THE PARADOX OF PIPELINES: ECONOMIC AND POLITICAL EFFECTS OF TRANSIT WEALTH

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ABSTRACT

BRANDON RICE: The Paradox of Pipelines: Economic and Political Effects of Transit Wealth
(Under the direction of Dr. Malada Anna Vachudova)

This article investigates the impact oil and gas pipelines have had on the political and economic development countries such as Ukraine and Belarus. The article uses post-Soviet Ukraine as a case study to develop a transit curse theory highlighting the negative effects of transit revenues. This transit curse in many ways operates similarly to the well-known resource curse, disrupting healthy economic growth and preventing the establishment of responsible governance. The example of Ukraine shows that even once the transit revenues are effectively removed, the legacy of the formal and informal institutions built up by those revenues continues to hinder healthy economic growth and accountable governance.
ACKNOWLEDGEMENTS

While my name may be the only one officially listed in the author line, this thesis certainly could not have come to fruition without the help, support and encouragement of my advisor and committee members, Dr. Milada Anna Vachudova, Dr. Graeme Robertson and Dr. Jacqueline Olich. I am especially grateful to Drs. Vachudova and Robertson, whose seminar on democratization laid the seed that eventually became the thesis before you now.
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INTRODUCTION

The sight of tents and orange-clad protesters on the streets of downtown Kyiv marked what many observers thought was the beginning of a new chapter in Ukraine’s post-Soviet economic and political development. The 2004 electoral revolution in Ukraine was hailed as yet another surge in the “third wave” of democratization. Such optimism, it appears, was premature. While we have seen intense political competition, fairer elections and more orderly rotation in office since those snow-filled weeks in 2004, Ukrainian elites have failed to significantly improve the way the government and economy are managed. This disappointing state of affairs raises two questions. First, why did this democratic breakthrough only materialize in late-2004, and not earlier like in many of Ukraine’s eastern European neighbors such as Estonia, Latvia, Lithuania and Poland? Second, why has stronger political competition and regular political turnover not brought more effective and accountable management of the economy and state?

I argue that oil and gas pipelines have contributed substantially to Ukraine’s political and economic backwardness. First, in comparison with many of its neighbors, Ukraine failed to exhibit healthy economic growth and develop truly democratic institutions in the late-1990s and early-2000s. I argue that transit revenues systematically damaged the economy while simultaneously enabling the government to maintain a tight grip on power despite such failings. \(^1\) Crucially, significant revenues generated by the

\(^1\) Authors such as Michael McFaul have noted that there was impressive growth in Ukraine’s GDP in the last years of Kuchma’s reign, but I contend that such GDP growth was buoyed by large transit revenues and
pipelines allowed the ruling elites to subsidize society, thus dampening internal demands for democratization and liberalization. Additionally, the pipeline network enabled then-President Leonid Kuchma to act as a rent-distributing arbiter to ensure the loyalty of economic and political elites. In this way, transit revenues in Kuchma-era Ukraine permitted the establishment of a two-tiered rentier society built around oil and gas pipelines.

Second, the post-Orange-Revolution elites have failed to reliably and effectively govern. I argue that here too the pipeline network has played a significant, albeit more indirect, role in hindering accountable governance. While the electoral system was significantly improved, many other aspects of society remained unreformed. Most importantly, the rentier society that emerged under Kuchma (and was significantly supported by transit revenues) was left untouched while at the same time the energy trade remained opaque and riddled with corruption.

In 2006, the situation changed dramatically: the country’s leaders agreed to an arrangement that effectively negated the substantial transit revenues flowing into state coffers. The loss of such revenues has put enormous strain on the Ukrainian state budget, already burdened by the legacy of high subsidies and low taxation. Ukrainian leaders, however, fearful of taking social benefits away from the electorate, have allowed the budget to amass larger and larger deficits, bringing the economy as a whole to the point of collapse. While increased political competition did lead to the institutional reforms prescribed by comparative politics scholars, such as an improved electoral system, it did not bring improved governance.

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government expenditures. Such growth was neither healthy nor sustainable, as evidenced by the collapse of economic growth following the removal of such significant transit revenues in 2006–2009.
My purpose in this thesis is two fold. First, I develop a theory identifying substantial transit revenues as an important mechanism hindering healthy economic growth and democratic development in countries. I call this theory the \textit{transit curse}. Second, I show that while increased political competition may foster much-needed institutional reforms, it does not necessarily lead to improved governance.

This article is divided into seven sections. Before I deal with the complex processes at work, I need to first establish the facts regarding transit revenues in Ukraine. Therefore, the first section is devoted to sorting through the details of what is a rather opaque business. To do so I rely on a myriad of Russian-, Ukrainian- and English-language sources. Among first-hand sources, I utilize Naftogaz annual reports, official Ukrainian state budgets and documents from other official statistical offices. I rely on second-hand sources as well, such as publications from the Oxford Institute for Energy Studies, the Institute for Economic Research and Policy Consulting, Ukrainian newspapers and a leading scholars in the field.

The second section introduces the main elements of the transit curse that afflicts countries such as Ukraine. In doing so, I tap the vast literature on the development-retarding aspects of natural resource endowment, also known as the resource curse. The transit curse has three main effects: the \textit{Dutch disease} hinders healthy economic growth; the \textit{rentier effect} dampens domestic pressure for more effective governance; and \textit{sending state leverage} affords the energy-exporting state extraordinary influence over the transit government.

Having established the existence of transit rents and the theoretical underpinnings of the transit curse, in the third section I explore how the recently centralized transit
revenues affected the economic development and democratic trajectory of Ukraine—a country which, given its history, location and population, should have been among the success stories of post-communist eastern Europe, not one of the laggards. I examine three effects of the transit curse from 2000 to 2005 in Ukraine. First, I show that at the very least Ukraine’s economy possesses many of the symptoms of one caught in the resource trap. Second, I highlight how Kuchma’s regime used the pipeline network to buy patronage from the masses and extract loyalty from the elite. Third, I demonstrate how Ukraine’s ‘double dependence’ afforded the Russian government and state-owned export monopolies extraordinary influence over Ukraine.

Billions of dollars in transit revenues, while able to buy patronage and loyalty in the short and medium term, failed to prop up the corrupt and inefficient regime in the face of a nearly unified international outcry against a horribly botched attempt to steal the 2004 presidential election for Kuchma’s hand-picked successor. Addressing the confluence of factors that allowed the Orange leaders to seize on an outburst of popular support is beyond the scope of this paper, but suffice it to say that it took the coincidence of powerful internal and external dynamics to make it possible. This ‘revolution’ was nearly immediately hailed as a huge success for democracy in eastern Europe. It was thought by many to be the beginning of Ukraine’s long-awaited reconnect with Europe. Unfortunately, the electoral and institutional reforms that followed have not moved the country any closer to Europe, nor have they led to improved governance.

With that in mind, in section four I first discuss the expectations placed on post-Kuchma Ukraine by observers and scholars, both domestic and foreign. Those expectations, however, have simply not been met. Five years on we see little to no
improvement in internationally assessed governance indicators, continued corruption and
an economy on the brink of total collapse.

So why did genuine, even robust, political competition in adequately fair elections
fail to bring about responsible and effective governance? I argue that Ukraine’s pipelines
and the unreformed society built up around them lie at the root of the problem in section
five. I argue that since the post-revolution reforms failed to address the corrupt, opaque
and monopolistic energy sector as well as the pipeline-revenue-based rentier society, the
new leaders have retained the two-tiered model to buy loyalty that existed under Kuchma.
Despite a few new faces in the halls of power, Ukraine under Viktor Yushchenko in 2005
remained the same corrupt transit-supported rentier state. This uninspiring situation was
made even worse in 2006 when Russian-state-owned Gazprom demonstrated how badly a
doubly dependent state such as Ukraine could be hurt by the sending state. The
agreement arising from the 2006 gas dispute turned Naftogaz from an important
contributor to the state budget into a massive drain on state resources. As a result, the
Ukrainian government now lacks adequate resources to finance the programs traditionally
used to buy mass patronage and support. The combination of Ukraine’s bloated,
unreformed rentier society and the loss of significant transit revenues has resulted in a
persistently corrupt government that has driven the country to the edge of bankruptcy.

Having answered my two puzzling questions, in section six I move on to a
shadow case study of Belarus to test the generalizability of my preliminary theory. I
demonstrate how Aleksandr Lukashenka, similar to Kuchma, has defiantly held onto
power, funding his largely socialist state with transit revenues. The crucial difference for
Lukashenko has been that his regime, and the society over which it rules, is even more reliant on transit-related revenues than Ukraine and has learned from Kuchma’s mistakes.

Section seven addresses several alternative explanations, such as the lack EU engagement, an ethnically divided populace and common problems of post-communist transitions. I find that such hypotheses simply do not appear to be the cause of Ukraine’s lackluster democratic performance, or are impacted by transit revenues themselves.
MONEY FOR NOTHING

Revenues generated from transiting oil and gas give rise to forces that hinder economic development and impede democratic transition and consolidation. In order to develop such a theory more fully, I must find a transit country that represent what Max Weber calls an ideal type. Given Ukraine’s strategic geographic position between the world’s largest energy producer (Russia) and largest combined consumer (the European Union), it would appear to be just that ideal. Therefore, this section lays out the details of the Russian-Ukrainian energy trade and argues why I feel Ukraine represents the best case to study in the theory-generating endeavor.

The energy trade in eastern Europe and the former Soviet Union is, unfortunately, an opaque industry. As a result, I am forced to piece together the transit puzzle from multiple sources, including Russian-, Ukrainian- and English-language publications. In part I draw on Naftogaz and Ukrtransnafta reports to provide much of the general information about the energy transit trade. There are, however, significant gaps in the public record on many of the most important issues (especially concrete pricing and payment structures), for which I must rely on second-hand sources, such as Ukrainian and Russian newspapers, publications from the Oxford Institute for Energy Studies and Institute for Economic Research and Policy Consulting, analysis from dedicated scholars as well as correspondence with experts in the field.²

² Based on personal correspondence with an anonymous source in Ukraine, November 2009.
First, some very simple background figures: Russia is the single largest exporter of energy resources in the world. Russia’s primary market is central and western Europe. To get energy resources from the extraction well to the consumers, a large share must pass through Ukraine. Annually, roughly 115 billion cubic meters of natural gas and 30–50 million tons of oil travel through pipelines in Ukraine, pipelines owned by government-controlled companies (Naftogaz and Ukrtransnafta). These pipelines through Ukraine carry over 80 percent (down from over 90 percent in the 1990s) of Russian gas exports destined for Europe and a significant percent of oil exports. The revenues from these exports provide Russia with the financial resources necessary to support its behemoth state and bloated bureaucracy.

So what does Ukraine receive for enabling Russian exporters (and, by proxy, the Russian government) to earn such astronomical profits? Nominally speaking, quite a lot. The amount varies, but according to my calculations, Ukraine generally receives between US $2 and $3 billion annually for transit-related services. In the past several years the figure has certainly been closer to US $3 billion combined for oil and gas transit and underground storage in facilities located near Ukraine’s western border. Since independence, Russia has paid a transit fee ranging between US $1.09 and $1.70 per thousand cubic meters per 100 km—which was initially paid wholly in kind—for natural gas (which accounts for the vast majority of transit revenues) and has provided energy resources at steeply discounted prices (Naftogaz; Tsarenko 2007; Pirani 2009; anonymous source 2009). Also, Russia has paid between US $4 and $6 per million metric tons—depending on the pipeline utilized—for the transit of oil (Energy Charter

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3 For a more detailed breakdown of transit fees and import prices between Russia and Ukraine, see Appendix 1.
Secretariat). Lastly, Ukraine has received between US $4.95 and $7.85 per thousand cubic meters for underground storage (see IERPC; Tsarenko 2007; Pirani et al. 2009; Pirani 2009). In addition to those transit and storage services, Ukraine was able to re-export energy resources imported from Russia for an additional US $1−1.5 billion per year (Balmaceda 2008). In total, Ukraine has received between US $3 and $5 billion from combined transit, storage and re-export. It is difficult to confidently state what precise percentage of government revenues such sums total given the lack of transparent accounting practices of Ukrainian energy companies and government. I can, however, assert with some level of certainty that in Kuchma’s second term (1999−2004), the value of transit-related revenues was equal to between one-half and one-third of government revenues. Additionally, transit-related revenues amounted to roughly ten percent of Ukrainian GDP.

The most important thing to note, however, is the evolving nature of payments. Given the fluidity of the relationship, I have identified four distinct periods in the Russian-Ukrainian gas trade that help make sense of what is an opaque and complex business. Below, in Table 1, you can see the important characteristics of the four distinct periods.

<table>
<thead>
<tr>
<th>Year</th>
<th>Import price</th>
<th>Payment type</th>
<th>Controlled access to energy rents</th>
<th>Re-export allowed?</th>
<th>Direction of cash flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991−1999</td>
<td>Low</td>
<td>Barter</td>
<td>Oligarchs</td>
<td>Yes</td>
<td>None</td>
</tr>
</tbody>
</table>

4 I should note that here my analysis is based mostly on gas relations between the two states since gas transit is responsible for roughly 80 percent of total transit and storage revenue. Additionally, there is significantly less information available as to the details of the oil trade.

5 For additional details, see chapter 7 in Balmaceda (2008).

6 For additional details, see chapter 7 in Balmaceda (2008).
<table>
<thead>
<tr>
<th>Year</th>
<th>Period</th>
<th>Payment</th>
<th>Source</th>
<th>Government</th>
<th>Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000–2005</td>
<td>Low</td>
<td>Increasingly cash</td>
<td>Central government</td>
<td>Yes, but only through Naftogaz</td>
<td>Naftogaz to budget</td>
</tr>
<tr>
<td>2006–2008</td>
<td>Moderate</td>
<td>Cash</td>
<td>Central government</td>
<td>No</td>
<td>Budget to Naftogaz</td>
</tr>
<tr>
<td>2009–</td>
<td>High</td>
<td>Cash</td>
<td>Central government</td>
<td>No</td>
<td>Budget to Naftogaz</td>
</tr>
</tbody>
</table>

The first (1991–1999) was marked by barter arrangements, subsidized imports and a lack of centralization. Prior to 2000, the pipeline and storage facility operators were paid in kind (i.e., in oil and gas equivalent to the determined fee) (see IERPC; Tsarenko 2007). The revenues generated from selling the obtained oil and gas were used by the companies themselves to fill the gaping holes created in their budgets by artificially low consumer prices (set by the government) and chronic nonpayment by both industrial and household consumers (IERPC; IMF; Tsarenko 2007). Additionally, oligarchic groups took advantage of the loose regulatory system and lax government oversight, capturing the majority of energy- and transit-related rents for themselves (Balmaceda 2008).

However, in the middle of 2000, the Ukrainian government could apparently no longer be on the outside looking in at the huge transit rents available. The law “On State Budget of Ukraine 2000,” required state-owned Naftogaz Ukrainy (which had been established and centralized all aspects of the energy trade in 1999) to transfer a portion of transit payments received for Russian energy to the state budget (IERPC; Balmaceda 2008). Thus began the monetization of transit payments, a process that, as will be shown later in the paper, has had major implications for the political and economic development

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7 Even though the official amount to be transferred to the budget was only a fraction of the total fee paid by the sending companies, I consider the entirety of the transit fee to be government revenue for my analysis. It is prudent to do so because Naftogaz, the company that collected transit payments, was/is a wholly state-owned company, whose management is appointed by the government. Furthermore, prior to 2005 Naftogaz did not publish any public accounting or operating reports. Kuchma’s use of Naftogaz revenue and assets for his personal political gain has been widely discussed both among Ukrainian and US-based experts (see D’Anieri 2007, Balmaceda 2008 and Dubrovsky 2007b).
in Ukraine. Additionally, Ukraine also received another form of payment: highly
discounted prices for the additional oil and gas purchased from Russia.

The second period (2000–2005) was characterized by centralization through
Naftogaz Ukrainy, the phasing out of in-kind payments and the continuing subsidization
of imports. By 2005, the Ukrainian pipeline operators were receiving 65 percent of the
transit fee in cash, giving the government spare resources it had not seen throughout the
1990s (Tsarenko 2007; Pirani et al. 2009; Pirani 2009). Interestingly, this new inflow of
cash at the beginning of the 2000s neatly coincides with manipulation and rigging of
elections as well as increasing expenditures by the state. Additionally, during this period
world and European prices for energy resources began their seemingly unstoppable rise
(which could only be halted by a worldwide economic meltdown), all the while the prices
paid by Ukraine for imported energy remained roughly the same—and in the case of
natural gas, actually declined. State-owned Naftogaz now controlled access to the highly
profitable scheme of re-exporting natural gas (Balmaceda 2008).

In 2006, however, a third era (2006–2008) in Ukrainian-Russian energy relations
arrived, one characterized by complete monetization of transit payments but shrinking
subsidies. In response to Ukraine’s mounting energy debt and the arrival of more
Western-leaning leadership, a gas dispute between Gazprom and Naftogaz came to a
head in early 2006. The result of this dispute was the complete disavowal of the barter
system, a significant increase in import prices and the establishment of opaque
intermediary companies (Pirani et al. 2009). Despite the import price increases, in
2006–2008 Ukraine still paid more than US $100 less per thousand cubic meters than its
closest neighbors (excluding Belarus) and EU countries (Tsarenko 2007; Pirani 2009).
Still, the price increase was substantial—and was not coupled with increased prices for domestic consumers—leaving state-run Naftogaz with huge budget holes to fill. At the same time, the transit fee paid by Gazprom was not significantly increased. As a result, the billions of dollars of transit revenues that had been a boon to the government budget were now required to cover Naftogaz’s operating losses; a troubling situation that was only to be made worse by the 2009 dispute between Naftogaz and Gazprom.

Again on the basis of charges of accumulated debt, another energy row between Ukraine and Russia arose in January 2009. The arrangement resulting from this dispute has led to the fourth era of energy relations between the two countries. The opaque intermediary companies were cut out of the lucrative gas trade (Pirani et al. 2009). Henceforth Ukraine would pay a substantially higher price for natural gas, 80 percent of European netback (i.e., minus transportation costs) in 2009 and the equivalent of European netback prices in 2010, thus ending the 17-year tradition of discounted gas imports. Additionally, the transit price for natural gas remained the same, at US $1.70 per thousand cubic meters per 100 km (Pirani et al. 2009). In stark contrast to the situation in the early-2000s, the Ukrainian government is now forced to use budget resources to keep Naftogaz out of bankruptcy and help it cover its increasing losses.8

While the significant inflow of transit revenues into the Ukrainian budget (until 2005) ought to have been a positive and growth-enabling mechanism, I argue that it is precisely these rents that prevented the development of an effective government and functioning economy under Kuchma. This phenomenon is what I call the transit curse. Additionally, I argue that even though Ukraine’s budget is no longer buoyed by such

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8 For example, in the first two months of 2010, the government has had to pay over 50 percent of Naftogaz’s imported gas bill (Interfax March 5, 2010).
revenues, political elites have been unable or unwilling to end the costly subsidies that were made possible by transit-related revenues and cheap import prices. With that in mind, the following sections lays out my basic conceptualization of the curse and the legacy of Ukraine’s transit-based society.
THE TRANSIT CURSE THESIS

In the seventies and eighties the notion of a resource curse arose from the counter-intuitive observation that the developing countries that had been predicted to perform the best, due to their generous natural-resource endowments, were nearly universally underperforming both economically and politically in comparison to other developing nations. As a result of much research and insight, scholars and analysts concluded that it was precisely the existence of natural-resource wealth that was hampering significant progress. I argue that essentially the same processes at work in resource-rich states are at play in transit states as well. Here I draw heavily on Terry Lynn Karl’s, The Paradox of Plenty, especially in conceptualizing the processes at work in the political realm. I find that there are two areas in which the effects of excess transit revenues very closely mirror those of substantial extraction revenues (political and economic development) and one area unique to transit countries (state autonomy). I turn now to the three ways that transit rents impair a transit-dependent state’s development towards effective governance and a diversified economy.

The Dutch Disease

World Bank analysts were some of the first to systematically explain the counter-intuitive trend in developing countries (Gelb 1988; Syrquin and Chenery 1989). In their work, these authors identified several characteristics shared by states receiving an extraordinarily large proportion of their budgetary revenues from mineral extraction and
export that negatively affected their economic development. These states were said to suffer from what was termed the Dutch disease. The additional revenues flowing into state coffers during a price or production ‘boom’ increase demand for both tradable and nontradable goods, which applies upward inflationary pressure, driving up the strength of the domestic currency, eventually damaging the international competitiveness of other industries (Gelb 1988; Syrquin and Chenery 1989; Auty 1993; Karl 1997). These macroeconomic and sectoral effects lead to a decline in the agricultural and manufacturing industries of the economy as well as a distorted expansion of the service sector. Such distorted economic development often leads to an eventual ‘bust’, especially when the inputs that fueled the initial boom disappear. In resource-rich states this generally happens when prices precipitously fall. In transit states like Ukraine, any removal of transit revenues could elicit a similar bust.

The Rentier Effect

Transit revenues, much like resource rents, also seriously affect the social and political aspects of a state. In fact, many of the socio-political effects give rise to the economic ones (Karl 1997). When political institutions are too weak to effectively constrain regime behavior, transit rents are employed to 1) buy patronage in an effort to gain support for their regime and 2) dampen bottom-up pressures for institutional reform, improved governance or regime change. This is what has been called the rentier effect (Ross 2001). Here the processes at work are two fold: one that garners loyalty through lavish government expenditures and subsidies (the spending effect), and the other that lessens the tax burden on the population (the taxation effect). Additionally, even when a
government adopts potentially useful reforms after the introduction of transit revenues, such reforms will be hi-jacked by rent-seeking groups, thus robbing them of the positive effect they were intended to have (Karl 1997). Taken together, these aspects provide a strong theory for explaining how a government, even if not consciously rent seeking and predatory, is driven by transit revenues to use taxation, subsidization and patronage to resist pressure to reform institutions and allow them to cling onto power through the next election.

**Sending State Leverage**

There is another negative effect of increased budgetary revenues, one that is unique to transit states: sending state leverage. This leverage, in my opinion, may have the most important implications for transit states due to its ability to affect both the political and economic spheres of relevant countries. I argue that transit states are extraordinarily beholden to the energy-resource sending state, so much so that their ability to chart independent economic and political policies is effectively undermined. I argue that transit states are doubly susceptible to leverage from the sending state. They are vulnerable in the traditional sense that most, if not all, transit states are heavily dependent (generally upwards of 75 percent) on the sending state to fulfill their domestic energy needs. An oil or gas cut-off (or even the mere threat) gives the sending state the ability to influence both the economics and politics of the transit state. Secondly, the fact that the sender provides the transit state with an unusually large portion of its budget revenues, a cut-off or construction of bypassing routes again affords the sending state significant sway over the transit country.
Again, a weak institutional arrangement is crucial for this lever to be truly harmful for the transit state. In a developed institutional environment, politicians would be held to account for such blatantly poor decision making. In the absence of strong institutions, transit rents can be employed to buy loyalty and manipulate elections, thus reducing government accountability and blocking the population’s only weapon, the threat to “vote the rascals out.”
THE TRANSIT CURSE IN UKRAINE, 2000–2005

Many casual observers and followers of Ukraine argue that the country’s problems under Kuchma stemmed from the president’s suffocating grip on power throughout the late-1990s and early-2000s. He has been labeled an authoritarian, a neo-patrimonialist and a rent-distributing arbiter (Kuzio 2005; van Zon 2005; Dubrovsky 2007b). While such labels are certainly appropriate, I argue that he was only able to be such things on account of the massive pipeline network traversing his country. With that in mind, in this section I show how transit revenues led to unhealthy, unsustainable economic growth and allowed Kuchma to maintain his hold on the country in the face of popular discontent and rising political competition.

The Dutch Disease: Economic Distortion

The Dutch disease operates in the following way: As extraordinary revenues pour into a state, the domestic currency strengthens and demand for both tradable and nontraded goods increases. The demand for nontraded goods can be satisfied domestically by shifting the economy to favor nontraded sectors, especially the services sector. Doing so places upward pressure on wages in all sectors and shifts resources (both human and monetary) away from tradable sectors like agriculture and manufacturing. The combined effect of a strong currency, wage pressure and reallocation of resources makes the agricultural and manufacturing sectors less competitive abroad. Therefore, we expect
to see a significant decline in such sectors of the economy coupled with extraordinary
growth in the services sector.

In order to investigate the presence of the Dutch disease in Ukraine I employ a
relatively straightforward operationalization. I utilize a technique pioneered in some of
the seminal works on the resource cure and create sectoral benchmarks (see Gelb 1988;
Syrquin and Chenery 1989; Raiser et al. 2003). I rely on data from the World Bank and
International Monetary Fund to create such benchmarks, which illustrate the extent to
which Ukraine’s economy has been affected by the inflow of transit revenue since the
establishment of the state-owned company, Naftogaz Ukrainy, and monetization of
payments. I take a 50-country sample and create a benchmark for the expected share of
agriculture and services per gross national income per capita (GNI PC). I use GNI PC
because it has been established that as a country becomes wealthier, the economy
naturally shifts towards a service-based economy. Therefore, my analysis allows for
Ukraine’s economic structure to be compared to countries of similar wealth.

Ukraine’s agricultural output in 2000 is shown in Figure 1 below. In 2000—the
final year that transit payments were solely barter based—we can see that the country’s
agricultural sector very closely matched the estimated curve. In fact its agricultural sector
was performing slightly better than predicted by the curve.
However, by 2005 we see that Ukraine’s agricultural sector had precipitously declined, at a rate much faster than its economic growth would predict. In Figure 2 we can that Ukraine’s agricultural sector had become rather distorted, relative to other economies of similar size.
Furthermore, when one compares Ukraine to countries that share a communist past, the same pattern emerges. In figures 4 and 5 we see how closely (or not) Ukraine’s agricultural sector—in 1999 and 2005, respectively—fits the expected line based on central and eastern European countries and states of the former Soviet Union. Again, we can see that by 2005, Ukraine’s sector had become significantly distorted.

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9 Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Kazakhstan, Kyrgyz Republic, Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovak Republic, Slovenia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.
Figure 3: Agricultural Output, % GDP, CEE and FSU Countries, 1999

Source: World Development Indicators, World Bank; Author’s calculations
Figure 4: Agricultural Output, % GDP, CEE and FSU Countries, 2005

Source: World Development Indicators, World Bank; Author’s calculations

We observe a similar pattern of distortion in Ukraine’s services sector. In figures 6 and 7, the respective shares of the service sector in 2000 and 2005 are shown. In this case, the service sector in 2005 does not appear to be significantly distorted, but when compared to the 2000 figure, we can see that it is in the process of correcting for its former negatively distorted value. These preliminary findings suggest that the Dutch disease may have indeed afflicted Ukraine and invite further research.
Figure 5: Service Sector, % GDP, 2000

Gross national income per capita, PPP, current US $

Source: World Development Indicators, World Bank; Author’s calculations
The Rentier Effect: A Rentier Society and Rent-Seeking Elites

As I explained earlier, transit revenues had a negative socio-political effect as well. To my mind, transit rents allowed the state to buy both mass and elite support and dampen bottom-up pressure for reforms. First, transit revenues had a spending effect, which enabled the regime to buy patronage through various subsidies. Second, the substantial external source of revenue permitted a taxation effect, whereby the government demanded considerably less in terms of taxes. Third, the natural monopoly of transit-related rents led to an elite-loyalty effect, which allowed Kuchma (and
Yushchenko in his first year as president) to buy elite support by distributing rents among the various elite groupings.

I make use of data from the World Bank and International Monetary Fund to provide some quantitative analyses of taxation rates, subsidies and budgetary expenditures as well as rely on analysis from Ukrainian scholars and researchers to provide anecdotal evidence of such a rentier and rent-seeking society in Ukraine.

**The Spending Effect: High Subsidies**

Since the establishment of a state-owned energy company and introduction of monetized payments for energy transit, there has been a consistently upward trend in the expenditures of the government. For example, over the period of 2000–2005, general government spending on state employees grew from roughly 8 percent of GDP to 11 percent (IMF Government Financial Statistics). Such increases were used to both increase the number of citizens employed by the government as well as increase the salaries for such employees, which is evidenced by the 32, 28 and 10.5 percent increases in civil service wages in 2003, 2004 and 2005 respectively (SIGMA 2006). Additionally, between 2000 and 2005, unemployment benefits experienced a nearly 1,000 percent increase. In Figure 4, you can see that Ukraine has an abnormally high level (for a country of its wealth) of subsidies as a percentage of government expenses.

\[10\] While this could be part of a wider post-communist phenomenon (O’Dwyer 2004), the problem has been more pronounced in Ukraine. Public-sector employment in Ukraine has continued to grow irresponsibly, despite the arrival of meaningful competition and fair elections. ILO data on Ukrainian public-sector employment, the overall number of government employees hasn’t grown exceptionally, but that fails to account for the privatization of thousands of state-owned companies in 2005–2009.
Figure 7: Subsidies, % of Expenses, 2000

Gross national income per capita, PPP, current US $

Source: World Development Indicators, World Bank; Author’s calculations
When we compare Ukraine’s expenditures on subsidies to other post-communist countries, Kuchma’s willingness to deploy state funds in a bid to gain popular support becomes all the clearer. While many of Ukraine’s neighbors were busy dismantling the Soviet-era system of huge government expenditures and subsidies, Kuchma employed the newly centralized transit to increase what was, by international standards, an already generous system of subsidies. In figures 10 and 11 below, we see that from 1999 to 2005, Ukraine significantly increased the amount of subsidies it doled out to the population. I argue that such generous increases were made possible by the monetization and centralization of transit rents in 2000.
Figure 9: Subsidies, % of Expenses, CEE and FSU Countries, 1999

Source: World Development Indicators, World Bank; Author’s calculations
Additionally, under Kuchma Ukrainian citizens paid an artificially low price for natural gas. As evidenced in Appendix 1, the price paid for imported Russian gas was generally US $100 per thousand cubic meters of natural gas less than its European neighbors throughout the 2000s. This drastically reduced price was in turn passed onto Ukrainian consumers, amounting to a very sizable subsidy to the population. I argue that this subsidy was crucial in the government’s attempts to buy political loyalty.

In 2004, 45 percent of the population still selected Yanukovich in the re-run of the second round of the 2004 presidential elections, after it had been widely established and
accepted that Kuchma and Yanukovich had committed massive fraud in an attempt to
steal the election (see Section 4 for a brief description of the events surrounding the 2004
election). The fact that such a large portion of the electorate is willing to support the
government after such public revelations indicates more of a client-patron relationship,
than of a healthy democracy. While transit revenues did not allow Kuchma to buy the
support of the entire population, it appears that he was able to create a sizable base whose
loyalty was unwavering.11

*The Taxation Effect: Low Taxes*

Just as transit revenues provide the government with additional resources with
which to subsidize society, they also permit the government to lessen the tax burden, in
an effort to dampen demands for accountable governance. Scholars such as Barrington
Moore, Jr. have argued that a government’s need to levy taxes and support an army led to
citizen demands for increased participation. Therefore, the less a government demands
from its people in the form of taxes, the less the people demand from the government. In
figures 12 and 13 we can see that Ukraine in the early- to mid-2000s collected very little
of its revenues from taxes on individuals.

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11 The generous social benefits (which were largely made possible by transit revenues) were not the only
reason nearly half of the population supported Yanukovich in the re-run of the 2004 presidential elections,
but I imagine they played a less-than-insignificant role in the calculations of voters.
Figure 11: Tax on Income, Profits and Gains, % Revenue, 2000

Gross national income per capita, PPP, current US $

Source: World Development Indicators, World Bank; Author’s calculations
Compared with other relatively poor countries (in terms of gross national income per capita), Ukraine’s tax revenues from individuals are nothing terribly out of the ordinary. It is grouped rather tightly with other countries of similar wealth. However, when you consider that Ukraine did have a relatively high level of revenues (see figures 14 and 15 below), especially for an economy of its size, you can see that the government demanded considerably less from its citizens. It was able to demand less due to the reliable inflow of external sources of cash, transit revenue. I would argue that absent significant transit rents, the Ukrainian government would simply have lacked the funds to pay for the aforementioned generous subsidies and expenditures.
Figure 13: Revenue, % of GDP, 2000

Source: World Development Indicators, World Bank; Author’s calculations
Figure 14: Revenue, % of GDP, 2005

Elite-Loyalty Effect: Distributing Rent

The pipelines through Ukraine, as a centralized natural monopoly, also permitted the government to distribute the significant rents available in the transit and energy businesses. In other post-Soviet countries, the dispersed and non-monopolized nature of rent-seeking opportunities allowed non-state actors to take control the most profitable industries. In Ukraine, however, Kuchma was the sole arbiter in energy-trade-related sectors of the economy (Dubrovsky 2007b). This was an incredibly important means by which Kuchma could guarantee the support of economic elites. In the literature on Kuchma-era Ukraine, many scholars note that the president masterfully balanced
different oligarchic groups, ensuring they remained loyal without any single one becoming too powerful (Balmaceda 2008; D’Anieri 2007). The support of such oligarchic groups was exceedingly important for Kuchma as he relied on these elites for financial support in elections and the deployment of their vast and varied media resources.

This client-patron arrangement in a semiauthoritarian system was able to maintain equilibrium in the short to medium term. However, simmering domestic opposition disenchanted by, among other things, the Gongadze affair and continued corruption, as well as sustained international pressure showed that an undemocratic regime buoyed by transit wealth may not be stable in the long run. Some opportunistic rent-seeking elites (both economic and political) sensed that regime turnover was possible and lent support to Yushchenko in the run-up to the 2004 presidential election. These crucial ‘flip-flops’ proved to be just enough, in combination with major international support, to usher in what was then seen as the arrival of democracy and legitimate governance.12

**Sending State Leverage: Russian Influence**

There is one more way in which transit states can be said to suffer from some sort of curse. I argue that countries such as Kuchma-era Ukraine are doubly dependent on the country that sends the oil and gas. In 2000–2005 Ukraine was especially susceptible to pressure form Russia due to the fact that it provided the country with a significant

---

12 The fact that a transit-revenue-supported semiauthoritarian state is less stable than resource-rich states is not surprising. The fact that Saudi Arabia and Russia have significantly greater resources at their disposal, allow their regimes to spend more and tax less, thus enabling their regimes to be more stable in the medium to long term. However, the simple fact that transit revenues delayed the eventual democratic opening in Ukraine has had lasting consequences (Vachudova 2005). This post-transit-wealth legacy will be addressed in Section 4.
proportion of its energy resources for domestic consumption as well as a large sum of budgetary revenues. Additionally, Ukraine’s energy-intensive economy (in the top three by the International Energy Agency’s calculations) depends on relatively cheap energy resources to remain profitable. Theoretically, the entire chemical production industry becomes loss making when the price for gas exceeds US $200 per thousand cubic meters (Davis et al. 2005).\textsuperscript{13} Similarly, the steel industry also requires cheap energy to produce internationally competitive products.

I argue that it is precisely for these reasons that Russia has been able to wield extraordinary influence in Ukraine. This influence expresses itself in arrangements and deals that can be seen to run counter to Ukrainian national interests. The 2000s are rife with examples. The most obvious relate directly to the energy trade itself. All three fees charged by Ukraine (gas transit, oil transit and gas storage) are grossly out of line with international norms. For example, in Table 2 below, you can see how outrageously low the transit fee charged by Naftogaz under Kuchma was in comparison with some EU countries.

Table 2: Assorted Gas Transit Fees

<table>
<thead>
<tr>
<th></th>
<th>Ukraine</th>
<th>France</th>
<th>Denmark</th>
<th>Hungary</th>
<th>The Netherlands</th>
<th>EU average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transit fee\textsuperscript{14}</td>
<td>1.09</td>
<td>4.58</td>
<td>7.82</td>
<td>6.66</td>
<td>5.54</td>
<td>5.35</td>
</tr>
</tbody>
</table>

Source: “Gazovoy viklik”

The gas dispute of 2006 serves as a useful example to demonstrate the power of Russia’s leverage. Gazprom managed to steeply increase the price paid by Ukraine while keeping transit revenues far below market norms. The result of the 2006 dispute and

\textsuperscript{13} Considering the European market price for natural gas was US $241, $248, $350 and roughly $400 in 2006, 2007, 2008 and 2009 respectively, it is unrealistic to expect the chemicals industry to remain competitive in market conditions.

\textsuperscript{14} In US dollars per 1000 cubic meters per 100 km
subsequent unfavorable agreement has placed a huge strain on Ukraine’s budget, which has led to dangerously large budget deficit each of the past four years. Furthermore, the higher import prices negatively affected other sectors of Ukraine’s economy, depressing the export of metallurgical and chemical products (Segura and Pogaska 2006). Evidence of the impact of higher import prices on the health of the Ukrainian economy can be seen vividly in Table 3 below. The higher fee charged by Gazprom has made Ukrainian steel and chemical products less competitive, which has significantly depressed exports.

Table 3: Current Account Balance, % GDP

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ukraine</td>
<td>4.7</td>
<td>3.7</td>
<td>7.5</td>
<td>5.8</td>
<td>10.6</td>
<td>2.9</td>
<td>-1.5</td>
<td>-4.2</td>
<td>-7.6</td>
<td>-9.7</td>
</tr>
</tbody>
</table>

Source: Government Finance Statistics, IMF

In total, since Yushchenko came to office in 2005, the transit price has only increased by 35 percent while the price charged by Russia has increased 450 percent (Tsarenko 2007, Pirani et al. 2009, Pirani 2009). This is the price Yushchenko has had to pay for his willingness to adopt policies undesirable to the Kremlin. Such an extraordinary rate hike placed an incredible strain on the regime’s ability to govern effectively. For example, the 2009 increase in import prices largely contributed to the 15 percent contraction in GDP and 12 percent budget deficit in 2009.

Such economic effects have also spilled over into the political sphere as well. Ukraine’s poor economic performance was largely responsible for both Yushchenko’s and Tymoshenko’s defeat in the 2010 presidential elections. Furthermore, Russia has the ability to influence Ukrainian politics by hinting that some presidential candidates may be able to negotiate better deals with Moscow than others.
REVOLUTION AND UNMET EXPECTATIONS

In 2004, post-Soviet Ukraine went through its fourth iteration of presidential elections. Kuchma and his loyal oligarchs spent lavishly in the run-up to the first round of polling that took place in October, doling out millions of hryvnias in pension increases and wage arrears. In that first round of voting, however, Kuchma’s hand-picked successor, Viktor Yanukovich, finished behind Viktor Yushchenko, who had allegedly been poisoned during the campaign. Since no single candidate obtained a 50-percent majority, electors went to the voting booths again on November 21. After the results were counted, Yanukovich held a slim 3-percent lead. His winning vote tally, however, included nearly 100-percent turnout in Yanukovich’s home region of Donetsk as well as a suspiciously large influx of last-minute absentee ballots from the southern and eastern parts of Ukraine. The results were unanimously decried as fraudulent by impartial observers.

Apparently Kuchma and Yanukovich overestimated their ability to withstand accusations of manipulation. However, by 2004 anti-Kuchma forces had learned from other electoral revolutions abroad and were better able to expose blatant fraud, unlike in 2000 and 2002 (McFaul 2007). As a result of massive protests and international pressure, a re-run of the second round was held on December 26. Yushchenko narrowly won.

For many, the events culminating in Yushchenko’s victory marked the beginning of a new era in post-independence Ukraine (Christensen et al. 2005). Domestic and international press as well as scholars proclaimed that the orange-clad tandem of
Yushchenko and Tymoshenko were going to effect the change many Ukrainians had been waiting for. For example Taras Kuzio argued that, “The election in 2004 completed Ukraine’s transition from a post-Soviet state to a European one” (Kuzio 2005). Additionally, in 2005 many major journals devoted significant space to discuss what the ‘revolution’ meant and how it would change Ukraine.15 The initial reforms and constitutional alterations only encouraged such supporters all the more. A balancing of presidential power, strengthening of the party system and depoliticizing of electoral regulations gave democracy advocates much to cheer about.

Unfortunately, such optimism proved to be short lived. Despite the rhetoric of change employed during the campaign, the team of Yushchenko and Tymoshenko (as president and prime minister, respectively) introduced the fewest number of legislative proposals in any period in post-Soviet Ukraine (Tudoroiu 2007). While we have seen a genuine improvement in the fairness of electoral contests and more limited presidential powers, accountable governance has failed to arise with them.16 Therefore, I look at Ukraine’s annual budget deficits as well as corruption indices to measure Ukraine’s progress in terms of governance. Contrary to what many expected, Ukraine has performed abysmally. Despite the fact that politicians now face the real possibility of being replaced in free and fair elections, Ukrainian leaders have failed to govern effectively and responsibly. In Table 4, you can see the lack of improvement in Ukraine’s score in Transparency International’s Corruption Perceptions Index since the Orange Revolution. Whereas in Table 5, it is evident that Ukraine’s budgetary situation has markedly worsened since Kuchma’s time in office.

15 See the spring 2005 issues of Journal of Democracy, Problems of Post-Communism.

16 I define accountable governance as fiscally responsible and corruption minimizing.
Table 4: Corruption Perceptions Index Scores, 2004–2009

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPI score, 10-point scale</td>
<td>2.2</td>
<td>2.6</td>
<td>2.8</td>
<td>2.7</td>
<td>2.5</td>
<td>2.2</td>
</tr>
<tr>
<td>Percentile</td>
<td>15%</td>
<td>32%</td>
<td>39%</td>
<td>34%</td>
<td>25%</td>
<td>18%</td>
</tr>
</tbody>
</table>


Table 5: Average Annual Budget Deficit, % GDP

<table>
<thead>
<tr>
<th>Average deficit</th>
<th>2000–2004</th>
<th>-0.92%</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005-2009</td>
<td>-3.37%</td>
<td></td>
</tr>
</tbody>
</table>

Source: IMF, International Financial Statistics; Author’s calculations

Additionally, Transparency International’s Nations in Transit report has shown there to be essentially no improvement in terms of governance as that organization defines it.

Table 6: Nations in Transit Ratings\(^{17}\)

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance</td>
<td>4.75</td>
<td>4.75</td>
<td>5.00</td>
<td>5.00</td>
<td>5.25</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nat’l democratic governance</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>5.00</td>
<td>4.50</td>
<td>4.75</td>
<td>4.75</td>
<td>5.00</td>
</tr>
<tr>
<td>Local democratic governance</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
<td>5.25</td>
<td>5.25</td>
<td>5.25</td>
<td>5.25</td>
<td>5.25</td>
</tr>
</tbody>
</table>


In addition to the orange-clad duo’s stated intentions to clean up the economy and political system, they also made a lot of noise about reforming Ukraine’s energy business. Most notably, Yushchenko and Tymoshenko touted initiatives to build a pipeline from Turkmenistan, acquire oil and gas from Iran as well as produce energy abroad (through Naftogaz) and transport it into Ukraine cheaply (Balmaceda 2008). Just

\(^{17}\) On a scale of one to seven, one represents the best score.

\(^{18}\) Starting with 2005 edition, Freedom House introduced separate analysis and ratings for national democratic governance and local democratic governance to provide more detailed and nuanced analysis of these two subjects.
as the Orange coalition did not follow through on promises to improve economic and
democratic governance, they also failed to enact meaningful energy-sector reforms. With
that in mind, the following several paragraphs detail how little Yushchenko and
Tymoshenko actually changed in the energy trade.

On first glance, there did seem to be quite a shake-up in the energy industry in
2005. All of energy heads closely associated with Kuchma (i.e., the presidents of state-
owned energy companies as well as the minister of energy) were replaced in the first
several months of Yushchenko’s tenure. While the exit of bureaucrats widely viewed as
corrupt should be considered a step in the right direction, Ukrainian-energy expert
Margarita Balmaceda (2008) noted that the old elite were simply replaced with “second-
tier” elites and oligarchs associated with Yushchenko. Within months of this changeover,
energy-related scandals were already surfacing. In early 2005, the new justice minister
and a parliamentary deputy were involved in an illicit oil re-export scheme and abuse of
power, respectively (Balmaceda 2008). Additionally, many of the new appointees were
associated with factions that had simply fallen out of favor with Kuchma in preceding
several years. For example, Naftogaz’s new head, Aleksey Ivchenko, was closely tied to
Igor Bakai, whose trading company was the main intermediary company bringing central
Asian gas to Ukraine prior to the formation of Naftogaz in 1999 (Balmaceda 2008).
Furthermore, many of the major players under Kuchma, such as Sergey Pereloma, were
merely placed in second-line positions. Furthermore, in 2006 it became known that
Dmitriy Firtash (one of the main energy-related oligarchs and who can be linked to the
most powerful opaque intermediary companies throughout the 1990s) was a major
financial backer of Yushchenko’s campaign (Balmaceda 2008). It is, therefore, hardly
surprising that Firtash benefitted handsomely from the 2006 arrangement following Naftogaz’s dispute with Gazprom.

Additionally, investigations into corruption in the energy trade failed to be executed in full. In March 2005, the new government appeared to be following up on one of its campaign promises to investigate corruption in Naftogaz (Balmaceda 2008). Inquiries into Yushchenko’s appointees were opened in early to mid 2005. However, it was widely reported that Yushchenko personally stepped in to halt the investigations into companies and ministries controlled by “his” people (Mostovaya 2006).

This lack of progress in energy-sector reform and governance has not gone unnoticed. Ukraine is now said to be at a ‘crossroad’ and the success of the electoral revolution began to be seriously questioned (Kuzio 2007; Tudoroiu 2007; Dubrovsky 2007a). Clearly, post-Kuchma Ukraine has not only failed to live up to the lofty expectations assigned to it, but it has completely failed in improving citizens’ lives, managing the economy responsibly and reducing corruption.

This disconnect between improved elections and stagnant (if not declining) governance begs the question: Why is governance worsening despite better democratic standards? It is well beyond the scope of this paper to explore all of the arguments underpinning the rationale for democracy, but if leaders regularly have to face voters, they should pursue policies viewed as effective, sustainable and responsible. Clearly this is not happening in post-Kuchma Ukraine. So what, then, is preventing good governance from arising?
THE LEGACY OF A PIPELINE-BASED RENTIER SOCIETY

I argue that Ukraine’s pipelines are largely responsible for the disappointing performance of post-Kuchma governments in Ukraine. The Orange Revolution only brought about a change of leadership and limited electoral reform. The Dutch-disease-afflicted economy, the extant rentier society and Russia’s extraordinary influence all remained in place (Aslund and Paskhaver 2010). First, despite the rotation of president and prime minister in 2005, the three-pronged transit curse was still present in Ukraine. Looking at the World Bank’s World Development Indicators, we see growth in the main indicators related to the Dutch disease and rentier effect. The agriculture sector continued to shrink while the services sector became even more bloated. At the same time, subsidies and expenditures continued to rise. In Table 7 below, you can see that the economic and social trends that arose under Kuchma only continued under Yushchenko. Interestingly, tax revenues did substantially increase in 2005. This only solidifies my belief that a more legitimate regime (one fairly elected) can demand more from the population by way of taxes.

Table 7: Transit Curse Indicators, 2001–2005

<table>
<thead>
<tr>
<th>Year</th>
<th>Agriculture, % GDP</th>
<th>Services, % GDP</th>
<th>Expense, % GDP</th>
<th>Tax revenue, % GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>16.37</td>
<td>48.90</td>
<td>27.62</td>
<td>12.06</td>
</tr>
<tr>
<td>2003</td>
<td>12.10</td>
<td>53.31</td>
<td>29.71</td>
<td>13.65</td>
</tr>
<tr>
<td>2004</td>
<td>11.93</td>
<td>52.20</td>
<td>32.98</td>
<td>13.28</td>
</tr>
<tr>
<td>2005</td>
<td>10.40</td>
<td>57.26</td>
<td>36.05</td>
<td>17.12</td>
</tr>
</tbody>
</table>

Source: World Bank, World Development Indicators
I believe this situation would have continued if not for the 2006 and 2009 gas disputes. Russia’s deep-rooted leverage became painfully clear in the winter of 2005–2006. At the end of 2005, Naftogaz and Gazprom were in the midst of a price dispute. There has been much discussion of and disagreement about the underlying factors (political and economic), but the fact remains that Russia—through state-controlled Gazprom—was able to exert its significant influence and received supply and transit agreements extremely favorable to the Russian side. Gazprom managed to extract a 100-percent increase in the price paid by Ukraine in 2006, lock in hugely discounted transit fees and capture distribution rights for the few profit-making sectors of the domestic Ukrainian market (Pirani 2009; Ukrainskaya Pravda 2009). The fact that the Ukrainian side would agree to such unfavorable terms, I believe, demonstrates how much leverage the Russian side had in the negotiations.

This 2006 agreement effectively flipped the arrangement whereby the Ukrainian budget received significant inputs from transit-related revenues on its head. With one stroke of the pen, the Ukrainian leadership effectively cut off a major source of revenue for both the state company, Naftogaz, and the state budget. If the initial doubling of the import price was not enough, the price was stipulated to grow every year. In fact, in the first quarter of 2010, prices paid by Naftogaz were significantly higher than European spot prices.

At the same time, domestic Ukrainian consumers failed to pay a proportionally increased price for resources consumed. In fact households actually paid a lower fee in 2009 than they did in 2006 (Pirani et al. 2009). This situation has resulted in huge losses for Naftogaz, even after the billions of dollars in transit revenue paid by Gazprom. In
2009 the company lost US $2.5 billion from the business of supplying households with natural gas (Pavel 2009). Additionally, electricity-generating companies are running up exorbitant losses as a result of the increase in energy prices. Such huge losses have had to be covered by funds from the national budget. Furthermore, a Gazprom subsidiary was guaranteed a 25 percent share of the domestic industrial gas market, a share which has since been increased to nearly 50 percent (Pirani 2009; Ukraïnskaya Pravda 2009). This is significant because the regulated tariff for industrial consumers is three times higher than that for households and is the only profitable sector of Ukraïne’s gas distribution market (Tsarenko 2007). The combined effect of all of this has been the reversal of the flow of budgetary revenues that existed under Kuchma.

Despite this huge loss of revenues to the government, political elites have failed to adjust government expenditures accordingly. I believe that the rentier state, similar to formal governmental institutions, is extremely ‘sticky’ and difficult to dismantle once it has been established. Other governments, notably Latvia, have, in the face of declining revenues, reduced the subsidies and increased taxes. In Ukraine this has simply not happened. In fact, in the run-up to the 2010 presidential elections, both Yushchenko and Tymoshenko increased pensions as well as agricultural and industrial subsidies (FT 2009).

It is safe to say that Ukraine currently finds itself in a ‘bust’ period very similar to the one experienced by oil exporting states amid the collapse of prices in the 1980s. Ukraine has lost a significant source of revenue and its leaders appear unable to dismantle the vast network of social benefits that arose when the government could rely on a steady stream of external revenues.
Lukashenka’s Pipelines

As my transit curse theory is, as far I know, the first to link oil and gas pipelines to stunted economic and political development explicitly, it would be prudent to see if another country with transit-related revenues is similarly affected. With that in mind, this section details post-communist Belarus, a country as comparable to Ukraine at independence as possible. Both countries share similar pasts. Historically, they constitute two parts of ancient Rus’ (Shevtsov 2005). In the twentieth century they were original Soviet republics and somewhat reluctant breakaways of the Soviet Union. Currently, and for my purposes most importantly, they are the major transit routes for Russian energy resources.

Whereas Ukraine is the main corridor for Russian natural gas, Belarus is the chief passageway for crude oil and oil products. Annually, 50 percent, or 70–80 million metric tons, of Russia’s oil-related exports pass through Belarus. Additionally, 20 percent, or roughly 25 billion cubic meters, of Russian natural gas finds its way to European markets through Belarusian pipelines. Much like Ukraine, Belarus has managed to leverage its strategic position to receive significant monetary benefits from Russia. Interestingly, Belarus has been able to extract even more money (both nominally and relative to GDP) and cheaper prices than Ukraine.

Like Ukraine, Belarus has received certain tariffs for transiting oil and gas as well as payment for storage near its western borders. Over the years the sum has fluctuated, but on average, the state-owned companies have received approximately US $1–2 billion
for such services. Besides those sizeable revenues (especially when you consider that Belarus’s GDP only surpassed US $20 billion in 2004), Lukashenka’s government has annually earned and additional US $5 billion from various re-export schemes. The most profitable scheme—by which Belarus purchases oil from Russia ostensibly for domestic consumption but then refines and sells a large portion to European consumers, with an export duty attached—has netted the government between US $3 and $4 billion in recent years (Novozhilovo 2006). Additionally, Belarus has continued to receive energy imports at a steeply discounted price while Ukraine essentially pays European netback prices. For example, in January 2010 Ukraine paid US $305 per thousand cubic meters whereas Belarus paid US $168 (Gavrish et al. 2010). Some analysts have calculated the discounts received by Belarus to total US $10 billion dollars, or roughly a quarter of the country’s GDP (Fadeyev 2006).

Such large revenues are particularly impressive bearing in mind that Belarus is a resource-bereft country with Soviet-era industrial production facilities. Without such large revenues, it is unlikely that Lukashenko’s unreformed economic and political system would still be intact (Shevtsov 2005; Gayduk et al. 2009). The transit-related resources have enabled Lukashenka to establish a rentier state even more encompassing and resilient to reform than in Ukraine. Just as Kuchma did in Ukraine, Lukashenka has highly subsidized society through lavish social spending and low taxation. For example, in 2006 the government doled out US $2 billion in agricultural subsidies (Zlotnikov 2006). In return he receives a passive citizenry, content in the fact that their standard of living was protected from the nosedive seen in all other post-Soviet economies (Marples 2007; Gayduk 2009).
Interestingly, though, Belarus has experienced uninterrupted growth since the mid-1990s—while most other post-Soviet countries were still wallowing in the doldrums of transition. Belarus’s growth has been anchored by its strong industrial sector, which still accounts for a quarter of its GDP. Clearly, then, a transit-induced Dutch disease has not stricken Belarus as has happened in Ukraine. Considering the fact that Belarus’s economy is largely controlled by the government, which directs the majority of human and financial capital, it is not terribly surprising that the Belarusian economy managed to avoid the transit trap that ensnared Ukraine. As I mentioned earlier, the shift of productive capacity from the manufacturing and agricultural sectors to services is the key ingredient in Dutch-disease-related distorted economic growth. Since Belarus’s economy largely lacks the necessary market principles, its non-market economy has not experienced such adjustments.

So what does all this say about the prospects for economic and democratic development in Belarus? Despite the fact few cracks have appeared in the regime, a new development ought to give Lukashenka something to worry about. In January 2010, a relatively minor dispute arose between Russia and Belarus. The agreement signed to end the dispute did not call for significant import price or transit fee increases, instead Belarus is no longer able to import duty-free energy products to be resold to European consumers. As this re-export scheme has been the prime cash cow for Lukashenka in recent years, this has serious consequences for the state built up by the Soviet-era strong man. It will be important to see if this loss of government revenues will result in significant expenditure cuts and tax rises as well. I believe that the ‘stickiness’ of the

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19 From 2006 onward there had been increasing duties paid by Belarus, but until 2010 there had always been significant loopholes and profitable schemes.
rentier society in Belarus—just as in Ukraine—will prevent such fiscally responsible moves.
**ALTERNATIVE EXPLANATIONS**

In this section, I seek to strengthen my transit curse theory by demonstrating that several alternative hypotheses are not better able to explain the disappointing democratic development of the late-1990s as well as early- and mid-2000s. I have identified potential competing theories as to what has stunted Ukraine’s post-communist development: 1) the lack of EU engagement; 2) ethnic divisions; and, 3) exploitation of partial reforms by post-communist rent seekers.

First, it has been argued that EU involvement is one of the most effective democratizing levers (Vachudova 2005; Cameron 200720). It stands to reason, then, that a lack of engagement from the EU (as was the case in Ukraine) can be seen as a hindrance to democratization. Had the EU been more actively involved and offered a viable path towards membership—as it did with Poland and the Baltic states—Ukraine would have had a better chance at developing a better functioning democracy. However, with regards to Kuchma-era Ukraine, it seems that the lack of engagement was mostly from the Ukrainian side. Kuchma and his allies thrived on the opaque business, regulatory and institutional environment; an environment that would have had to be reformed in any accession process. An authoritarian ruler such as Kuchma, with reliable access to revenues (through the pipeline network) and whose power came from his ability to disperse associated rents would never voluntarily agree to the scrutiny and reforms demanded from the *acquis* process. Additionally, Russia’s ability to cripple Kuchma’s

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20 The author does provide numerous caveats, but does at least credit the hope of joining the EU as a strong indicator of economic and democratic development.
rentier state most likely factored into his decision not to seek closer ties to the EU. Therefore, while one could make the argument that EU non-involvement was responsible for lagging political development, transit pipelines would have to be considered as at least one of the causes of non-engagement.

Second, Ukraine’s geographically and linguistically divided population could also be seen as the main obstacle to democratic development. There are many examples from around the globe where one group (be it ethnic, linguistic or geographic) dominates political and economic life and impedes further reforms in order to maintain its privileged place in society. However, most scholarship attests to Kuchma’s unique ability to balance the different regional and ethnic groups (Balmaceda 2008; D’Anieri 2007). Therefore, I do not believe ethnic or geographic divisions can be responsible for undermining democratic development under Kuchma.

Third, many scholars have noted that poor economic and democratic development is common among post-communist states that did not immediately replace old communists with reformers and experience intense electoral competition. In many cases, old communist elites simply exploit the partial reforms for their political and economic benefit (Hellman 1998). These elites will continue to pillage the state and its resources so long as there is no meaningful competition and realistic threat of losing power in relatively fair elections (Vachudova 2005; Grzymala-Busse 2006). These arguments have proven to possess significant explanatory power across the post-communist world. For example, in Romania, Bulgaria, Moldova, Belarus and Ukraine, the first stage of transition was exploited by former elites and reforms were predictably frozen. In Ukraine in the early- and mid-1990s, this lack of complete reform had little to do with the pipeline
network and transit revenues. However, I would argue that by the late-1990s economic and democratic pressures were creating the opening for a second stage in the transition of the initial laggards. Challenges to the ruling regimes began to appear as many grew frustrated with the fact that elites had promised so much but delivered so little. In some countries increased competition led to reforms and democratic consolidation. In Ukraine, however, Kuchma centralized rent-seeking opportunities and all domestic power by establishing firm control over the country’s transit resources. Kuchma then used transit revenues and access to the energy markets in order to bribe a populace into relative passivity, buy loyalty from rent-seeking elites and cheat his opponents out of electoral victory. While elites in Romania and Bulgaria were forced to adopt further reforms in the face of increased competition, Ukraine—and Belarus—was able to employ its resources to stymie such challenges. It is appropriate and instructive to extend Hellman’s, Vachudova’s and Grzymala-Busse’s theories into the later stages of post-communist transition.
CONCLUSION

I started this research project seeking to answer two vexing questions. First, what was preventing Ukraine—a country which should have been one of the post-Soviet leaders—from fostering healthy economic growth and democratic development throughout the late-1990s and early-2000s? And second, why, despite the eventual improvement in electoral fairness following the Orange Revolution, is Ukraine still hampered by irresponsible governance and rampant corruption? My research indicates that Ukraine’s massive pipeline network, and the revenues it generates, can be seen as the root of both evils.

I argue that after Lenoid Kuchma centralized the transit-related rent-seeking opportunities by establishing an overarching national energy company, Naftogaz Ukrainy, the country became afflicted with a transit curse. This three-pronged curse damaged healthy economic growth, created a corrupt rentier society and gave Russia extraordinary influence over the country as a whole. Unfortunately for Kuchma, such a transit-revenue-supported rentier state was not stable over the long term. The shifting loyalty of both elites and the masses allowed for the seemingly monumental events of December 2004. Additionally, the fact that Naftogaz Ukrainy was not established until 1999 allowed for non-state groups to amass substantial power and wealth, which proved difficult for Kuchma to rein in and control completely (Way 2005).

In 2005 there was much optimism and hope for Ukraine’s newly democratic future. Unfortunately, only select electoral laws and institutional arrangements were
reformed in the aftermath of the Orange Revolution. As a result, Ukraine’s opaque energy sector and rentier society remained, while Russia continued to possess undue sway over the government. The early weeks of 2006 witnessed a demonstration of Russia’s leverage. The agreement that ended the gas dispute was breathtakingly unfavorable to Ukraine. The transit revenues that had been a boon to the government budget were now not sufficient to cover the losses incurred by Naftogaz. In the following years, no leader has proved willing to upset the electorate and disassemble the expansive rentier state established under Kuchma. As a result, Ukraine’s government now stands on the brink of bankruptcy.

Additionally, the unreformed energy sector has remained a bastion for corrupt business practices and affect all aspects of life in Ukraine. Since Yushchenko took office, the major corruption indices have shown corruption in the country to be on the rise.

Lastly, Russia still retains much of its leverage, albeit slightly diminished now that it does not effectively prop up the Ukrainian budget. Russia can still affect domestic Ukrainian politics by favoring particular politicians and suggesting who might be able to win more favorable energy deals with Gazprom.
APPENDIX

Gas Transit in Ukraine

<table>
<thead>
<tr>
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<th>2000</th>
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<th>2002</th>
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<th>2007</th>
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<tbody>
<tr>
<td>Transit (bcm)</td>
<td>119.9</td>
<td>122.8</td>
<td>119.4</td>
<td>123.2</td>
<td>132.4</td>
<td>130.7</td>
<td>128.5</td>
<td>115.2</td>
<td>119.6</td>
<td></td>
</tr>
<tr>
<td>Transit fee per 1000 cm per 100km</td>
<td>1.09</td>
<td>1.09</td>
<td>1.09</td>
<td>1.46</td>
<td>1.09</td>
<td>1.09</td>
<td>1.6</td>
<td>1.6</td>
<td>1.7</td>
<td>1.7</td>
</tr>
<tr>
<td>Value of transit service (million US $)</td>
<td>1,468</td>
<td>1,418</td>
<td>1,597</td>
<td>1,456</td>
<td>1,569</td>
<td>1,536</td>
<td>2,200</td>
<td>2,200</td>
<td>2,200</td>
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<tr>
<td>Price paid by Ukraine for gas (US $ per 1000 cm)</td>
<td>50</td>
<td>50</td>
<td>50</td>
<td>67</td>
<td>50</td>
<td>50</td>
<td>95</td>
<td>130</td>
<td>179.5</td>
<td>360</td>
</tr>
<tr>
<td>European market price (cif) for gas (US $ per 1000 cm)</td>
<td>90.3</td>
<td>115.3</td>
<td>96.1</td>
<td>122.2</td>
<td>126.7</td>
<td>165.3</td>
<td>241.4</td>
<td>248.1</td>
<td>350.3</td>
<td></td>
</tr>
</tbody>
</table>

Source: Tsarenko 2007, Pirani 2009, various Naftogaz and Ukrtransnafta reports and BP Statistical Review of World Energy; Author’s calculations
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