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AN INSTITUTIONAL FRAMEWORK FOR ECONOMIC DEVELOPMENT IN UKRAINE

The paper discusses the nature and types of institutions, raising the issue of the international involvement to change them. Also, the work addresses the problem of economic institutions in Ukraine. In specific, the author addresses the property rights as a bundle of rights, suggesting the necessary preconditions for their effective exercising. Also, the paper deals with the current state of property rights in Ukraine, illustrating its main deficiencies. Finally, a brief perspective onto the privatization of enterprises in Ukraine is presented.

Key words: *institutions, types of institutions, property rights, security of property, privatization in Ukraine.*

Identifying the problem. The economic growth is often measured in quantitative terms like GDP, exports and imports dynamics, unemployment, inflation, etc. At the same time, there is another term that may be as equally if not more, considered to measure changes in the economy. It is the economic development. While the former quantifies the picture, the development also includes qualitative changes and more holistic indicators like the standard of living and the institutional maturity, which lay the ground for the current work. The institutional framework substantially defines the ‘rules of the game’ and may either promote or hinder the economic development of a country and eventually affect its quantitative indicators. The notion of institutions has no single definition; neither has a defined subject area. Therefore, this article zooms in into the nature of institutions, their kinds, and applicability from different perspectives and fields. We will pay closer attention to property rights and their applicability in Ukraine. As a case study, we will consider the privatization of state enterprises in Ukraine.

Literature review. The subject of institutions is widely discussed by many authors

including Douglass C. North [1], Carlos Pereira and Vladimir Teles [2], A. Hritsenko [3], and other authors that will be referred to below in the text. While research seems to abound, the author of the paper felt the need to deeper understand the discussed subject and bring more interdisciplinary approach into its consideration. In this work, he attempts to present a clear and concise addressing the institution as an abstract concept, as well as present a fusion of political science, in specific, neoclassical realism, with institutional economics, while applying this theoretical framework onto the current Ukrainian situation.

1. Institutions as an abstract class

The notion of institutions is broadly defined, and it includes several approaches. The present conception of institutions and how they mark economic growth results goes back to Douglass C. North, who briefly described them as “the rules of the game,” the norms and mechanisms of society [1]. In other words, institutions create possibilities and limitations, which the society imposes on itself via its understanding of what rules have to be and how they should be executed. Though nothing is static, these concepts in

the minds of people are not easy to change, as will be shown below. It is these norms that affect individuals and social groups in economic, social and political terms.

Like everything in nature, institutions do not exist separately from a) the minds of people; and b) from each other. Indeed, economic institutions are closely interrelated with political and social institutions, which essentially reflect the attitudes of society in various areas of human expression [2]. Together they form a system or structure of relations in society. However, we may go even further by saying that certain institutions guide *all* spheres of human existence. Thus, they could distinguish between *technological* (technical, methodological), *socio-economic* (political, economic and social), and *ideological* institutions (ideology, beliefs, religion, tradition, and norms) [3, p.28]. Further, institutions as such can either be formal (legislation, contracts) or informal ('unspoken laws,' traditions and norms). The latter essentially project the former but go beyond them.

Now, if institutions constitute the norms of behavior and interaction among the units of society, then *limitations* necessitate the adjustment of activities in a certain direction. Taken broadly, these limitations can be of economic (income / economic assets), political (voting rights, citizenship), social (social cleavages, traditions) nature, as well as in timely measure. This is also true if you take a certain specific instance, such as a product. Any product has a cost, and the end price, which aims to (but not always does) correspond to the assigned value of this product. This value may be *nominal* (essentially expressed in the price), *real* (neatly satisfying the need, which initiated the product's emergence) and *imaginary* (that overlaps or even contradicts the former, and is largely inherent to the luxury products).

As mentioned before, the institutional framework of society does not easily change. Indeed, you could compare it to the conservative or form-preserving aspect, aiming to preserve the *status quo* [3, p. 48]. It does not mean, however, that institutions do not change at all. On the contrary, new ideas,

once having received the public support and consensus among social groups, firmly established. One of the best examples of this can be the abolition of slavery. In many cases, even when new ideas become popular, but yet lack a) the coordinating effect of society and b) the solid reflection in the legislation, and c) enough resources to back them, their impact will be limited. By the solid reflection I not only mean respective legislative base, but also effective mechanisms of enforcing this in practice. Otherwise, the wishes for the new 'rules of the game' will remain wishes, and economic agents – hostages to the prevailing order, which they are not able to change. In this way, weak and rudimentary institutions produce a weak effect on society in the end. Contrary, strong and mature institutions raise the effectiveness of resource distribution, informational exchange and thus improve the economic well-being of society at large.

Finally, institutions are strong when easily enforced. The two forces can shape the institutional framework, and they are internal and external forces. Internal forces include *society groups* (workers, small and medium entrepreneurs, civil activists, economic elites), which coordinate their collective action to achieve the set objectives and modify the rules. Externally these are essentially *third* (usually powerful) *states* and *international organizations*. The latter may either be interested in preserving the status quo or initiate institutional transformations. At the international level, the degree of receptiveness to the external pressure depends on several factors. Steven Levitsky and Lucan Way in their book *Competitive Authoritarianism* define two major factors, i.e., the *Western leverage*, and *linkage to the West*. Western leverage may be defined as governments' vulnerability to external pressure. It rests on the potential of the economy of a recipient state, unity of efforts between and domestic and international actors, and counterproductive measures of other powerful states. Linkage to the West as a center of change is another important factor showing the degree of (inter)dependence that "connect individual polities, economies, and societies to West-

ern democratic communities” [4, p.41]. This linkage may be in the area of the economy, technology transfer, intergovernmental co-operation, and lastly between the societies in the actor’s and recipient states. In this regard, I would also add another two factors, i.e., *geographical proximity* and *(inter)dependence between the promoter of institutional changes and a (quasi)authoritarian state* that also has its interests in the given recipient state. International actors *ceteris paribus* tend to take an active role when the linkage with the recipient state is high; yet should the latter also have a great degree of dependence on the huge ‘conservative’ opposing state, the result may become quite different.

Once again, the interrelation between institutions matters, yet economic institutions seem to matter the most. Indeed, Roll and Talbott find that nine institutional variables explain over 80 percent of the international variation in per-capita gross national income, with property rights (+) and black market activity (–) having the highest levels of significance. The other variables are stated regulation (–), inflation (–), civil liberties (+), political rights (+), freedom of the press (+), government expenditures (+), and trade barriers (–) [5, p. 4].

II. Economic institutions & Property rights

The economic system nourishes the society with necessary material means of production and consumption and defines the rules of interaction of economic agents. Moreover, it supplies individuals with economic power, which they easily turn into political preferences and shape the political agenda. Likewise, economic institutions shape the incentives of key economic actors in society. In particular, they influence investments in factors of production (capital, human development, technology), and essentially frame the state’s distribution of economic resources.

The main economic institutions divide into two categories: *basic* and *advanced*. The basic ones include the rule of law, market predominance, property rights, and a respective judicial system able to effectively protect them. Advanced institutions – institutions

of factors of production – build on the basic ones, and include not only the physical property but also financial assets, contracts enforcement, and intellectual property rights. Also, macroeconomic stabilization and mitigation of negative market externalities (through social protection and the welfare state), and transaction costs play an important role as well.

As noted before, power matters. To understand how economic institutions form, we need to consider the political actors, who have *de facto* political power. These can naturally be the ones possessing *de jure* power, such as government, but may also include other actors like the army, oligarchic circles or religious elites. These agents can shape the political agenda and thus the “rules of the game.” For example, in Ukraine, oligarchic circles are directly connected with the government, with Ukrainian presidents being one of them.

Any property is the result of labor regardless of its nature – be it physical or intellectual labor – which creates the means of production. Depending on the attributing the result of labor, the property can either be *private*, *collective*, or *state* (with the state property being a specific case of collective property). The proportion between these two, i.e., private and state property, essentially defines an economic freedom and rule of the market. However, in practice, a purely private property often does not exist due to the taxes, which are essentially expropriation of a part of the value of the created product.

The two essential elements of property rights are (1) an exclusive right to use their resources as they see fit as long as they do not violate someone else’s rights and (2) the ability to transfer or exchange those rights on a voluntary basis. The broader and stronger the protection of private property rights is, the more effectively prices are set and resources – allocated [6].

From the institutional perspective, a property right is not a single right, but rather a bundle of interconnected and mutually inclusive rights. According to A. Honore, there are eleven sub-rights for property, and these are as follows: the right to *possess*, the right

to use, the right to manage, the right to the income, the right to the capital, the right to security, the incident of transmissibility, the incident of absence of the term, the prohibition of harmful use, liability to execution, and residuary character [7, pp. 370–375]. While most of these are self-explanatory, one right requires an additional emphasis and clarification. This is the right to security.

To start with, the right to security refers to the owner's position to remain as such for as long as he wishes. Legally speaking, this is security from expropriation, based on clear rules which prohibit such an action in cases others than bankruptcy and execution for debt. In the latter case, the transmission of ownership is consensual. In this respect a relevant question on the actors of expropriation may arise, namely, if some property poses a strategic interest to the state security and to be nationalized. Cases like this indeed took place in history, especially during war times. However, other things equal, if the state conducts a well-grounded expropriation, in cases specified by law, an adequate compensation to be paid to the previous owner. Naturally, such an action is not feasible with ordinary economic agents in cases others than previously referred to.

Building strong property rights in poor (or weak) countries is pretty difficult. Historically, weak institutions in colonies were desirable by the European powers to obtain and sustain the access to natural resources in these countries. Indeed, per Acemoglu, Johnson, and Robinson [8, pp. 1167–1199], many colonies in Africa, Central America, the Caribbean, and South Asia, did not enjoy much protection of private property rights, nor did they have effective checks and balances against the government. Since the aim was to extract resources, “throwing a bone” to the local elites and government officials and “respecting their property” sufficed. At the same time, the vast majority of the population had no such rights and was largely incapable of securing them. Such a disproportion naturally produced a massive inequality and impeded the economic growth. Even today small and medium enterprises create the majority of the

country's GDP, not huge holdings. However, in cases when Europeans decided to settle (United States, Canada, Australia, New Zealand), it was in their interest to introduce an effective protection of property.

The lack of protection of property rights is the fundamental cause for weak economic institutions and is the source of inequality. Put plainly, this lack of protection and “redistribution” is called stealing and expropriation. While the motivation to obtain a bigger share of the country's wealth may stay the same, kleptocratic leaders have various means of achieving this goal. For instance, in Zimbabwe, the mass expropriation of agricultural land led to an economic collapse, with the GDP per capita falling by around 50 percent since the introduction of the Fast-Track land reform policy in 2000. In Ghana in 1970s agricultural policies were motivated by the same desire to redistribute incomes, but the property rights of rural producers were never challenged [9, p. 10].

III. Property rights and privatization in Ukraine

The introduction of private property in Ukraine took place with gaining independence in 1991. Since the country did not have a long history of independence, it negatively affected the development of political, economic and social institutions at large. Before the communists' takeover, the territory of Ukraine had primarily been the resource base for other powers, including the Tsarist Russia. None of them wished mature institutions. Therefore the protection of private property, especially for SMEs and peasants was quite limited.

The communist era aggravated things even further. With the introduction of collectivization, “de-kulation¹,” and the Famine, fragile market institutions saw their end. Private property was expropriated and nationalized, with naturally no compensation to the previous owners. They often had to flee the country, since otherwise, they faced death or exile. In this way, by 1990 when the Union broke, the Ukrainian society was not ready to actively step on the market rails and was primarily preoccupied with the physical sur-

¹ The term standing for expropriation of land and capital from the population by the Soviet regime.

vival. Such a situation gave way to the local oligarchic clans, who obviously had a direct connection to the government.

Today the right to *own* is documented in the Ukrainian Constitution, the Civil Code and other legislative documents. Art. 13 of the Constitution states that “the state ensures the security of rights of all subjects of property rights ... All subjects of property rights are equal before the law [10].” Art. 41 continues and specifies: “Compulsory alienation of objects of the private property rights can be applied only as an exception for reasons of public necessity, on the grounds and in the manner established by law, and subject to the prior and full reimbursement of their value. The expropriation of such objects with subsequent full reimbursement of their value is allowed only under conditions of martial law or State of emergency.” Finally, Art. 32 of the law “On property” emphasizes that the owner has the right to reclaim their property from unlawful possession.

In practice, however, the institution of securing the property does not function as it should, and this is for several reasons. First and foremost, legislation often lacks clear implementation mechanisms along with the lack of enforcement mechanisms. Second, due to corruption and inefficiency of judicial system court proceedings may last for a very long time, and they require a sufficient amount of money to keep going. Third, there is a relatively limited financial and legal literacy among the population. And last but not the least, the rule of law usually effectively functions in well-off societies, where citizens are wealthy enough to defend and exercise them actively.

To illustrate, Ukraine is famous for raider capturing of enterprises and other property objects. Raiding contains signs of fraud, robbery (robbery), legalization of property obtained by crime, and sometimes enactment of the knowingly unjust court decision. Therefore, a classic case of raiding includes three stages: scamming the ownership documents, factual seizure with use of physical force, and resale/transfer of the property to the “new owner.”

During the period from 2000 to 2007 in Ukraine between 800 and 3,000 companies were seized, with the average profit exceeding 1000%, and annual volume segment of mergers and acquisitions (excluding privatization) about USD 3 billion [12; 13]. According to some estimates, there are about 30-50 specialized raider groups in Ukraine. They rely not only on lawyers, but also armed groups, and sometimes even law enforcement officers.

The victims of raiding have been the «1 + 1» TV channel, Dnipropetrovsk oil extracting plant, Norwegian company «Teenor», which owns the shares of «Kyivstar», etc. Attempts of raider attack were made on Kryukovsky Train Repair Plant and Brovary Plant «Strela» [14].

While still widespread, some attempts to fight raider are being made. Notably, The Cabinet of Ministers of Ukraine amended paragraph 12 of the Procedure for the State Registration of Rights to Immovable Property and their encumbrances, by which state registrars are obliged to check the real estate judicial decisions in the single state register for their availability [15]. In addition, the Law No. 5067 provides for the introduction of criminal liability for crimes in the sphere of state registration of business and rights to real estate (up to eight years of imprisonment with the possibility of seizure of property), technical improvement of the real estate register as well as the improvement of special software for the implementation of registration activities [16]. These measures could be indeed helpful, since widespread illegal changes in the property registers are still often documented, with the Commission of the Ministry of Justice satisfying 50% of all complaints submitted to delight business and real estate in 2016.

With economic miseries blossoming in the 1990s, privatization of national wealth was gaining momentum. By April 1997, over 9,600 out of 18,000 existing medium-sized and large enterprises were privatized, with 6300 being completely privatized². Additionally, 38,600 out of 45,000 small enterprises owned by

² I.e. having over 70% of shares distributed to private owners.

the state had also been privatized. By early 1999, the overwhelming majority of the 277 largest enterprises, with assets exceeding 170 million UAH, have been privatized only partially. In this way, the new class of oligarchs, people that had influence and/or affiliation to politics and possessed economic resources, emerged and was strengthening its positions³.

According to the Ministry of Statistics of Ukraine on 1 July 2001, about 74,465 enterprises were privatized. By and large, by the end the presidency of Leonid Kuchma in 2004 the most important objects in metallurgy (Metallurgical Complex “Azovstal”, Metallurgical Complex of V. Ilyich, Yenakiyev Steel Plant, Khartsyzsk Pipe Plant, etc. Krivorozhstal / Arcerol Mittal) have already received new owners. The last case of Arcerol Mittal is probably the soundest one, during all privatization history of Ukraine. In 2004 president Kuchma gave a “green light to purchase of the biggest metallurgical plant in Ukraine to his close counterparts – V. Pinchuk (the husband of the only daughter of Leonid Kuchma), and R. Ahmetov. After coming to power in 2005, Tymoshenko’s government made the appeal submission to the Supreme Court of Ukraine with a demand to cancel privatization, and the Supreme Court agreed on 1 March 2005. On 24 October 2005, the new tender took place, where a Germany based company, Mittal Steel GmbH., bought 93% of shares of Kryvorozhstal for 4.8 billion US dollars. The new price for the plant was six times bigger than the amount received for it in 2004.

At the same time, it is important to differentiate between the formal privatization and *de facto* control over enterprises. Irrespective of formal ownership changes, spontaneous privatization in the 1990s means the *de facto* appropriation of state assets. The first form of spontaneous privatization is leasehold and joint stock companies. Thus, “DTEK”, the company owned by R. Ahmetov, became the owner of 25% of shares of

“Dniproenergo,” 25% of “Kyivenergo”, 40% of shares of “Donetskoblenergo” 45% of “Zapadenergo”, 45% of “Krymenergo” and 50% of shares of “Dniproenergo.” [18] In 2015-2016 the Cabinet of Ministers of Ukraine signed decrees to start another round of privatization. In particular, some 450 state companies, as well objects of movable and immovable property, including 20 large companies and 50 medium-sized companies, are to be privatized [19].

Conclusions. Institutions in the broadest sense frame society in many ways. They define both opportunities and limitations of interactions between [economic] agents and thus present the crystal lattice of society. With respect to the economy, property is one of the fundamental institutions, which shapes the distribution of material resources. This institution is composed of a bundle of rights, which include the right to own, transfer, and secure [private] property.

Given the lack of statehood, constant foreign intervention and the subsequent Soviet rule, economic institutions in Ukraine have been historically weak. In Post-Soviet Ukraine, the process of attributing the property to private individuals (privatization) in Ukraine has been far from transparent. Enterprises have been distributed into the hands of oligarchic clans using opaque schemes and often also criminal methods. In addition, the right to security of private property has also been fragile, given the frequent raiding and quasi legal expropriation of assets. Despite sound declarations of politicians, the society receives little if anything from the income gained after such privatization. Moreover, this situation does not change with every subsequent government, which proves the hypothesis on crystallization of governance structure in Ukraine. Thus a successful transformation of the current rules shall first depend on the big players in economy, as well as a coordinated effort of society to enforce and facilitate this process.

³ A post-Soviet oligarch a) engages a primary accumulation of capital, not without criminal methods; b) is directly involved (personally or through marionettes) in politics; c) population knows him primarily in face. The Western capitalist conversely a) does not usually engage in politics directly, using professional lobbyists; b) he is not a direct target of people’s anger and often achieves his goals while staying in the shadow.

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В статье рассматриваются природа и типы институтов, освещается вопрос роли международного влияния на их изменение. Кроме того, рассматривается проблема экономических институтов в Украине, в частности права собственности как совокупность прав. Автор анализирует необходимые предпосылки для их эффективного осуществления. Также рассмотрено текущее состояние прав собственности в Украине, представлены их основные недостатки.

Ключевые слова: институты, типы институтов, права собственности, безопасность собственности, приватизация в Украине.

У статті розглянуто природу і типи інститутів, порушено питання про роль міжнародного впливу в їх зміні. Крім того розглянуто проблему економічних інститутів в Україні, зокрема права власності як сукупність прав. Автор пропонує необхідні передумови для їх ефективного здійснення. Також розглянуто поточний стан прав власності в Україні, наведено їх основні недоліки.

Ключові слова: інститути, типи інститутів, права власності, безпека власності, приватизація в Україні.

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