budget resources into price subsidies for communal services and food and the continued exemption of some part of energy consumption from taxation. The problem with this kind of social benefit is that the beneficiaries of price subsidies are all households, including those

that do not need any support. In the case of energy supply, the practice leads to rather absurd consequences. Given that the benefit depends on the amount consumed (the larger the consumption the larger the subsidy received) and given that low income households will generally lack the means to install appliances, which would raise energy consumption, it is likely that the share of subsidies received by wealthier households continues to increase. Similar reservations have to be made when it comes to subsidising food prices. In the case of agricultural products subsidised consumption has a clear price depressing effect on food producers, and thus on the prices agricultural producers receive. Thereby, income is taken from farmers and given partly to consumers and partly to the state budget. Assuming those Ukrainian agricultural producers are not really the most well off sector of the population, this “redistribution technique” does not seem to make much sense.⁵⁹ Moreover, consumers are encouraged to waste the subsidised product due to its artificially low price. And last but not least, government will have to spend its scarce resources to ensure that the cheap products are not re-sold on the world market at higher prices.⁶⁰ So on the whole, price subsidies and government intervention in the market are highly costly and their benefits are disputable, to say the least. Furthermore, they enforce the irresponsible attitude towards consumption that was developed under communism.

Another signpost of misguided government policies is the maintenance of the social sphere of enterprises. This is considered

to be a part of the social security system and subsidised by the government. The role of the enterprise as a provider of social benefits is a survival from communist times. In the Soviet Union enterprises often provided and paid for workers utilities (heating, hot water). They ran their own canteens, health facilities, owned vacation houses that provided cheap holidays and subsidised child care. In addition to some ideological reasons for anchoring social benefits in enterprises, linking them to working for a monopoly employer, the state, ensured political obedience. Those who did not work for the state were treated as non-persons.

Although expenditure on the social sphere of enterprises has decreased considerably after independence, in 1999 the level of expenditure still amounted to about 4 per cent of GDP. The fact that this sphere remains incorporated in the enterprise today impedes the mobility of both labour and capital; and it hinders progress in privatisation and the purchase and sale of enterprises because potential buyers may fear the costs associated with maintaining a mandatory social sphere. Employees are reluctant to abandon the benefits combined with the location of their work place, particularly if housing is provided. On the other hand, the maintenance of the social sphere provides managers with extra power over their workers. They can direct the members of their enterprises as they please by threatening them with exclusion from social benefits.⁶¹ This dependency of workers is clearly opposed to real freedom of choice. The high degree of risk aversion hinders people from “inventing” themselves and to take their life into their

own hands. Consequently, they rather face the harassment and adopt their preferences to the perceived boundaries of feasible options. Only the provision of an alternative social security system, that encourages responsible agency and the beginning of open discussion and political participation can break up this circle of fear and dependency and enable people to move on in the new game of capitalism.

To avoid the shortcomings and dangers of the subsidisation of certain goods and services and the social sphere of enterprises, these measures have to be replaced by targeted support to those in need of it. This would not only decrease the degree of dependency and irresponsibility among the beneficiaries but it would also generate net savings for the state budget. Furthermore, without going into the details of creating an efficient pension system, health insurance and unemployment insurance⁶², government should reduce the barriers for private providers of social security services (e.g. health insurance, pension funds, education, etc.) to open the doors for competition and improved services. Of course, some regulation and secure and independent monitoring of social insurance on the basis of regular balance sheets and income expenditure statements is important.

Education

The provision of education plays an important distributive role especially in a transition country like the Ukraine. One reason for that is that inequality measured by the Gini coefficient has already

risen to higher levels than the average level in OECD countries. If we acknowledge a high economic growth potential in the long run, then the initial worsening of the income distribution could be corrected in the medium run, if the currently economically deprived households could participate better in the primary distribution of that rising future income. This is going to happen, if their income generating power is promoted. Education is both decisive for the earning potential of individuals and for economic growth.⁶³

Thereby it enhances people's capability to help themselves and others and to assume responsibility. Therefore, access to education should be kept open. However, one should keep in mind that means testing could have positive effects on the overall situation of the educational system in the Ukraine. Currently, the lack of such means testing combined with the reduction of finance especially for higher education institutions means that it becomes more and more difficult for these institutions to offer quality services to their students. Consequently, to some extent these institutions have resorted to accepting payment in exchange for admitting students. This process is going to weaken admission standards and the provision of higher education is likely to become dependent on the ability to pay.⁶⁴ So there is a need to introduce tuition fees and means testing with respect to higher education, because that would improve the financial situation of these institutions and inhibit the crowding out of qualified people by those who have the money to buy their seat in the lecture theatre. By providing loans to students

who are members of low-income households, the government would keep access to higher education open for everyone.

While the inefficient and costly version of the social insurance system incentivates people to invest their capital in other countries or to retreat to the informal sector, a system of substantial direct support to low income households combined with an efficient social insurance system is more likely to promote incentives to work, learn and invest in the official economy.⁶⁵

The Shadow Economy

In 1998 the share of the Ukrainian shadow economy was measured to be around 40 to 50 per cent of GNP. The main reasons for its growth were a lack of opportunities in the formal sector⁶⁶, the burden of administrative controls on foreign and domestic trade, unformalised property relations, high and frequently altered taxation and the strain of social security contributions. Note that it is the combination of these reasons rather than one ultimate reason that causes the shift from the formal to the informal sector. For instance, we would apply a too narrow perspective if we just claimed that people resort to the extralegal sector because it is a tax heaven.⁶⁷

In order to combat hyperinflation the Ukrainian government reintroduced most administrative controls in 1993. The resulting over-regulation has played a significant role in the decline of the

formal sector of the economy and the formation of the shadow economy.

The formation of the underground economy has some interesting implications for the discussion of freedom measured by the amount of regulation within society. One can hypothesise the following: Up to a certain point the intensification of administrative measures by the state leads to positive or even increasing marginal yields. This means that increasing regulation would lead to increased control over economic activity. But from this point onward any further intensification of administrative measures leads to a decrease of real control over economic activity. This would be the point when people start leaving the official sector and resort to the shadow economy. This hypothesis can be illustrated by reference to the issue of tax regulation. If government tries to combat the weak payment discipline (partly due to the bad economic situation, partly due to a relatively lax payment attitude and a lack of credible sanctions) with increased administrative controls, this is likely to encourage people to flee to the informal sector and thus lead to decreasing state revenues. One might, of course, object, that it is not the amount of regulation but rather its transparency and comprehensiveness that is decisive. However, I suppose that the increase of regulation beyond a certain point is very likely to lead to an opaque regulatory system.

The institution of the Ukrainian shadow economy is inefficient but stable. It is inefficient because the transaction costs arising within the informal sector (information, negotiation and enforcement

costs) are rather high. Extralegal businesses have to hide their operations from authorities. They have to make transfers outside legal channels; they are not able to hold property efficiently to enforce contracts through the courts. They cannot secure formal credit and they cannot raise sufficient money for investment. Moreover, the only insurance available to them is that provided by “local protection services”. Long-term investment does not occur and many transactions, which would be beneficial to economic agents, simply do not come about due to prohibitive transaction costs.

It is remarkable that even if the state reduces its controls and restrictions, economic agents will only react to this with significant delay. Such stability can be explained as follows: The stability of an institution is linked to the costs of its establishment. With every additional transaction that is performed within the current institutional matrix, the costs per completed transaction decrease. Thus, the longer an economic agent is working and investing within this institution the more expensive it becomes for her to leave that path. Furthermore, if somebody is working in the shadow economy, then her business partners also tend to be situated in the informal sector. Thus, if she goes back to the official economy, she would have to invest lots of energy in order to establish an efficient co-operative network again. However, if an agent entertains positive expectation about a return to the official sector, the costs needed for that change (sunk costs) would not alter her decision to

do so. What is needed to encourage people to return to the formal sector of the economy is comprehensive large-scale deregulation combined with the opening of investment opportunities.

Furthermore, people need to realise that a return to the formal sector and to legality is going to strengthen their standing in society. Only members of the legal system of a country can exercise their full political, economic and social rights. Here the necessary link between rights and duties becomes apparent. People remaining in the extra-legal sphere are weak in many respects. They cannot live up to their rights because they have left the realm where these rights apply and thus have also lost the basis on which they could fight for them. Thus, if people remain in the informal sector, they will forfeit an essential component of their freedom and development potential.

Transparency and Competition

A *Leitmotiv* that winds its way through all these considerations is the issue of transparency. What is needed for sustainable development in a transition economy such as the Ukraine, and in particular for the development of the agricultural sector of the country, is not the absence of any kind of regulation, but rather its predictable and transparent implementation. Regulation implemented in such a manner is the complement of competition.

“The “invisible hand” of the market depends heavily on the support of a thick “glove” of rules, norms, and institutions, including governments. But too often the glove is opaque,

obscuring flows of information essential to the efficient and equitable functioning of both markets and the national and international institutions that regulate them'⁶⁸ The call for more transparency has become very fashionable in recent times. It usually goes together with the demand for strengthening the corporate governance structures of enterprises. However, the concept of transparency takes different, even though related meanings in different contexts. In the realm of politics it refers to enabling citizens to learn about government activities by obtaining information provided by the government. Transparency is therefore an essential component of political freedom. In economics and finance transparency means "*the process by which information about existing conditions, decisions, and actions is made accessible, visible, and understandable*"⁶⁹

What all definitions have in common is that transparency is always closely linked to accountability. As Florini expresses it: "*the purpose of calls for transparency is to permit citizens, markets, or governments to hold others accountable for their policies and performance*".

Making agents accountable for their actions is closely linked to attempts to overcome the principal-agent problem, that is, the difficulties (due to information-asymmetry) principals face in ensuring that their agents do what the principals want them to do.

I have already discussed this problem with respect to insider privatisation of former state owned agricultural enterprises.

Strikingly enough, although an important argument for this kind of

voucher privatisation has been fairness, its result has mostly been an increase in inequality. In many cases managers have effectively expropriated minority investors (namely the members of the respective enterprises). Due to the opaqueness of the privatisation process, unclear property relations and the absence of well-functioning laws, managers engaging in asset-stripping and outright theft were the winners at the end. This practice has been reinforced by the absence of hard budget constraints, a lack of competition and government corruption.

In the absence of competition, managers were neither inclined to restructure their enterprises in accordance with the principle of profitability nor to increase the transparency of their actions.

Government was often too involved into the wheelings and dealings of businessmen to take action against them or it was simply not able to perceive what was actually going on. Instead, subsidies were pumped into unprofitable enterprises without questioning the reasons for the lack of profitability.

As pointed out earlier, burdening newly established enterprises financed the costs of subsidising. Moreover, a whole range of often arbitrary rules and restrictions (certification and standardisation procedures, a complicated tax-system, trade barriers, etc.) made it incredibly difficult for newcomers to establish themselves in the market. Despite ongoing privatisation the market has remained the playground for only a few inefficient enterprises. Competition agencies such as the Ukrainian Anti-Monopoly Committee have not focused sufficiently on the elimination of entry barriers for new

enterprises and their influence has often been too weak. With all its administrative power and lobbied by influential interest groups, government and other executive bodies have prevented competition by abstracting the entry of new domestic and foreign enterprises and by simultaneously granting privileges to favoured existing ones.

Under non-competitive conditions it is difficult to encourage enterprises to disclose information. If, on the other hand, enterprises compete in the market and are forced to work in accordance with the principle of profitability, then an enhanced level of transparency and a good corporate governance would be crucial to reassure stockholders and potential investors about the quality of management and the profitability of the enterprise. Thus, if competition prevails, enterprises will be incentivated to provide information voluntarily as to use transparency and good corporate governance as a comparative advantage in the market. And only under these circumstances will management have no alternative other than to clarify ownership and responsibility structures within the enterprise as well as initiate restructuring.

Implications

What do we learn from all these mistakes? Firstly, I would say that they confirm Amartya Sen's integrated approach to development as freedom. But furthermore we see how important Hayek's emphasis on non-arbitrary regulation and the rule of law is in order to avoid the abuse of discretionary powers.

Many different aspects have to be taken into account and only by interacting will they suffice to lift the level of development in a country. Policy advisors cannot just focus on liberalisation and privatisation although these processes are very important. They also have to pay attention to the manner and the setting in which these processes are performed.

For responsibility and accountability to evolve it is not enough to transform state ownership into private ownership. The transformation has to be managed in a transparent way, meaning that all participating agents ought to have access to the relevant information. For this to work it is not only essential that information is provided but also that the recipients of information are able to use it to evaluate the provider of it according to some accepted standard of behaviour. Thus, the prevalence of a common set of values and social norms is a precondition for the meaningfulness of any call for transparency and accountability. In order to shape these values and norms education and open public discussion play a decisive role. For them to be effective the free competition of ideas and a free and vibrant media are of utmost importance.

It seems to be intuitively true that a free and vibrant media, a strong civility and a “good” educational system are desirable for a democratic and free society. However, this tells us neither how to change things in practice nor who would be in charge of such a change. Opinions might even diverge strongly when it comes to

defining what a “strong civility” and a “good educational system” could mean.

Especially when people talk about the necessity of a vigilant “civil society”, it is hard to say what the content of this concept may be.

I agree that the laws of the state need to be supported by certain social norms, values and conventions, but it is difficult to give any advice as how to influence such norms if they are in tension with the formal order. As Philip Pettit points out: *“We know little or nothing about how to generate widespread civility where it has more or less ceased to exist. Who is to say what the state can do in a society where civility and the expectation of civility are at a minimum – where there is little social capital – and where people only put their trust in friends and family?”*⁷⁰

While governance structures can be changed in a short time, the general institutional environment (economics of property rights and other formal rules) adjusts under normal circumstances over more than a decade and the informal institutions, customs, traditions and norms of a society might change only over centuries.⁷¹ Even if we assume that the process in transition economies is accelerated by the rapid break down of the communist block, we probably have to accept that our opportunities to calculate the evolution of informal institutions are rather insignificant. Thus, one can and probably has to acknowledge the importance of informal institutions such as social norms, etc., but policy makers and economic advisors should have a hard time in influencing or even changing them.

In the Ukraine people have been confronted with a predatory state for most of the time after independence. This means that the state, or at least a considerable fraction of it, was until very recently less interested in maximising social welfare but rather in supporting the narrow vested interests of certain influential groups. This climate has only started to change slightly over the last two years.

How is one supposed to change an environment of opportunism and corruption when such patterns of behaviour are not even considered to be particularly blameworthy? Punishments that deter people in stable democratic societies from cheating are nearly always so mild that we hardly notice them. Severe punishment such as imprisonment plays a relatively minor role in deterring people from defection. It is more the combination of hints and clues that our fellow citizens use to communicate their disapproval when we go astray. That makes it clearer, why it is so difficult to reform a country like the Ukraine where corruption and criminality have become relatively socially acceptable. Altering the culture of society or its pool of knowledge is a requirement for its successful reformation, but as we know, people do not change habits of a lifetime overnight.

As long as there is no established common standard in society that holds the opportunism of state officials and enterprise managers as blameworthy, then all calls for transparency and accountability made by outsiders will not make much sense. The political and

economic circumstances under communism supported, rather than punished rent-seeking behaviour and free riding. Opportunism is not a new phenomenon; it has a long history. By the 1980s, bargaining and black market trading within and outside the official distribution networks permeated the Soviet economic system. Thus, even before its dissolution, the socialist state had lost a great deal of control over the final allocation of resources and was concerned considerably with the allocation of rents among public servants. Additionally, due to a lack of proper incentives (e.g. the absence of private property) and the fact that decisions were basically made for citizens, people did not learn to take responsibility. On the other hand, government rules were not accepted as being legitimate by a great part of the population. They were only reluctantly, or even resentfully, respected. Thus, trust in the political order was low. Under these conditions opportunistic behaviour was not regarded as a major offence or crime but rather as a basic means to survive in a comfortable manner. Over time it became more and more common place.⁷² The more people were engaging in it, the less it was regarded as blameworthy. People did not feel guilty for stealing or covering information. This attitude prevails until today in many ex-socialist states, and it will take a while until a changed incentive structure will lead to a different understanding.

Another point worth mentioning is the following. In former socialist states people were subject to the surveillance by a well established network of secret services. This network was definitely

not encouraging any kind of vibrant and contestable civil culture within society. Its main success was scaring people into tranquillity and obedience. It even undermined the level of personal trust among people considerably. Since nobody knew exactly who was a member of such an organisation, potentially everybody could be.⁷³ Thus, citizens would only dare to communicate their real opinions within a very narrow circle of friends or the family.⁷⁴ The media would report what the state wanted it to report and the part of the population able to receive Western TV channels in the former GDR, for example, would keep quiet about it.⁷⁵ The cognitive dissonance arising from always being forced to separate one's official from one's unofficial opinions did not have any positive effect on people's standing in society and in any case it was not helpful in giving people a chance to learn the patterns of behaviour that are essential for the working of a free and democratic republic. Patterns of behaviour learned under conditions of fear and uncertainty are hard to be neutralised. In the case of the Ukraine these patterns might be traced back to the 1930s and 1940s when under Stalin millions of Ukrainians were shot, exiled, or incarcerated.⁷⁶

However, I do not want to paint too pessimistic a picture with regard to the likelihood of changing informal institutions and the societal equilibrium of a country as a whole. If people realise that other forms of behaviour are more likely to support their well-being, they will not be too reluctant to adopt them. This can happen by copying patterns that have proven to be successful for citizens in

other societies, for instance. Furthermore, the adoption of new formal institutions, such as the rule of law and contract enforcement, work as major driving forces for the kind of social evolution needed. However this adoption may occur, the process is bound to take time. Social norms cannot be sustained by instrumental reasoning alone – they have to be internalised, so that violating them is felt to be not just an ordinary mistake but something shameful. All that policy makers can do, given that they want to do something, is to provide an appropriate legal and social framework within which a new equilibrium supported by certain social norms and values can arise.

Who is the Man?

Although the political and economic environment has improved, the Ukrainian State has still not really left behind its parasitic equilibrium. So who is responsible for pushing the country onto a path that will lead to a better equilibrium and for keeping it on that path? “The people!” one is tempted to scream. Only when they demand a non-parasitic state, then it will develop towards that destination in the long run. For this to come true people have to stand up to the rights that are formally granted to them in the constitution.⁷⁷

When Yushchenko, Ex-Prime Minister of the country and one of the most reform-minded leaders the Ukraine had seen after

independence, was voted out of office last year, only one thousand Ukrainians made the effort to demonstrate against his dismissal in Kiev. That was disappointing for all foreign observers and a slap in the face of freedom and democracy.

Nevertheless, that lack of civility is explainable. Opposition has to be learned. Unlike other transition countries such as neighbouring Poland, Ukraine as part of the former Soviet Union did not have something like a state independent economical or political domain. Basically everybody and everything was under state control. In Poland, on the other hand, a substantial number of private businesses existed even under communist rule and agriculture was never collectivised. Furthermore, the civil opposition to the communist government in the form of Solidarity and the Catholic Church enjoyed enormous popularity long before 1989. And when Solidarity came to power, the new government was endowed with a much higher degree of trust than the government in CIS countries, which hardly saw any significant change in leadership. These differences in the institutional legacy of countries in transition need to be taken into account.

Opening New Perspectives

This does not mean that patterns of behaviour do not change. In order to mobilise people one needs a sufficient amount of independent information. The freedom of the media is, therefore, one of the crucial institutions that need to be fully established in the

Ukraine. Unfortunately, non-state media still face difficulties in providing unbiased information to the public and in operating free of governmental and financial pressure. Harassment, buyouts, and personal attacks on journalists were the rule during the last couple of years and have coerced the media into a submissive role. During the election campaign in 1999, for instance, 25 out of the 64 member stations of the Ukrainian Radio Broadcasters Association reported that they had received anonymous threats or were harassed by tax authorities. The Government of the Ukraine exerted pressure on the media to keep the communist opposition off the air.

Furthermore, the President of the country, his chief of staff, and the Interior Minister were accused of involvement in the disappearance, and possible murder, of the Ukrainian journalist Georgy Gongadze in November 2000, who was an outspoken critic of government corruption.

Support of an independent media landscape in the Ukraine complemented by the spreading of information by foreign media can be helpful in strengthening the political awareness and self-confidence of the Ukrainian people. Equally, exchange programmes can play an important role when it comes to opening different perspectives to people.

What is encouraging is that a few Ukrainian-German agricultural exchange programmes exist. A good example is the German-Ukrainian Agro Development and Investment Project (DUAP) that we visited in Vinnicia. Within the framework of this programme,

German agrarians, who experienced the restructuring of the East German agricultural sector, help to analyse Ukrainian farms and offer practical advice. German students of agricultural economics can also participate in these programmes, work on Ukrainian farms and get into contact with the people. On the other hand, Ukrainian farmers and students can visit agricultural enterprises in Germany and see what they like and what they do not like about them. Such exchange programmes do not only serve the exchange of knowledge and expertise; they also bring people together and create trust between them. Pure exchange of information can be useful, but if people really work together and overcome practical obstacles together, a proper foundation for future co-operation can be created. Foreign investors can give advice and make suggestions to improve or restructure, but solutions can only be found in co-operation with the locals.⁷⁸ Only when local farmers participate in the establishment of restructuring programmes, will those programmes stand a chance to be implemented. As a result of such participation, the local farmers's sense of responsibility for the success of certain measures will be much stronger than under circumstances when outsiders just throw their programmes at them.

The Role of International Institutions⁷⁹

What is true in the particular area of agricultural assistance programmes also makes sense when we approach the grand political, economic and financial level. The simple transfer of ready-made programmes rarely works. Whether we like it or not,

not every country is happy to converge on the Anglo-American style of capitalism immediately. From this perspective I also see the international integration of the Ukraine. It seems to be conventional wisdom that liberalisation of trade and access to foreign exchange can be better sustained by multilateral commitments, which help to anchor these measures in well-established institutions. In particular WTO accession, IMF Article VIII on currency convertibility and EU agreements on regional integration and free trade are expected to reduce the likelihood of policy reversals and are meant to add to the transparency and predictability of the respective trade and payment regimes. Commitments to these institutions might also contribute to the development of institutions in the country that support markets and private enterprises. But, of course, signing an agreement with the IMF does not necessarily signal strong commitment by governments to carry through the agreed policies. However, in the case of the states that were part of the Soviet Union, such commitments provide less impetus for reform than in countries such as Poland or Hungary. WTO negotiations are slow and due to the absence of prospects for closer integration in the near future, EU accession agreements have not exercised significant influence on the reform process in the CIS. Therefore, possibly the strongest anchor for liberalisation in this region is the commitment to the IMF under macroeconomic adjustment loans. However, IMF loans are an arbitrary development tool. On the one hand the Fund tries to convince governments to implement certain reforms with

economic arguments and by making loans dependent on the compliance with certain standards. Yet the various financial crises in the end of the 1990s have shown the other side of the coin: an IMF that apparently under much geo-political pressure (especially pressure from the U.S.)⁸⁰ generously gives away credits and thereby, as “lender of last resort”, leads other lenders astray to take excessive lending risks. This often leads to weakened reform pressure, corruption, excessive debts and ultimately financial and economic crisis.⁸¹ These incidents also illustrate that liberalisation, beyond a certain level and under adverse conditions, can have negative effects. This insight coincides with my considerations at the beginning of this work. The wisdom is not “the more liberalisation, the better”, but to find the balance between regulation and control. Both over-regulation and the lack of regulation are bound to be sub-optimal for freedom and development. Moreover, policy makers and evaluators should focus increasingly on the quality of liberalisation and regulation and not only on their quantity.

Under the Clinton administration, for instance, the IMF and the World Bank pushed lots of countries in the direction of capital account liberalisation. Simultaneously, countries, which applied for credit, were “encouraged” to liberalise their current accounts: remove tariffs, import quotas, export subsidies, etc. The absence of comprehensive regulation allowed money to enter and to exit countries without any kind of control – and that is exactly what contributed immensely to the emergence of many financial crises.

Ownership and Conditionality

Thus, liberalisation is a mixed blessing and its benefits will depend heavily on its implementation and the institutional history and circumstances of a country. There is simply no “one type suits all” recipe. The programmes initiated by international institutions will never be successful, if their “advisors” do not listen to the voices from the respective countries.⁸² Only the citizens and experts of the respective country will be sufficiently familiar with the existing conditions and their history – and their input will therefore be an essential ingredient for any policy advice. Thus, governments and local experts need to participate in the formulation of development programmes. They need to experience a certain sense of “ownership” of them. Only if this is the case, will governments be sufficiently committed to implement the respective policy measures. Remember: one of the property effects that De Soto points out is that property enhances the sense of responsibility and the accountability of the respective owner. That is not only true when it comes to assets but also when we consider ideas and plans. If it is my idea to go for a difficult hike or if I have at least happily agreed to undertake this mission, I will put much more effort to make things work than I would have if I had been forced into it. I will actively look for solutions when obstacles occur, I will learn from mistakes and I will be less likely to blame my fellows if things go wrong. That does not mean that lending institutions should not make their loans dependent on the compliance with

certain standards. Attaching conditions to borrowing does not have to conflict with the support of homegrown programmes. But programmes should encourage responsibility by allowing countries more room to set their own priorities.

In the formulation of its *Comprehensive Development Framework*⁸³, the World Bank made a step in the right direction, emphasising the partnerships among governments, donors, civil society, private donors and other development actors. According to this new conception the country which asks for help should be in the lead both “owning” and directing the development agenda, with the Bank and other partners each defining their support in their respective plans. There remain, of course, some practical challenges to this approach. The lack of capacity and confidence within countries, reluctant governments and nascent civil society organisations pose significant obstacles to the implementation of all good development resolutions. However, that should not stop international institutions from trying to broaden ownership in development programmes without compromising the level of debate or external development partners’ participation in them. Increasing collaboration between the staff of lending institutions and experts in the respective country and stronger country involvement in upstream joint analytical work, even before policies and programmes are formulated, are perfectly reasonable goals.

All these considerations do not deny that support from international lending institutions can play an important role in transition

countries. What is crucial, in my opinion, is that programmes are designed in co-operation with the respective country and that more attention is paid to their actual implementation. What the money is used for and how it is going to be channelled needs to be made transparent. During the 1990s, for instance, lots of stories circulated that IMF resources were simply passing through Russia briefly on their way to Swiss bank accounts. In providing loans to developing countries or to countries in transition, the Fund takes on a considerable level of responsibility. Thus, the transparency of its operations and the accountability of the Fund itself are crucial issues that are worth investigating and that need to be put to public debate.

However, a country is always better off if it has more than one financial source on which to rely. Especially institutions that do not try to provide money directly to the government of a country⁸⁴, but support specific development projects, are of utmost importance. These institutions usually interact with private institutions, encourage co-financing and foreign direct investment. Such activity is typical for projects financed by the EBRD, TACIS⁸⁵, USAID⁸⁶ and some other World Bank projects. Furthermore, bilateral programmes supported by countries such as the UK (British Know How Fund), Germany, Canada, the Netherlands, etc., push development significantly. It is desirable that the various donors meet regularly to exchange information on joint activities and key developments and to co-ordinate their efforts. The EC Delegation

in Kiev, for instance, maintains regular dialogue with the IMF, the World Bank, the EBRD, IFC, UN bodies, the US, the Canadians and with the EU Member States' representatives.

Most of these programmes are directed to the support of economic reform and private sector development but a considerable amount of resources is also devoted to such key issues as environmental problems, the adaptation of the Ukrainian health system to the needs of society⁸⁷ and investment into education. Moreover, there exist various initiatives aiming at strengthening civil society in the country via NGO development and certain training and exchange programmes. In the field of education, the Tempus programme run by TACIS has made a promising start. It supports the development of the higher education system in Ukraine. The academic priorities cover international relations and European studies, law, economics and banking, environmental sciences in relation to energy and transport, agricultural studies and human resource management.

The Monitoring Role of International Institutions

What I am unambiguously positive about is the monitoring role that international institutions can play. The IMF, the World Bank, the EBRD and all the other institutions I have mentioned release annual reports that evaluate developments and policy strategies in the respective countries.⁸⁸ This monitoring activity is of course not completely altruistic. It is in the very interest of foreign donors to obtain as much information about the conditions in a country where

they want to invest their money. That should be a strong incentive for them to investigate the political and economic climate of the respective country properly. Complemented by the results of surveys made by Transparency International, the Carter Centre and Freedom House, these reports offer a fairly reliable source of information that is useful not only to potential foreign investors but also to the citizens of the respective country. The information publicised in these reports provides a useful tool for scrutinising state action, holding governments accountable to their commitments and for stimulating public debate. Thereby, these reports can contribute to an enhanced level of certainty with regard to government policies and the economic environment and consequently the creation of trust within and outside society. For this to happen, it is of course, necessary that these reports are widely available to the public. Due to the underdeveloped telecommunication infrastructure of the country, only a small part of the population has access to the Internet and to the relevant national and international web pages.⁸⁹ Another point is that reports should be made available in Ukrainian or Russian in order to be understood by Ukrainians interested in them.

Progress in Privatisation – the Agro-Monopolies Privatisation Project⁹⁰

Foreign privatisation consulting has been important for the country. That is not changed by the fact that some mistakes have been made in the process. The project of privatising the enterprises and assets

of a country where basically everything was owned by the state is new and challenging. And – as mentioned several times already – privatisation is not just a “laudable” goal in itself. It only changes the legal status of an enterprise. In order to reap its benefits, managers have to change their patterns of behaviour, restructure their enterprises and find new ways of interacting with their suppliers and customers.

A successful privatisation project is the Ukraine Agro-Monopolies Privatisation Project and in particular its elevator privatisation component. It demonstrates that both co-operations between different donor organisations and co-operation between such organisations and local institutions can be effective.

I have mentioned before that the Ukrainian food processing industry and the marketing sector were highly uncompetitive. In particular, grain marketing was considered to be of “strategic” importance by the government and even if privatisation took place, the state insisted on keeping a significant percentage of the respective enterprise shares. Especially worrisome was the monopolistic position of Khib Ukrainy, the state agent for the purchase of grain and the distribution of inputs and the legal successor to the former Ministry for Grain Storage and Supply. It was given the outright ownership to one hundred of the countries best grain elevators including the important port elevators at Odessa and Mykolaev. Furthermore it controlled dozens of other strategically important grain storage and processing facilities.

Only in late 1997 did the government finally respond to the repeated nagging from international donor and private investor communities to reorganise and privatise the grain storage industry. Under these conditions USAID financed the Mass Privatisation Project under which PricewaterhouseCoopers (PwC), a well-known Washington Consulting Practice, provided the Ukrainian State Property Fund (SPF) with methodological and informational assistance in the privatisation process.⁹¹ The main objectives of the initiative were the privatisation of Ukraine's grain elevators and the de-monopolisation of para-statal organisations in the agricultural sector that threatened the development of a private and competitive agricultural market – that meant especially the de-monopolisation of Khib Ukrainy.

PwC helped to draft the Cabinet of Ministers Resolution 1218 “*On the immediate acceleration of the privatisation of grain storage and grain processing enterprises*” and negotiated the terms under which certain grain elevators would be privatised while Khib Ukrainy would retain others. Throughout the project, PwC consultants tried to provide objective reporting on privatisation to the international donor community and particularly to the World Bank and the IMF and thereby enhanced the transparency of the process considerably.

From 1996 to 1998 the World Bank's *Enterprise Development Adjustment Loan* was crucial for initiating and accelerating the privatisation process. This loan contained, among other things, the

first targets on the privatisation of grain elevators (300 grain-marketing and distribution enterprises to be privatised to 70 per cent). These targets have been met.

From 1998 to 1999 the IMF played the leading role among donor organisations in terms of privatisation – but a lot of its set targets have not been fulfilled.⁹²

Additionally, project consultants advised U.S. and Ukrainian officials of the *Gore-Kuchma Commission on Trade and Investment* on progress in achieving the privatisation objectives agreed on in 1996. At this time the Ukrainian government had made a commitment to the Commission to fully privatise all but 100 of the countries 543 grain-elevators.

PwC also worked together with the Ukrainian Antimonopoly Committee (AMC). It drafted procedures for the restructuring of agro-industrial holding companies and gave various recommendations regarding the establishment of grain storage co-operatives and conducted training seminars for AMC officials on privatisation and de-monopolisation.

In the short period between November 1998 until June 1999 PwC consultants conducted twelve privatisation and corporate governance seminars for more than four hundred people in eight oblasts. Seminars focused on property registration, free transfer of shares to grain suppliers, tender regulation, and attraction of foreign investment, shareholder rights and corporate structures.⁹³

The participants of these seminars included the management of joint stock companies, representatives of state organisations that

were involved in the privatisation process and finally the shareholders of grain elevators such as farmers. In addition to these training seminars project consultants also provided direct enterprise assistance to dozens of grain elevators in Odessa, Poltova, Kiev and Lviv.⁹⁴

Last but not least, PwC has created the web site of the State Property Fund with USAID support. This web site provides up-to-date information on share-sales, privatisation procedures and relevant legislation for everybody who is interested and has access to the Internet. Additionally one can find SPF reports that demonstrate government's progress in meeting the privatisation targets established by the donor community. Thereby it provides a good instrument to keep people⁹⁵ informed about what is going on and gives them a tool to hold their government accountable to its promises and commitments.

Through all these efforts the elevator privatisation programme can be considered one of the successes of Ukrainian agricultural reform.⁹⁶ One of its main objectives – the de-monopolisation of Khib Ukrainy - has been largely met.⁹⁷ This, in turn, is beneficial for the farmers who can now freely choose their suppliers and do not have to fear as much arbitrary state interference as before.

The positive role international donors *can* play is illustrated nicely by this example. Through the funding of specific projects, through strategic and legal advise, they can incentivate the government, managers and potential investors to reorganise both the regulatory

setting and enterprise structures in a manner that allows market forces to work for the benefit of all.

Furthermore, in the Final Report, Kevin Covert – the leader of the project – remarks that he learned from it that “*economic reform targets [need to] be concrete, measurable, agreed in writing with Government officials and linked directly to donor funding*”. He considers it to be highly doubtful that government officials would have embarked on the relatively aggressive schedule for the privatisation of grain elevators set by the project had not, for instance, the IMF particularly insisted on it. Thus, the “locking-in” mechanism provided by government commitments to foreign lending institutions could be a strong complement to the various consulting initiatives provided.

Civic Activism

USAID has contributed to the growth of civic activism in the country. Civic watchdog groups like the Committee of Voters of Ukraine, community based anti-corruption partnerships in Donetsk and Lviv, and the Freedom of Choice Coalition have received support both through financial help and training programmes. TV, radio, and print professionals have received USAID- supported training in business management and investigative journalism.⁹⁸ Furthermore, another programme provides lawyers or legal advice to journalists and media outlets when they face politically motivated libel suits, licensing restrictions or other problems. The

same programme works with judges, lawyers, and journalists to raise their awareness of Ukrainian and European Media law.

*Anti-Corruption Initiatives*⁹⁹

One of USAID's special initiatives is the Anti-Corruption programme. By informing people about their rights, supporting efforts to have those rights upheld and publicising examples of successful cases of citizens defending their rights, the organisation hopes to generate greater expectations among citizens that corrupt officials should be accountable under the law. Two pilot programmes have been established in Lviv and Donetsk by Management Systems International (MSI), a USAID contractor, to promote strong partnerships between local governments, NGOs, business and media. The goals of the initiative are the combat of corruption, stimulation of economic growth, improvement of the investment and social climate and the enhancement of good government practices. The *Public Independent Committee Against Corruption* in Lviv and the *Partnership for Integrity* in Donetsk are said to represent a broad constituency from civil society and the private sector. They are expected to work in close co-ordination with the oblast and municipal administrations on concrete activities aimed at reducing or preventing corruption. The simplification and streamlining of procedures that reduce bureaucratic discretion and opportunities for bribery is considered to be crucial. Moreover, public awareness campaigns highlight citizen rights to government

services and provide legal advice to citizens and business people through *Citizens' Advocacy Offices*, which run a 24-hour hotline. MSI representatives visit the respective cities several times a year to provide technical assistance, assessment and oversight.

According to USAID the initiative has helped to improve the business environment considerably. In 2000 a U.S.-British venture decided to invest over US\$ 65 million in a sunflower processing plant in Donetsk stating that the extensive anti-corruption campaign conducted there had increased its confidence. But of course, such reports are only partially useful and it is pretty hard to check the "real" success of certain initiatives. What remains true, however, is that there is a strong link between the intensity of regulation and corruption. Much is won if authorities do not interfere in matters that are none of their business and the administrative process is simplified. If programmes pursue these goals, they are likely to contribute to an improvement of the situation.

*Civil Society and NGO Development*¹⁰⁰

Even though all these initiatives have their positive effects, it is hard to evaluate them properly. The significance of the whole civil society issue, for instance, is highly controversial.

The concept might imply citizen's knowledge of their rights and responsibilities and their ability and willingness to defend those rights and to fulfil those responsibilities. But in another sense it is also used to demand pluralism through broad citizen participation

in non-governmental and informal activities or a balance of power between citizens and the state.

I have no doubt that formal democracy, characterised by press freedom and reliable expectation of non-rigid and regular elections is absolutely central to economic modernisation and sustainable growth. It is another question, however, whether a so-called “deep” democracy, i.e., a mode of government in which consensus amongst organised interest groups, including municipal bodies and labour unions, is taken as a necessary aspect of policy choice.

Some of the NGOs that are praised so widely might represent interest groups that are narrowly focused. If they can wield their power by threatening vetoes if they do not get their rents, that could be rather counterproductive for sustained development.

Although growing activity of the NGO sector might be a sign of a more vibrant civil society, one must not equate NGO activism with a strong civil society. In the Ukraine, for example, the public is largely unaware and generally disinterested in NGO activities.

A Non Governmental Organisation is ordinarily defined as a non-profit association of citizens that operates independently of government or business structures. It is expected to bring citizen concerns to the government, to monitor government policies and to encourage political participation. However, in the case of the Ukrainian NGOs, it is important to realise that the structure of many is still highly centralised and personalised leadership structures are common. Furthermore, transparency seems to be a foreign concept for most of them. Members of such organisations

often consider the disclosure of information concerning their operations and finances to the public as a rather unreasonable demand. While it is true that the threat of potential harassment by tax authorities and criminal elements is real, organisations also refuse to be accountable to the public because of cultural legacies of the Soviet era. So far there is simply no culture of openness and accountability for the use of public funds. There is hardly any understanding on the part of NGOs that the benefits they receive as public organisations are largely at the expense of taxpayers, and that this alone is a sufficient justification for transparency.

Thus, similar to their governmental counterparts, NGOs face incompetence and corruption. Additionally, different NGOs tend not to work together – even though they might have the same objectives. Information is hardly shared and often enough the main worry is to outbid other NGOs when it comes to foreign funding.

Another worrisome phenomenon is the tendency of local administrators or deputies to start up their own NGOs or get employees to register in NGOs in order to ensure their departments are adequately funded or can demonstrate relationships with NGOs while still maintaining full control of programming, initiative, and funding. Needless to say, such conditions are not beneficial for any kind of independent monitoring! Thus, the increase in NGO activity does not necessarily strengthen the development of a stronger civil society. In many ways it seems that the NGO sector largely repeats the structural deficiencies of the governmental sector, does not balance the power of the state and has not actually

had any significant beneficial influence on government action so far. Consequently, foreign donors have to be rather careful as to where they will direct their resources. A certain degree of conditionality and the coherent introduction and implementation of international accounting and financial reporting standards are crucial.

Implications

The transformation of a transition country like the Ukraine is a complicated and time-consuming process. After only ten years it cannot be expected to be complete.¹⁰¹

Supporting this process means supporting it honestly and for a long time on all levels and in a sufficiently regulated manner. Policy consulting and advice from foreign experts, especially legal advice that takes into account the respective economic background is valuable. These projects can fail, of course, when foreign advisors have the wrong incentives. But the same is more often true for their Ukrainian counterparts. However, admitting that certain projects can be performed in a bad manner or that they do not always have a significant effect does not render them useless. In many cases foreign investment and policy consulting have been very beneficial and have pushed the development of specific sectors in the right direction. Technical assistance has been very helpful. In Kiev, for instance, the Germans have put up a banking academy, a bakery and a butchery school that provide Ukrainians with the opportunity to benefit from Western Know-How. As mentioned above, I am in

favour of all sorts of exchange programmes whether they may be among schools, universities, or companies. This should be the most effective way to make people familiar with the new technologies, standards and institutions they might want to apply in their country without patronising them. With regard to this, it is rather unfortunate that it is still very difficult for Ukrainian students to study in Western Europe and that only a small amount of Western students are adventurous enough to study in the “Wild East”. But all beginnings are difficult and there is a good chance that the success of exchange programmes will encourage more people to join them, especially when the respective governments simplify their administrative obstacle courses somewhat.¹⁰² However, this practice will only bear fruit in the long run.

Despite all the negative aspects I have discussed, the Ukraine might have found at least the right runway on its search for freedom and development. Since Independence in 1991, a new generation of politicians and businessmen has grown that might be able to change the “old rules of the game”. In 2000, the real GDP growth of the country was 5.8 per cent and in 2001 it even amounted to 8 per cent. Real wages rose by 20 per cent last year and the inflation rate that once happened to be around 10,000 per cent has dropped to an annual rate of 6 per cent.¹⁰³ The stabilisation of the economy is very likely to contribute to the overall development of the country. Entrepreneurs and businessmen have started to realise the economic potential in the official sector of the economy: new jobs

will be created, tax revenues will increase and more funding will be available to finance both the social security and the educational system.

In March 2002, the new Ukrainian Parliament will be elected and so far competition among the different parties appears to be stronger and fairer than in previous years.¹⁰⁴ Thus, it can be expected that this competition will lead to the election of a government that is checked and balanced by a range of different political forces.

Without a doubt, the conditions for the development of a free and prosperous society are not ideal – but they have improved. There are still many obstacles in the way, but people now recognise these obstacles as such and want to overcome them. When the people in the country are willing to change their circumstances, when they dare to take the responsibilities that come with freedom, then they will use some of the tools that foreign advisors are offering to them for removing the obstacles to development.

A free agent - whether it is an individual, a firm, or a state - is not necessarily somebody who fights heroically alone against the rest of the world. Freedom does not presuppose ultimate independence – neither at the individual, nor at the national or global level. The emphasis on independence makes sense only when we want to distance ourselves from the kind of oppressive dependency existing

under coercive regimes, which do not allow an agent to invent herself in accordance with her ideas of a good life.

The ability to learn from each other is one of humanity's most precious assets and the precondition for any kind of progress. This includes both learning from other agents' mistakes and looking for new solutions.¹⁰⁵

Freedom and development allow for - or rather demand - cooperation and mutual help. Well-designed and regulated foreign assistance can offer many new opportunities to a country – opportunities the people of this country can choose from and develop in their own specific context. They can help to pilot a country to the right runway and support it so that it does not lose its way again.

C. Recapitulation

Back to Theory!

After giving this detailed account of developments in the Ukraine, I would like to close the circle of this work by returning to the theoretical framework. I started off with describing two influential liberal theories – one by Amartya Sen and the other by F.A. Hayek. While the work of the latter is usually subsumed under the category of *classical liberalism*, Sen's capabilities approach is often associated with the concept of *deep democracy*. For both authors

individual freedom is of utmost importance. It is both a political value and the precondition for development.

If we compare the approaches of Hayek and Sen, we have to keep in mind that their ideas arose under different circumstances. While Hayek's *Constitution of Liberty* was written in the late fifties in the United States, Sen wrote *Development as Freedom* in the late nineties mainly inspired by empirical studies in developing countries. This difference in time and space might explain some of the basic differences in their respective theories.

The American Constitution is Hayek's prime example of an institution embedded in the rule of law. The United States has been established on the liberal principals that are expressed in this constitution and never really deviated from them. The only threat to their equilibrium in the fifties was probably seen in the ghost of communism haunting the capitalist world. It is understandable that political liberalists at this time were especially wary of socialist practices such as the compulsory redistribution of income. Hayek's opposition to socialism might have also led him to argue so sharply against the idea of "design" in society.¹⁰⁶ In that he opposes the "*the crude rationalism of the socialist, who wants to reconstruct all social institutions according to a pattern prescribed by his individual reason*".¹⁰⁷ However, his general aversion to any form of creeping administrative discretion is probably more significant in that respect.

In the context of developing or, for our purpose, transition countries, however, the situation is different. Socialism is in its last gasps in the world – coping with its legacies is the challenging task that remains. Liberal principals have to be (re-) *introduced* in former socialist countries. The introduction of these principles does not happen in a vacuum. One has to take into account history and has to work on the initial conditions, including the already established institutions¹⁰⁸, in the respective country. People have to be convinced of the merits of a liberal society. They have been assured for decades that the way of life they led under socialism was the right one and they had arranged their lives in accordance with the perceived circumstances. Whatever Western theorists might wish to think, people in socialist countries did *value* the lives the system allowed them to lead - whatever role one considers *adaptive preference formation* to have played.

After the breakdown of communism, people have to feel sufficiently secure before they will accept major changes. It is not easy to go from one path of development to another. There are many intermediate steps on the way. History does not jump. A liberal society has to evolve gradually and it is bound to be different from those societies found in the Anglo-American world for quite a while.

The difference between Hayek's and Sen's approach to freedom is the following: While Hayek's approach to individual liberty is mainly concerned with the processes that allow freedom of action

and choice, Sen puts considerable emphasis on the actual opportunities that people have to choose, given their personal and social circumstances. The question is if this difference is of a fundamental nature or is merely a shift of emphasis.

For Hayek justice is inherent in the rules of the law. But the *rule of law* is of a higher order and transcends our articulation abilities. Thus it must, for the greatest part, remain in the procedures, which express it. Therefore, Hayek is reluctant to specify individual rights in a more substantive way. His scepticism concerning the expressability of the rules of justice, norms and rights also shows itself in his attitude towards the role of public political discourse.

For him institutions, including social norms and values, evolve spontaneously and any deliberate attempt to (re)-form them - and with them society - is met with some reservation. However, Hayek writes within a context in which institutions such as a free press and free speech are already well established and internalised.

Within such a framework values, ideas and norms continuously adapt and needs are conceptualised or re-formulated. But if these institutions are lacking or are still very weak, confidence in them and in people's ability to participate in the political process needs to be created actively. This is especially important because these institutions provide efficient tools for monitoring the work of other institutions and for holding politicians accountable to their commitments. Although Sen would probably recognise the difficulties that will arise in any attempt to reform the institutions of a given country, he puts great emphasis on the role of public

debate and political participation for the conceptualisation of certain needs, values and rights. Only if rights and freedoms are formulated, then the political process will be sufficiently transparent and policy makers can be held accountable to them. While Hayek points out that the political process tends to favour existing powerful groups, Sen emphasises that open public discussion is likely to reduce the power of special interest groups. This is of course only the case if people are enjoying the substantive freedoms that enable them to take part in the process.

In the context of the Ukraine both the demand for procedural justice and the formulation and support of substantive freedoms or capabilities are crucial. The rule of law must establish rules that fulfil Hayek's formal conditions – they must be abstract and general, known and certain and apply equally to everybody independently of their position. Even if the complete fulfilment of these conditions is an ideal and not fully achievable in practice, they largely prevent the granting of exemptions and privileges, and therefore, most forms of rent-seeking behaviour. These rules are to be combined with the establishment of a formal property system. The institution of private property enhances the responsibility and accountability of economic agents and delimits the scope of individual liberty. What we found in the Ukraine was a network of non-transparent, arbitrary and often retrospective regulation that inhibits competition and opens vast opportunities for the abuse of bureaucratic discretionary powers. This system has been supported

by unclear property and responsibility structures in business and politics.

I have described the phenomenon of ubiquitous arbitrary regulation with regard to trade-barriers, taxation, subsidies, the implementation of bankruptcy laws and the social security system. In all these areas, regulation has not fulfilled its purpose of enhancing the certainty of agents in their political and economic environment. It has been unreliable, full of contradictions and subject to constant change. Regulation and state interference have coerced citizens in arbitrary ways and prevented them from exercising the rights formally granted to them in the constitution, rather than promoting the general welfare of society. That also includes measures that seemed to be beneficial at first sight such as the provision of subsidies to producers and consumers. In the case of subsidisation of state owned enterprises via credits, tax write-offs and preferential administrative treatment in the first years of transition, the private sector was subjected to a higher tax-burden to finance the respective subsidies and inhibit competition. Thus the privileges granted to one group resulted in discrimination against another. Complicated standardisation and certification procedures for newcomers worsened the situation. This created an enormous entry barrier to new businesses, reduced opportunities of job creation and prevented state enterprises from the necessary restructuring that would have been the precondition for efficiency and profit making. Thus the granting of favours and exemptions that contradicts Hayek's requirement for procedural justice, has

driven whole sectors of the economy to the verge of ruin and reduced the general welfare of society. Furthermore, the monopoly provision of certain services by the state forced citizens into a position of dependency and inhibited their development as responsible agents and consequently the progress of the country. The subsidisation of the social sphere of enterprises, for instance, prevented employees from looking for new employment opportunities and led them to oppose restructuring.

Additionally, the arbitrary character of regulations does not allow for the “spontaneous” evolution of beneficial institutions. Hayek described the task of the lawgiver as the creation of conditions in which an orderly arrangement can establish and ever renew itself. In this respect, the Ukrainian government has clearly failed for the part since independence.

On the other hand it is important to realise that resistance to arbitrary and coercive regulation was largely prevented because people were lacking the basic capabilities to stand up for their rights. Often they would not even be sufficiently informed about the scope and content of their rights – which was of course in the interest of rent-seekers and outright criminals, who capitalised on this ignorance. The breakdown of the Soviet Union led the country into tremendous economic recession. The fear of unemployment and income deprivation in general and the resulting uncertainty about the future left people weak. Old norms and value systems were carried over into the “new” system, since there had not been enough time for the formulation or *evolution* of new ones.

Here Sen's capability approach kicks in – the combination and mutual enforcement of political freedoms, economic facilities, social opportunities, transparency guarantees and protective security, which allow people to choose a life they have reason to value. These freedoms go beyond pure procedural justice and the demand for formal democracy, which is mainly embedded in the set of political freedoms and transparency guarantees. They are meant to empower citizens to become responsible agents – confident about their ability to exercise their rights, to invent themselves and to influence their surroundings.

The creation of an efficient social security system, for instance, has been regarded as crucial for the Ukraine. Since the emphasis is put on the responsible and free agent, it cannot be realised by consumer subsidies that support irresponsible attitudes, cause inefficiencies and do not encourage people to take their destiny into their own hands. The goal is substantial direct support to those in need combined with an efficient social insurance system. Means testing is an essential part of the kind of income support envisaged and will reduce state expenses, distort incentives as little as possible and fight irresponsible behaviour.

These demands are well in line with Hayek's recommendations in the third part of *The Constitution of Liberty*. In his view, competing types of welfare provision, may it be in the field of public health, unemployment support or education, are likely to increase the efficiency of these services. In the area of

unemployment provision Hayek wants the state to provide only a uniform minimum for those who are unable to maintain themselves. Any further provision should be left to competitive and voluntary efforts. Furthermore, if these services are offered by a variety of suppliers, the state monopoly of their provision will break down; the state's coercive power will be reduced and opportunities for rent-seeking will decrease significantly. The limitation of state power is especially important for the provision of education. Hayek acknowledges the need for compulsory basic education, but he also argues that compulsory education or even government-financed education does not require that educational institutions need to be run by the government. Competition among different providers will enhance the quality of the respective educational services and will lower the dangers associated with the transmission of societal values by one single institution. Thus, on the whole, government is obliged to secure basic education for all but it should, if possible, not be too involved with the actual education beyond a certain regulatory level. All of this is perfectly consistent with Sen's capabilities approach.

In the postscript of *The Constitution of Liberty*, Hayek admits that he dislikes many of the measures he tries to delimit in the third part of his book. However, he goes on to say:

"But, though I may dislike some of the measures concerned as much as they [the conservatives] do and might vote against them, I know of no general principles to which I could appeal to persuade

those of a different view that those measures are not permissible in the general kind of society which we both desire."¹⁰⁹

Hayek does not really rejoice about the blessings of the welfare state – he rather argues for their limitation – but he is also aware of the fact that he, as a liberal, does not know all the answers and that his answers are not necessarily the right ones. Additionally, he knows that certain services once introduced to society cannot easily be taken away from its citizens again. Thus, Hayek admits that *protective security* can and has evolved as a value in society.

What does that mean? Once a theorist admits *any* role for a certain measure, her theory will not allow her to set a non-arbitrary maximum level on its provision. Once the role of protective security has been acknowledged it is a matter of public choice to delimit its role and consequently the scope of the welfare state.

Thus both Hayek and Sen support the provision of facilities that enable people to access medical care, education and basic income support. Both agree that the provisions made must not deliver ready-made solutions, but rather encourage the individual to take her destiny into her hands and to look actively for solutions to her problems. Welfare provisions are meant to enable the individual to act responsibly and not to take responsibility away from her.

In comparing the approaches of Sen and Hayek it is quite interesting that Hayek, in his attempt to delimit the provision of supporting services, gives a more detailed account of the kind of implementation that he envisages than Sen. As somebody who does care about the developments and processes going on in society he

can hardly avoid becoming a bit more concrete about certain issues than the liberal language of purely procedural terms would allow him to do. The formulation of substantive freedoms and rights is important for their implementation and defence, even if we acknowledge that they might change over time.

Reconciliation

While Sen is relatively eloquent in listing development goals and substantive freedoms, he does not inaugurate to us who might be responsible for the just implementation of these freedoms and what measures would be available to delimit administrative discretion. In his view, the reinforcement of substantive freedoms and democratic debate seem to be magical tools that prevent society from rent-seeking and other forms of power abuse. However, it is hard to buy into that optimism – and Hayek certainly does not. Somebody - or rather something – has to guard the guardians. And that is the rule of law and its embeddedness in the various societal institutions.

Hayek's and Sen's approaches are not opposed to each other. They merely put different emphasis on the procedural and substantive aspects of freedom. It needs to be clear that Sen neither denies the importance of the rule of law nor leaves it out of consideration, but he does not allow an over-arching principle to constrain his set of instrumental freedoms. The rule of law just appears as a sub-element on his list of vector-components comprising freedom. In a sense it is understandable that he cannot attribute an "over-arching"

role to one kind of freedom. To him all the freedoms he lists are valuable in themselves. However, we must not conceive of the rule of law as just one other kind of freedom. For Hayek the rule of law is an enabling condition for *all* freedoms. Nowhere in *Development as Freedom* does Sen say anything to confute this. Thus there is no obvious reason why he should not accept Hayek's reasoning.

If Sen's approach is to be applied practically, an over-arching maximisation constraint on his complicated development project is necessary, otherwise doors will be left open for bureaucratic discretion and the dangers associated with it. Conflicts of interest arise within society because different people tend to care about different things. If a state tries to maximise complex development objectives, then bureaucrats, who are concerned with these objectives, might be tempted to abuse their discretionary powers and engage in rent-seeking and corruption. The arbitrary regulation and coercion that comes with these activities make society less free and impede development and growth. The respect for the rule of law in society is restraining discretionary powers and the negative effects that the actions performed by one group or agent can have on the freedoms of other people.

Thus, if Sen would allow Hayek's master-principle as a binding, governing constraint on the maximisation of his capabilities-vector, this would strengthen his theory considerably. Simultaneously, a corrective reading of Sen's and Hayek's approaches would save the latter from the charge that he has nothing to say that is relevant to

development as opposed to a sound constitutional order in an already mature democracy. The resulting theoretical framework allows us to describe development goals and point out certain shortcomings and inconsistencies in the policies and institutional arrangements of a given country. In the case of the Ukraine we have seen that development has not only been inhibited by the neglect of certain instrumental freedoms and rights but also by the lack of solid institutions that incorporate the rule of law or procedural justice. We have seen that both over-regulation and under-regulation, as subsets of arbitrary regulation, impede development. A balance has to be found between these extremes.

The implementation of political philosophy, however, is always an uncertain business and is likely to be inhibited by mis-interpretations and practical obstacles. Yet this does not detract from the role it can play in encouraging people to think and to scrutinise what is going on in society. Philosophy helps us to put our criticism into arguments, teaches us to find inconsistencies and encourages debate. This, to my mind, is one of the most effective weapons for the defence of freedom – freedom understood both in terms of the absence of arbitrary coercion and the freedom to choose a life one has reason to value.

Postscript

The elections that were held on 31 March 2002 led to mixed results. The Kuchma block won the most seats, but failed to achieve an overwhelming majority. Opposition parties, such as Yushchenko's party, managed to get into parliament. Thus, President Kuchma's powers will be more restrained in the future. However, the election process has been far from fair. Opposition candidates have been threatened¹ and found it hard to get a fair hearing on state television.

The main question is what the winners will do with their victory. The bureaucracy of the country is still unreformed and despite the significant economic growth in 2001, living standards in the Ukraine remain very low.

¹ *The Economist* found it worthwhile to point out that only one candidate was murdered in this years elections. See *The Economist*, April 6th – 12th 2002, p. 29

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- ¹ Ludwig Striewe is also a member of the German Advisory Group with the Ukrainian Government in Kiev.
- ² F.A. Hayek: *The Constitutions of Liberty*, p. 37
- ³ I am assuming that these rules and norms have evolved particularly to cope with the limits of human rationality due to informational and cognitive constraints. However, even without such constraints we would need rules and norms because of co-ordination problems.
- ⁴ According to Douglas C. North institutions are the formal and informal rules that shape human interaction by structuring incentives in exchange (political, social or economic).
On the evolution of institutions see Ken Binmore: *Game Theory And The Social Contract Volume 2: Just Playing*.
- ⁵ F.A Hayek: *The Constitution of Liberty*, p. 37
- ⁶ “Choosing a life one has reason to value” might sound somewhat metaphysical. However, I think Sen qualifies this notion sufficiently by explaining the interconnections among freedoms and especially by pointing out the necessity of public discussion and education as means to avoid adaptive preference formation. The term adaptive preference formation describes the phenomenon that individuals adjust their desires to the way of life they know. That is, of course, not necessarily a bad thing. When I was small, for instance, I was absolutely determined to become a queen later in life. But realising that this was not going to happen however hard I would try, I gave up on this idea. Seen in this way, adaptive preference formation is a basic means to keep one’s sanity. However, what people like Sen or Jon Elster have in mind when they talk about this are cases in which people are prevented from aspiring to goals such as political equality, a certain level of education and material well being. The mechanism of dissonance reduction, by adapting one’s preferences to the perceived circumstances, prevents people from changing these circumstances although this might be perfectly feasible. Thus, their capability of “inventing” themselves and consequently their freedom are severely constrained.
- ⁷ In Sen’s conception an agent is someone who acts and brings about change and whose achievements can be judged in terms of her own values.
- ⁸ In a sense, we cannot really talk about the “trade-offs” between Sen’s instrumental freedoms since each of them is *valuable in itself*.
- ⁹ F.A. Hayek: *The Constitution of Liberty*, p. 206
- ¹⁰ F.A. Hayek: *The Constitution of Liberty*, p. 207-209
- ¹¹ F.A. Hayek: *The Constitution of Liberty*, p. 40
- ¹² According to Aslund, in the 1990s the number of enterprise inspections was possibly the highest in the world, at least they were requiring more management time than anywhere else.
- ¹³ They would often earn their bribes by blocking laws that aimed at deregulation.
- ¹⁴ In 1996 a new stable currency (hryvnia) was introduced. Before that, the Ukraine had an interim currency (karbovanents).

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- ¹⁵ The principal-agent model can be applied to the wearing-out of Soviet-style planned economies. The skilful non-fulfilment of the centrally posed plan has been the optimal strategy for agents (collectives, enterprises, etc.), to minimise their costs (work) and to maximise their yields (time, "additional incomes"). Such opportunistic behaviour led to incurable inefficiencies.
- ¹⁶ Implying both transparent and enforceable property rights and responsibility structures
- ¹⁷ Hernando De Soto: *The Mystery of Capital*, p. 69-62
- ¹⁸ Transaction costs are the operating costs (beyond the price of the purchase) of conducting a transaction, whether those costs are money, time, or inconvenience.
- ¹⁹ Quoted in *Policies and Agricultural Development in Ukraine*, p. 29
- ²⁰ *Policies and Agricultural Development in Ukraine*, p. 29
- ²¹ "Law on Collective Agricultural Enterprises" 1992
- ²² The whole issue of land distribution is highly problematic, especially because until today the country has not managed to establish a land registry system.
- ²³ minimum export prices for goods subject to export restriction
- ²⁴ Presidential Decree "On Urgent Measures for Accelerating Reformation of the Agrarian Sector of the Economy"
- ²⁵ The following consideration do not only apply to the agricultural sector of the economy but are relevant in general.
- ²⁶ These functions are in accordance with the property effects described by De Soto.
- ²⁷ The Antimonopoly Committee is an exception. Its activities are made public in annual reports and it issues relatively clear injunctions and rulings. Unfortunately its powers are restricted when it comes to the activities of many state enterprises which have sufficient connections to political decision-makers in Kiev.
- ²⁸ Even after this moratorium, individuals will not be allowed to own more than 100 hectare of land until the year 2010. Moreover, foreign physical persons and legal entities cannot own agricultural land.
- ²⁹ Income through leasing payments and sales revenues would become an option in addition to the common subsistence farming of household plots.
- ³⁰ For instance, they can use the threat of unemployment or exclusion from the social sphere when somebody refuses to sell their land at a low price.
- ³¹ Land Code, Chapter 5: Land of Agricultural Purpose; Article 22/4: Land of agricultural purpose may not be transferred in ownership to foreign citizens, stateless individuals and foreign legal entities, as well as foreign countries.
- ³² Article 134: State- or communally owned land plots slated for sale to subjects of entrepreneurial activity for construction shall be subject to competitive sale.

Article 135/1: Land sales shall be conducted by auction or competition.

- ³³ A factor that contributes to that phenomenon is that under socialist property rule land registry systems deteriorated because they lost their judicial and economic significance.
- ³⁴ This attitude partially explains the reluctance of many Ukrainians to give away their land to foreigners.
- ³⁵ This attitude is not completely foreign to some Westerners either. If you suggest to a German farmer to abstain from cultivating her land, she might be very reluctant to do so, although the compensation she would receive could be equal, or in certain cases even higher, than the yield she would get after selling the crop.
- ³⁶ An institutional equilibrium arises if a system of formal rules (e.g. a formal property system) is completed by a system of informal rules and the respective enforcement arrangements. For this to happen, as mentioned already, values and social norms need to adapt to the new circumstances, hopefully informed by a high level of public discussion. Furthermore, a high amount of specific investment into politics and education is decisive.
- ³⁷ Land Code, Chapter 34: The State Land Cadastre; unofficial translation from Ukrainian.
- ³⁸ The following is drawn from the paper "Wesentliche agrarpolitische Entwicklungen in der Ukraine im Jahr 2001" by Ludwig Striewe, member of the Institute for Economic Research and Policy Consulting, University of Göttingen.
- ³⁹ Ukraine submitted its official application for WTO accession in November 1993.
- ⁴⁰ The use of indicative prices is banned under Article VII of GATT.
- ⁴¹ Decree No. 832, June 2000, raised the spectre of export certification. Together with measures such as mandatory crop insurance (January 2001) this decree opens a whole range of possible interference with grain exports.
- ⁴² All these measures undermine the Ukrainian Law "On State Regulation of Import of Agricultural Products" (Article 5), stipulating that "[...] *local governments are forbidden to ban the movement of goods among rayons and oblasts, to oblige farmers to deal with particular food processors and purchasers of agricultural products, as well as to set minimum farm-gate and wholesale prices*". This clash between the official commitment to trade liberalism on the one hand, and the imposition of all kinds of trade barriers on the other, definitely does not promote any confidence in state policies. It creates a climate of uncertainty and distrust.
- ⁴³ In „*Policies and Agricultural Development in Ukraine*“ p. 69
- ⁴⁴ Another danger arising from over-regulation and the huge tax burden for the formal sector is the transformation of business to the informal sector.
- ⁴⁵ Personalised income support and education programmes
- ⁴⁶ By enhancing transparency in this way, uniform accounting standards are an important means to solve principal-agent problems.
- ⁴⁷ Cabinet of Ministers Resolution No. 1461 "On Measures to Stabilise Agricultural Production"

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- ⁴⁸ Law "On Writing Off and Restructuring the Debts of Farms and Procurement Organisations on State Budget Loans" from 24 September 1999
- ⁴⁹ The number of farm workers per 100 hectare was 8.3 in 2000. This number is expected to shrink considerably. Unfortunately, the government has still not developed a consistent policy to deal with the consequences of this process.
- ⁵⁰ Here the significance of investment into human capital and modern technology becomes apparent.
- ⁵¹ The rather lax attitude towards debt repayment, developed under communism and nourished in the first years after independence by regular debt write-offs, reinforces the problem.
- ⁵² This inability is reinforced by the lack of the application of uniform accounting standards. Many enterprises also engage in double-book keeping.
- ⁵³ Information asymmetry is understood here in the way described in the principal-agent model.
- ⁵⁴ Interest rates in the Ukraine have after independence have always been well above 20 per cent.
- ⁵⁵ The term "credit" can be traced back to the Latin verb "credere", which means "to believe", "to trust".
- ⁵⁶ Other measures that were more costly were the writing off of tax debts and the exemptions of agricultural enterprises from VAT.
- ⁵⁷ The inefficiency of the social insurance system is partly due to the overlapping of benefits and subsidies. For instance overlaps occur between social insurance payments and government social expenditure on the one hand and enterprises' social expenditure on the other.
- ⁵⁸ The social security contribution rates in Belarus and the Ukraine are the highest in Europe, above all because the Chernobyl accident in 1986 was followed by the creation of a new social insurance fund (the Chernobyl funds) financed by an additional contribution on the gross wage (12 per cent of gross wage, reduced to 10 per cent in 1997) to alleviate the consequences.
- ⁵⁹ Even without mentioning that this quasi-tax on farmers works as a production disincentive.
- ⁶⁰ In the case of price intervention in the sugar market 1998, definitely not all "preferential sugar" ended up being sold over the counter. Traders who had access to it had strong incentives to sell it privately at higher prices.
- ⁶¹ Another point worth mentioning is that as long as managers have only limited control over the expenditure of the enterprise due to expenditure on the social sphere, the owners (state, private owners) cannot hold them fully accountable for the success of the enterprise. This increases the information asymmetry, which is at the root of principal-agent problems and thereby increases the scope for rent-seeking and corruption.
- ⁶² Suggestion for the development of these insurances and funds can be found on pages 174 – 182 in *Ukraine at the Crossroads*.
- ⁶³ Especially endogenous growth theory recognises human capital as a factor of

production in addition to physical capital and the labour force. Some of those models explicitly assume beneficial externalities of investment in human capital. However, the degree of these externalities is still unclear. For instance, it is difficult to measure the beneficial externalities associated with the relatively expensive educational services such as higher education.

- ⁶⁴ When I visited the University of Kiev in 1998 one of the professors "jokingly" told me how honoured she felt to teach the children of Mafia bosses.
- ⁶⁵ Additionally, relatively low tax rates and few tax exemptions are desirable.
- ⁶⁶ In rural areas, for example, subsistence farming and casual jobs play a crucial role in providing employment and income opportunities for many.
- ⁶⁷ The costs of operating a business in the informal sector generally outweigh any tax savings anyway.
- ⁶⁸ Ann Florini, Annual World Bank Conference on Development Economics, 1999
- ⁶⁹ IMF, n.d. "International Standards Related to Fiscal Transparency", Report of the Working Group on Transparency and Accountability, Washington, D.C., 1998
- ⁷⁰ Philip Pettit: *Republicanism*, p.253
- ⁷¹ See Oliver E. Williamson: *The New Institutional Economics*
- ⁷² Here the principal-agent model is applicable. The state was the principal, while each of the successive levels within the hierarchical economic structure were both principal and agent simultaneously. Due to hidden action and hidden information on the part of the agents, inefficiencies occurred and agents would keep an extra-yield for themselves (commodities, extra time). This, in turn, weakened the standing of the principal.
- ⁷³ Orwell's "1984" makes this point clear in a very vivid and shocking manner. It was not for nothing that the book was forbidden under communist rule.
- ⁷⁴ Sadly enough, members of the secret service often diffused even those narrow circles. When people in Germany, for instance, were allowed to read their Stasi-files, many found out that close friends or even their spouses had been reporting on them for decades. The destructive effect that had on many human relationships and on the psyche of people in general, is definitely considerable. It will take a long time to recover from such experiences of betrayal and distrust.
- ⁷⁵ Of course, it would be interesting to research how far Western media had an influence on the changes, which took place in 1989 and to what extent it helped to glorify the Western value system and standard of life.
- ⁷⁶ Benedikt Herrmann from the University of Göttingen is currently investigating the consequences that the Stalinist terror system of fear and uncertainty had on people's patterns of behaviour. The behaviour acquired under such conditions is likely to be transmitted from one generation to the next. Opportunistic behaviour like free-riding and the lack of sanctioning of such behaviour within society is expected to be such a consequence.
- ⁷⁷ When I asked a Ukrainian friend of mine about the current situation in his country, he reminded me of the following saying: "A people gets the government it deserves". Although that might sound cruel, it stresses the

fact that government will only improve when people actively demand it.

⁷⁸ The trust created through this kind of co-operation is also a major precondition for the success of every foreign investment project.

⁷⁹ For useful information concerning the work of these institutions visit the following websites:

<http://www.worldbank.org>; <http://www.ebrd.com>; <http://www.usaid.gov>

⁸⁰ The governments of high-income countries, which provide the funds for its operations, control the IMF. The U.S. government has apparently the greatest influence since it owns over 18 per cent of the voting shares in the Fund. Not surprisingly IMF programmes attempt to create the conditions that are likely to support U.S. interests and in particular the interests of U.S. based international operating firms.

⁸¹ Needless to mention that this does not encourage foreign or domestic investment either, what is a pity, since encouraging private capital flows is one of the IMF's main development objectives. See G. Birds article "A suitable case for treatment? Understanding the ongoing debate about the IMF".

⁸² The IMF has a particularly bad reputation when it comes to listening to local experts.

⁸³ See <http://www.worldbank.org.cdf>.

⁸⁴ Given the Government of the Ukraine's long-lasting ambivalence about comprehensive reforms, this makes a lot of sense.

⁸⁵ The TACIS programme was launched by the EC in 1991 and provides grant-financial technical assistance to 13 countries of East Europe and Central Asia aiming at enhancing the transition process in these countries.

⁸⁶ USAID is the United States Agency for International Development.

⁸⁷ For instance, under the World Bank's *New Assistance Strategy* for 2001-2003 for the Ukraine, US \$40 million are provided for the Social Investment Fund Project to support the development of community-based services for the worst-off in society; another US \$ 65 million are provided for the Tuberculosis and AIDS Epidemic Control Project.

⁸⁸ The *World Business Environment Survey*, for instance, asks detailed questions about various dimensions of governance. It elicits, for example, specific information about the share of bribes paid in total revenue and on the percentage bribe fee "cut" in public procurement projects. With the participation of the EBRD, this enterprise survey is largely complete for transition economies. See also: "Governance Matters – From Measurement to Action" by D. Kaufmann, A. Kraay, and P. Zoido-Labaton.

⁸⁹ Apart from this, Internet access is expensive. The possession of a computer alone is considered to be a luxury.

⁹⁰ For a full description of the project see USAID's Final Report by Kevin Covert: http://www.dec.org/pdf_docs/PDA.PDF.

⁹¹ PwC provided policy and strategy consulting. They designed new methods to accelerate free transfer and recommended share sale strategies to attract foreign investors and to meet IMF privatisation targets.

⁹² See Final Report, p. 10.

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- ⁹³ It's worth mentioning that the list of speakers only contains the names of Ukrainian experts, who have made their experience in the Ukrainian privatisation process.
- ⁹⁴ For example, from 1997 the project assisted the Skvyrskyi Grain Processing Enterprises in Kiev oblast with every stage of privatisation (preparation, registration of the company, etc.) Employees now own almost 60 per cent of the company shares and have developed a business attitude that helped them to improve the performance of their enterprise significantly.
- ⁹⁵ may they be Ukrainians or foreigners, potential investors or not
- ⁹⁶ Although the SPF did not meet the IMF target to privatise 442 grain elevators to 70 per cent by the end of June, 1999. For detailed privatisation data see the Annex of the Final Report, p. 40.
- ⁹⁷ It is still maintained in the ports.
- ⁹⁸ One might just hope that this kind of journalism does not copy the CNN-style in all the details.
- ⁹⁹ For a detailed account of the *Ukraine Anti-Corruption Support Project* see the Final Report submitted by MSI Management International:
<http://www.gov/democracy/anticorruption/p3/ukraine.doc> .
- ¹⁰⁰ For a detailed account of NGOs in the Ukraine see *Assessment of Non-governmental and Civil Society Organizations in Ukraine and Moldova* (July 2001, English) on <http://www.usaid.kiev.ua>.
- ¹⁰¹ One might think about Germany in the 1960s and 1970s as a comparatively harmless example. That was a period of change, but people were not poor today and rich tomorrow. Despite '68 they were not suddenly sexually liberated. Patterns of behaviour and attitudes have changed only gradually.
- ¹⁰² The German Government would do well in accepting that not every person from Eastern Europe or the FSU is a potential criminal. Locking people out of the country is not going to increase national security. On the contrary, people entering the country illegally will pose a more severe problem.
- ¹⁰³ See *The Economist: Ukraine's General Elections*, February 9th – 15th 2002, p. 27-28.
- ¹⁰⁴ Unfortunately that does not mean that the intimidation of journalists, the denial of access of some candidates to the media and slightly unbalanced news coverage are once and for all matters of the past.
- ¹⁰⁵ For the creation of their land registry, for example, Ukrainians are currently weighing up the advantages and disadvantages of the American version of a land registry and the German Grundbuch system.
- ¹⁰⁶ The only kind of design he accepts is the design of constitutions in accordance with the rule of law.
- ¹⁰⁷ F.A. Hayek: *The Constitution of Liberty*, p.406
- ¹⁰⁸ Including both formal and informal institutions
- ¹⁰⁹ F.A. Hayek: *The Constitution of Liberty*, p.402

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The web sites pointed out in the endnotes were visited between the 4th and the 14th of February 2002

For an update on current developments of the Ukrainian economy I highly recommend the IER web site <http://www.ier.kiev.ua> .