1 The Ukrainian Donbas in 'transition'

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Introduction: a phoenix rises from the ashes?

Until the so-called 'Orange Revolution' in November 2004, Ukraine had been regarded by orthodox transition economists as a failed 'transition country'. According to this view the Western prescription of stabilisation, liberalisation and privatisation had been implemented in Ukraine too late and too haltingly and had been reversed from time to time as the influence of reformers vacillated (Aslund and de Ménil 2000; Aslund 2000; Dubrovskiy and Ivaschenko 2002). It was argued that the prolonged severe economic depression that followed the disintegration of the USSR and the Soviet system was caused by a rent-seeking elite, which spanned the arenas of politics, economics and crime, that served its own interests and frustrated economic reform. Accordingly it was argued that political change was required in order to puncture the increasingly entrenched rent-seeking elite. However, following the financial crisis in Russia in August 1998, the Ukrainian economy began to grow rapidly without any notable political change taking place until the 'Orange Revolution'. (Ironically, following the 'Orange Revolution' economic growth slowed precipitously, from 12.1 per cent in 2004 to 2.6 per cent in 2005.) Whilst some continued to argue that the Ukrainian economy was plagued by a vicious circle of macroeconomic stability and entrenched structural problems, others sought to account for the emergence of economic growth. It was suggested that the structural reforms implemented by Viktor Yushchenko's government in 1999–2001, especially in the energy sector, had finally stimulated economic growth (Aslund 2001). It was also argued that artificially low prices for Russian oil and gas effectively subsidised the growth in industrial production. In addition the devaluation of the hryvnia following the Russian financial crisis also improved Ukraine's competitiveness in international markets.[1]

It is our contention that the economic growth between 1999 and 2004 was in part linked to the revival of the economy in the Ukrainian Donbas. This revival in Ukraine's industrial and financial heartland was due to four key factors. First was the restructuring of the industrial economy in the Donbas. This involved the vertical and horizontal (re)integration of the industrial economy, the accumulation and recycling of capital around the regional economy, the diffusion of financial intermediation, the emergence of new models of organisation and management and the gradual concentration of ownership in the hands of large business groups. Second was the emergence of a political consensus in the region that culminated in the formation of a regional 'party of power', the Party of the Regions, to which nearly all the major regional actors belonged. Third, an accommodation was reached between the leading regional actors in the Donbas and the central authorities in Kyiv. In return for minimising the electoral power base of the hard-line Communist Party of Ukraine and rejecting political regionalism, regional actors secured a favourable legislative regime for large industrial enterprises and industrial areas in the Donbas. Fourth, a benign national political and economic context meant regional actors were prepared to take risks. In particular, macroeconomic stability and a relatively united ruling elite produced a favourable backdrop for collective action.

The revival of the Donbas was symbolised by the appointment, on 21 November 2002, of the governor of Donetsk oblast, Viktor Yanukovych, as the tenth Prime Minister of Ukraine (Kuzio 2002; Kupchinsky 2002a). His nomination underlined the apparent rebirth of the Donbas in post-Soviet Ukraine. A core heavy industrial region in the Soviet Union's command economy, the 'Communist National Park' (Borisov and Clarke 1994) played a leading role in the construction and destruction of the USSR. The dislocation caused by the disintegration of the Soviet Union and Ukrainian independence led to a dramatic industrial decline that only began to abate in the late 1990s. Increased local autonomy beginning during *perestroika* and accelerating after independence was accompanied by the emergence of new actors and institutions for whom the interests of state-owned heavy industry and the region were indistinguishable. The so-called Donetsk 'clan', of which Yanukovych was a leading member, became increasingly influential in industrial and regional governance. Having been general director of several state-owned transportation enterprises in Donetsk, Yanukovych was appointed deputy governor of the oblast in August 1996 by President Kuchma, before rising to first deputy governor a month later and governor in May 1997 (Kupchinsky 2002a). Most of the socio-economic developments in the region discussed in this chapter have occurred under Yanukovych's five-year-long governorship. Hence a major aim of this chapter is to provide an empirically rich and evidence-based assessment of the developmental achievements of the Donbas and its two constituent oblasts at the later stage of the post-communist transformation.

The remainder of the chapter is divided into three parts. In the next section we examine the ways post-Soviet economic development has been theorised. This is then followed by a section that, whilst acknowledging all the caveats that must be attached to them, nonetheless uses official statistics to analyse the Donbas in 'transition'. Here we investigate the position of the region within Ukraine's changing space-economy, the comparative transitions in the two oblasts that make up the Donbas, Donetsk and Luhansk oblasts, and intra-oblast trends. The third section reviews the dominant explanation that has been advocated to explain the rebound in the Donbas economy. In the concluding remarks we challenge the standard analysis and point to ways of rethinking economic development in the Donbas.

Theorising 'transition' in the former Soviet Union

Economic 'transition' in post-Soviet Russia and most of the former USSR resulted in the emergence of two distinctive and related phenomena. Firstly, there was the demonetarisation of the economy and the proliferation of surrogate monies (Woodruff 1999). The liberalisation of prices in the early 1990s resulted in the rapid and inflationary monetarisation of the economy. Subsequent deflationary policies, designed to achieve macroeconomic stabilisation, merely resulted in the demonetarisation of much of the industrial economy, which responded by adopting barter as the primary means of exchange up until the late 1990s. Secondly, demonetarisation and the proliferation of surrogate monies were accompanied by the emergence of new organisational forms, variously called 'financial industrial groups' (Johnson 1997), 'conglomerates' (Burawoy 2001a) or 'holding companies' (Clarke 2004). These business groups – which combined so-called 'red directors', local state officials and alleged Mafia groups – were territorially organised (Pinto *et al.* 2000: 304) and operated their own de facto monies. However, following the Russian financial crisis in August 1998 there was switching of capital from speculative financial activities to investment in the industrial economy. In addition the devaluation of the rouble enhanced the competitiveness of Russian goods and services in both the domestic and the international market, and the increase in oil and gas revenues increased the liquidity of the economy. These trends enhanced the sovereignty of the state, re-monetarised the industrial economy and produced rapid economic growth (Hanson and Teague 2005). Economic change in the former Soviet Union (except for the Baltic states) has been theorised in at least three ways. Firstly, it is argued that an *inauthentic* or 'virtual' capitalism emerged in Russia in the 1990s. Secondly, it is contended that Russia and the other former Soviet states are in a *transitional* phase on a linear path to capitalism. Thirdly, it is theorised that distinctive post-Soviet *varieties* of 'really-existing capitalism' (Hanson and Teague 2006) have emerged. We now consider these three different theories in turn.

'Inauthentic' capitalism: the 'virtual economy' thesis

Gaddy and Ickes (1998a, 1998b, 1999, 2002) argue that, instead of moving towards a market economy, if anything the Russian economy became less like a market economy as the 1990s proceeded. They suggest major industrial enterprises were able to insulate themselves from the market and continue to operate with 'soft budget constraints'.[2] They conclude that a new economic system, which they term a 'virtual economy', emerged that is 'fundamentally not market-based and will ensure continued economic decline and further crises' (Gaddy and Ickes 1998a: 2 (online version)).[3] Gaddy and Ickes suggest that much of the industrial economy, especially manufacturing industry, is value-subtracting and only survives because of artificially low prices for raw materials and energy and the non-payment or non-monetary payment to suppliers, the state and employees. Tompson (1999: 273) defines the virtual economy as:

> a non-transparent system of subsidies which, by grossly distorting prices and concealing the true relative costs of various activities, has helped many enterprises that would otherwise have failed to maintain the appearance that they are both larger and more profitable than they are.

He argues that the virtual economy emerged because of the legacy of distorted prices and the dual economy in the USSR and because of the way economic reform in the early 1990s forced industrial enterprises to exaggerate prices. To 'sell' output, enterprises were forced to discount their official prices and engage in non-monetary transactions, creating a de facto parallel currency. Woodruff argues that the emergence of surrogate monies reflects that the Russian state failed to achieve a monopoly of sovereignty over transactions and concludes that the Soviet Union's 'economy of idiosyncrasies' was replaced by what he terms 'shallow marketization' (2000: 452, 439; see also 1999, 2004). Based on his analysis of the role of money and of corporate stock, he suggests that Russia 'created market institutions that function like their international models on the transactional level, but not on the juridical level' (2000: 439). He argues that what might be termed 'economies of practice' (Miller 2002) and the judicial framework are decoupled:

> in which ritualistic conformity to the norm of a single means of payments co-exists with the nonmonetary taxation that keeps the government running, and in which tactical conformity to the norms of corporate governance coexist with personalistic power in the factories.
>
> (Woodruff 2000: 471)

There are three important aspects to the virtual economy thesis: first, the role of non-cash payments systems; second, the spatiality of the state and economy; and third, the durability of the economic model. Firstly, it is argued that non-cash payment systems, such as barter or promissory notes, were central to the emergence of the virtual economy. Non-cash payment systems make it difficult to value economic activities and to undertake financial planning – and act as a disincentive to restructure and invest (Lindberg 2002) – and result in distorted prices. Pinto *et al.* (2000: 315–16) argue that non-cash settlements reorganised the industrial economy around alliances between enterprise managers and public officials motivated by personal enrichment. This entailed the formation by enterprise managers and public officials of intermediary companies to organise barter transactions in return for a commission and/or a proportion of the profits. Subsequently cash rich intermediaries became the source of working cash for industrial enterprises and combined to form 'financial industrial groups' (FIGs) (Pinto *et al.* 2000: 316). Pinto *et al.* (2000: 316) argue that production chains became entrenched and non-competitive as chains of barter transactions produced 'vertically integrated conglomerates impeding competition and new entrants. Barter schemes, including multi-stage ones intermediated by unregulated promissory notes, tend to embrace all stages of the production cycle, facilitating informal vertical integration within FIGs.'

Secondly, Pinto *et al.* (2000) argue that tight central government macroeconomic policy was undermined by lax microeconomic policy by the local state. This meant that energy companies subsidised manufacturing enterprises and passed the cost on to the state by not paying taxation, forcing the state to increase borrowing at high interest rates, prompting the 1998 economic crisis. Gaddy and Ickes (2002) argue that the virtual economy first emerged in the large industrial cities in the Urals and along the Volga before later becoming adopted by so-called reformers in Moscow. Oblast governors centralised and informalised economic policy making in their regions and intervened on behalf of local enterprises by providing tax exemptions, state contracts and hidden subsidies. Local governments encouraged barter by accepting non-monetary payments in lieu of tax revenues in order to minimise transfers to the federal government (Tompson 1999: 270–1).

Thirdly, analysts differ as to the durability and rationality of the virtual economy. On the one hand there are those who regard the virtual economy as a rational and potentially stable response to a specific economic and social context (Gaddy and Ickes 2002; Tompson 1999; Woodruff 2000; Lindberg 2002). The financial system and the fiscal and state budgetary regime provide incentives for barter, and the alternative would entail mass bankruptcies and redundancies and a slimmed-down state. On the other hand there are those who argue that the virtual economy is temporary and unstable (Aslund 1999; Pinto *et al.* 2000). Pinto *et al.* (2000) contend that the system depends on unsustainable government borrowing and that the welfare gains used to defend the system are ineffectual as capital is siphoned off into the hands of managers and public officials. Aslund (1999: 101) argues that non-cash payment is only rational for what he terms the 'relational economy'. This comprises large enterprises that preserve their lucrative political influence to evade taxation and to engage in rent seeking and corruption. He maintains that, as manufacturing enterprises engage less in non-monetary exchanges than other parts of the economy, even though they are supposed to have most to benefit, non-cash payment systems are neither rational nor possible for the majority of economic actors.

'Transitional' capitalism

From a variety of theoretical traditions there is a wide literature that argues that post-Soviet capitalism is either incomplete or in a *transitional* phase. Capitalism in Russia has variously been termed 'merchant' (Burawoy 1996), as 'industrial feudalism' (Ericson 2000), as 'extensive' (Clarke 2004), as 'gangster' (Holmstrom and Smith 2000) and as 'chaotic' (Lane 2000).[4] Burawoy (1996: 1109; see also Burawoy 2001a) argues that economic 'involution' has produced a merchant form of capitalism in Russia. Involution, he suggests, 'implies profound economic degeneration in which the economy feeds upon itself. It is the opposite of accumulation.' He argues that a combination of privatisation, persistent soft budget constraints, and re-distributive mechanisms reinforced the Soviet industrial system and led to the transfer of economic resources from the productive economy into trading and financial activities resulting in 'capitalists without capitalism' (Burawoy 2001b: 1112). 'The failure of the Russian state to organize the market economy has led to a coordination and entrepreneurial vacuum into which has stepped conglomerates, banks and mafia, siphoning off surplus from production to exchange' (Burawoy 2001b: 1114). Burawoy argues that economic involution was uneven across sectors and regions, depending on the structure of sectors and the opportunities offered by privatisation compared to lobbying for continued subsidies. A similar argument is made by those who claim that neo-patrimonial forms of political domination have emerged in the former Soviet Union (Erdmann 2002; on Ukraine, see van Zon 2001). Based on Weber's distinction between different forms of political domination, authority and legitimacy (Weber 1968), it is argued that former Soviet states have regressed from a 'legal-rational' bureaucratic state to a 'traditional' patrimonial state involving clientelism, a weak rule of law and a corrupt rent-seeking state bureaucracy. Hellman and his collaborators explain this by suggesting that oligarchic economic forces have been able to force the state to serve their own sectional interests, a process they term 'state capture' (see, for example, Hellman 2000; World Bank 2002).

Ericson (2000; cf. 2001) likens the post-Soviet economic system to 'industrial feudalism'. He argues that the Russian economic system features a 'weak central authority, with strong regional, local and industrial/financial leaderships, each exercising authority over particular, limited domains, although these domains are less territorially, and more functionally, defined' (2000: 15). Whilst Ericson remains uncertain whether 'industrial feudalism' is a durable distinctive form of capitalism or is merely transitional, Simon Clarke (2004: 419) argues that Russian capitalism is in a transitional extensive phase and is not yet intensive capitalism. Adopting an analytical Marxist approach, Clarke argues that whilst labour has been *formally* subsumed under capital this has not yet been achieved in a *real* sense, with the result that production is not subject to the laws of capital (see also Holmstrom and Smith 2000). However, Clarke contends that the economic crisis of 1998 marked a shift away from financial speculation (primitive accumulation) and towards the productive sphere of the economy. Whilst capital has penetrated the industrial economy since 1998 this has been achieved through the emergence of holding companies within which production continues to exhibit features of production under the Soviet system.

Lane (2000: 497–8) argues that a capitalist class has yet to emerge in Russia, resulting in a '"chaotic" social formation', which he defines as a:

> social and economic system which lacks institutional coordination and promotes social fragmentation: goals, law, governing institutions and economic life lack cohesion. Its characteristics are uncertainty about the future, elite disunity, the absence of a dominant and mediating class system, a mixture of media of exchange, criminalization and corruption, rent-seeking entrepreneurs, inadequate political interest articulation and an economy in decline characterized by inflation, unemployment and poverty . . . a chaotic social formation is perverse and system stability is precarious.

A feature of these analyses has been the emergence of new organisational forms, such as the FIGs, that link industrial enterprises and financial institutions and which combine elements of the Soviet system with elements of capitalism. These organisations have been interpreted either as political structures through which the *nomenklatura* used administrative power to socialise costs and rapidly accumulate capital (cf. Staniszkis 1991: 141) or as defensive structures designed to insulate actors from the laws of capital. Burawoy and Krotov's (1995) research on the timber and coal industries in the Republic of Komi suggests how and why these organisations emerged. In the context of a vertically integrated regional timber conglomerate, enterprises that felt exploited in the production chain withdrew from the conglomerate to market their products directly. However, the collapse of the conglomerate led to the disintegration of the sector, which meant individual enterprises lost their traditional suppliers and customers. As a consequence the timber industry became dependent on the local paper factory's ability to win export contracts. In contrast the horizontally organised coal industry conglomerate that had been controlled from Moscow and was used to subsidies from the centre maintained its internal structure as it sought to secure continued subsidies.

Johnson (1997) distinguishes between 'industry-led' and 'bank-led' FIGs in Russia:

> We find that, whereas industry-led FIGs for the most part represent failed efforts by enterprise managers and conservative politicians to salvage uncompetitive industrial ventures without restructuring them, bank-led FIGs have acquired powerful and potentially pivotal positions in the Russian economy today.
>
> (Johnson 1997: 335)

She argues that industry-led FIGs initially emerged spontaneously as a response to the commercialisation of branch ministries, the decentralisation of the planning system and the absence of capital but were subsequently encouraged by local and national public authorities. Johnson suggests industry-led FIGs are transitional structures that will either disintegrate or merge with bank-led FIGs. Similarly, Huber and Wörgötter (1998) identify what they call 'survivalist' business networks primarily engaged in rent seeking. They argue that high sectoral and geographical concentration under the Soviet system encouraged the emergence of vertically organised stable survivalist networks geared towards averting bankruptcy and/or personal enrichment. Industrial enterprises were able first to turn localities' dependence on them for employment, infrastructure and tax revenues into the basis for asserting their influence at the local scale and subsequently to use their local power base to exercise political influence at the national scale. This was achieved through managers at industrial enterprises establishing satellite and/or intermediary companies engaged mostly in trading from whose activities they could personally gain. The legacy of the Soviet economy, in which branch ministries and foreign trade organisations were located in Moscow, means survivalist networks are centred on Moscow with the result that monopoly rents accrued in Moscow where trading in commodities/products produced in the regions took place. Provincial enterprises did not leave the networks because they depended on the network fixers located in

Moscow. Huber and Wörgötter conclude that survivalist networks will only become profit driven entrepreneurial networks 'over a very long time period' (1998: 59).

Varieties of post-Soviet capitalism

In response to the normative orthodox transition literature, critical social scientists highlighted the path-dependency and diversity of post-Soviet transformations (see, for example, Chavance and Magnin 1997; Stark and Bruszt 1998, 2001; Smith and Swain 1998). This work showed that emergent capitalism involved 'self-reorganisation' (Chavance and Magnin 1997: 200) in which already existing social structures and practices in regions and countries inevitably combined with new capitalist practices to produce 'distinctively East European capitalism' (Stark and Bruszt 1998: 3). Stark and Bruszt called this 'recombinant capitalism' but also argued that different national state socialisms together with different paths of reform gave rise to a variety of national post-Soviet capitalisms (for a critique, see Burawoy 2001b). From an evolutionary and network approach, Grabher and Stark (1997) normatively argue that the presence of institutional diversity and friction encourages experimentation and produces regional economies with the capacity to adapt. More recently, drawing on the varieties of capitalism approach developed by Hall and Soskice (2001) and Amable (2003), attempts have been made to compare, contrast and categorise the different institutional forms that post-Soviet capitalism takes in different countries (see Lane and Myant 2006).

This approach highlights the extent to which actors, at the regional scale, acted collectively and strategically in the context of the disintegration of both the Soviet system and the Soviet state. Stoner-Weiss's (1997) research in four Russian oblasts indicates that the characteristics of regional economies, such as the degree of industrial concentration and specialisation, influenced the effectiveness of regional authorities and thereby regional economic performance. Her analysis suggests that: 'the more concentrated the regional economy, the more cooperative were economic and political elites, and the higher was regional government performance as a result' (Stoner-Weiss 1997: 165). She argues that 'the Soviet system's effective establishment of "company towns" appears to have provided a natural impetus for collective action in some regions once the command economy collapsed' (1997: 193–4). Interdependency between regional economic and political elites and dense horizontal professional networks spanning economic and political actors encouraged trust and predictable behaviour. Stoner-Weiss concludes that the acceptance of market principles through enrolment in foreign trade and competitive elections could prevent the emergence of regional oligarchies.

This work also contends that, rather than as barriers to reform, existing informal practices were the resources needed for social actors to self-reorganise, what Stiglitz (1999: 20–2) terms 'restructuring through decentralisation, reconstitution and recombination'. Sabel and Prokop (1996) found that some firms in the Urals actively reorganised and experimented despite both market (demonetarisation and absence of a valuing regime) and governance failure (opaque property relations and insider control). They concluded that corporate restructuring may be less explained by the presence of market signals, the form of property relations or the form of corporate governance than by the spread of economic discourses and particularly discursive quality standards, such as ISO 9000 series. More specifically, barter played an important role in preserving and reorganising the industrial economy. Chang (1999) argues that non-cash payment systems regularised the enterprises' activities in the absence of cash as a means of exchange. Equally, Marin (2002) argues that non-monetary exchange did not mask value-subtracting output but was a response to a lack of trust and liquidity in the economy and concludes that barter prevented an even more marked collapse in industrial output:

> [T]he non-cash economy helps to maintain output which otherwise would collapse due to imperfect input and credit markets. The imperfections of input and credit markets are reflected in the shift in the terms of trade of barter. Through the inflated price for the 'sale' and the price discount on the 'goods payment' the deal is actually saved by guaranteeing both parties a positive profit. The shift in the terms of trade is the mechanism by which the non-cash economy accomplishes the maintenance of output that would otherwise collapse in a cash economy.
>
> (Marin 2002: 198)

Marin (2002) shows that barter transactions increased in Russia after macro-economic stability had been achieved and decreased during the instability of the 1998 economic crisis. Based on an analysis of 165 barter transactions in 1997 in Ukraine, Marin concludes that enterprises resorted to non-monetary exchange because of a lack of liquidity in the economy and that once the rouble depreciated in 1998 increased export earnings permitted more cash transactions to take place (see also Campos and Coricelli 2002).

Similarly the emergence of large business groups may be considered as an innovative vehicle for industrial restructuring in a low-trust society. Even commentators who point to the negative role of business groups recognise that 'bank-led' FIGs (Johnson 1997) and entrepreneurial business networks (Huber and Wörgötter 1998) engaged in reorganisation and restructuring. Moreover, Perotti and Gelfer's (2001) econometric analysis finds that enterprises that formed part of business groups showed evidence of greater financial reallocation than independent enterprises. Following the Yukos affair, Hanson and Teague (2005, 2006) term 'Russia's really-existing capitalism' as Weberian 'political capitalism', verging on state capitalism, involving the allocation of profits according to political administration, a low-trust society and high levels of corruption. Contra the state capture thesis (see page 12), they contend that the legacies of shady privatisation and the size of strategically sensitive energy sectors have produced a form of 'state corporatism' (2005: 658) in which the state informally controls non-state bodies in order to implement government policy.

The Donbas in 'transition'

Post-Soviet restructuring of the Ukrainian space-economy

The disintegration of the Soviet Union and the central planning system plunged Ukraine into a long and severe economic depression.[5] However, the division between the predominantly urban industrial east and south of the country and the mainly rural and agricultural centre and west meant post-Soviet 'transition' unevenly affected the Ukrainian space-economy. A notable feature of this new phase of uneven development was that the Donbas, comprising Donetsk and Luhansk oblasts, performed relatively well in the context of the country as a whole. It is not possible to map uneven development from the beginning of transition because the collection of official statistics changed in 1996. The only consistently stable measure for evaluating the long-term impact of transition on different regions is population change. Figure 1.1, which shows population change, by oblast, between 1989 and 2005, reveals that the only territory where population increased is Kyiv city. In all other oblasts, as well as in Sevastopol, population fell, with the greatest fall taking place in Chernihiv oblast at the northern end of central Ukraine. The map also reveals a broad east–west pattern in which population has fallen most in the more populous east of the country and fallen less in the west of the country. Besides Chernihiv, Luhansk and Sumy oblasts, the steepest population decline was suffered by two central Ukrainian provinces, Zhytomyr and Kirovohrad, with Donetsk oblast coming the sixth from the bottom.

To show the impact of 'transition' on uneven development we have used World Bank data to map change in Gross Value Added (GVA) per capita (current prices) by oblast between 1990 and 1995 (Figure 1.2). The World Bank used official statistics to estimate GVA per capita at current prices in 1990 and 1995. In 1996 the Ukrainian government began to publish official GVA per capita data, permitting us to map regional change between 1996 and 2003 (Figure 1.3). It should be noted that until the late 1990s these data did not include estimates for the informal sector which is generally accepted as a significant factor in Ukraine. The two periods broadly correspond to the rapid economic decline in the first half of the 1990s and to the period when economic growth resumed in the late 1990s. Figure 1.2 shows that between 1990 and 1995 the two best performing oblasts were Kharkiv and Odesa and the worst relative to the national average were Kirovohrad and Chernihiv in the centre of the country and a band of oblasts in the west including Chernivtsi, Ternopil, Rivne and Volyn. Although the map shows GVA per capital fell in Kyiv city compared to the national average, the fact that Kyiv oblast performed relatively well suggests that there were spill-over effects from Kyiv city to the surrounding oblast. The map also reveals that GVA per capita fell less in the Donbas (Donetsk and Luhansk oblasts) than the national average. The neighbouring oblasts, Dnipropetrovsk and Kharkiv, also declined less than the national average, whereas the greatest fall was in those predominately agricultural oblasts in the centre and west of the country.

Figure 1.3 reveals that as economic growth in Ukraine resumed the pattern of uneven development became more complicated. Between 1996 and 2003 the cities

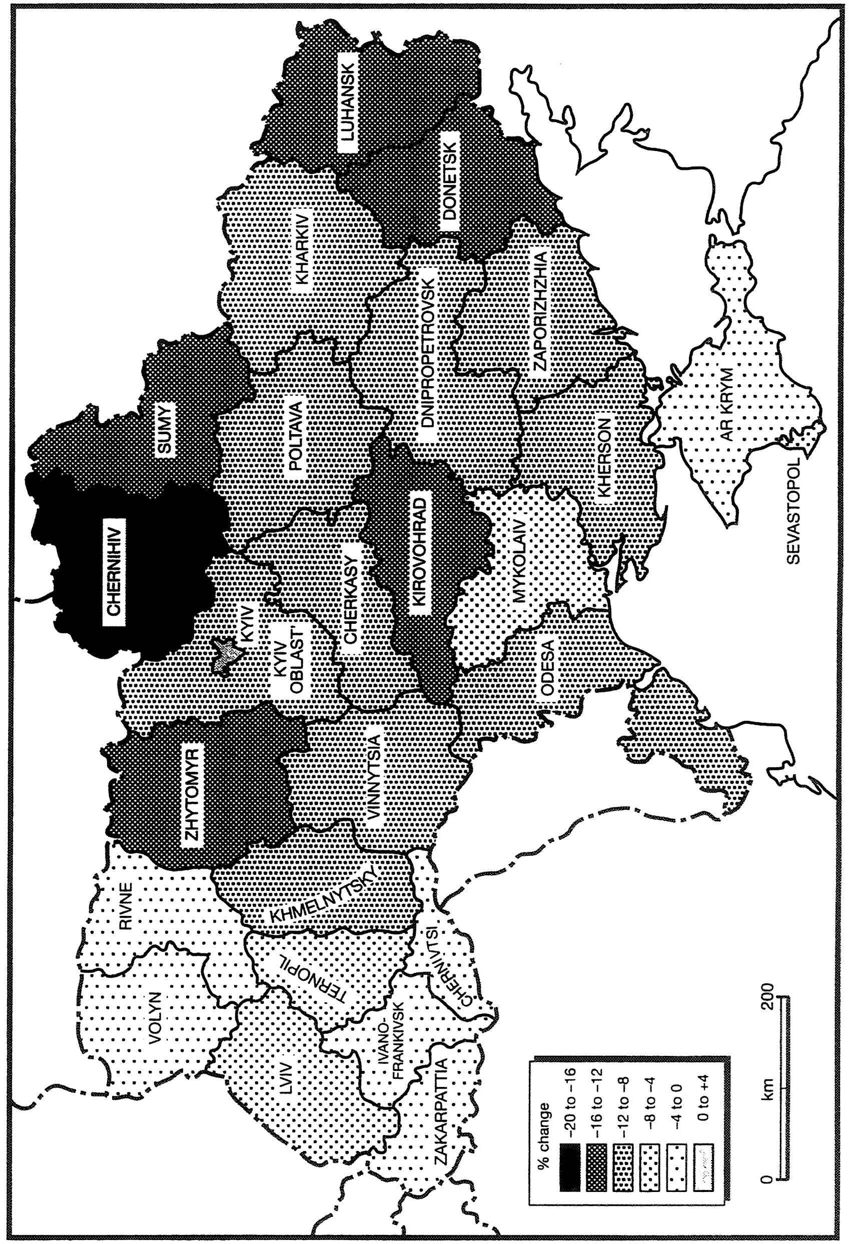

Figure 1.1 Population change by oblast, 1989–2005

Source: Authors' own calculations on the basis of Ukraine State Statistics Committee 2004a, 2005b.

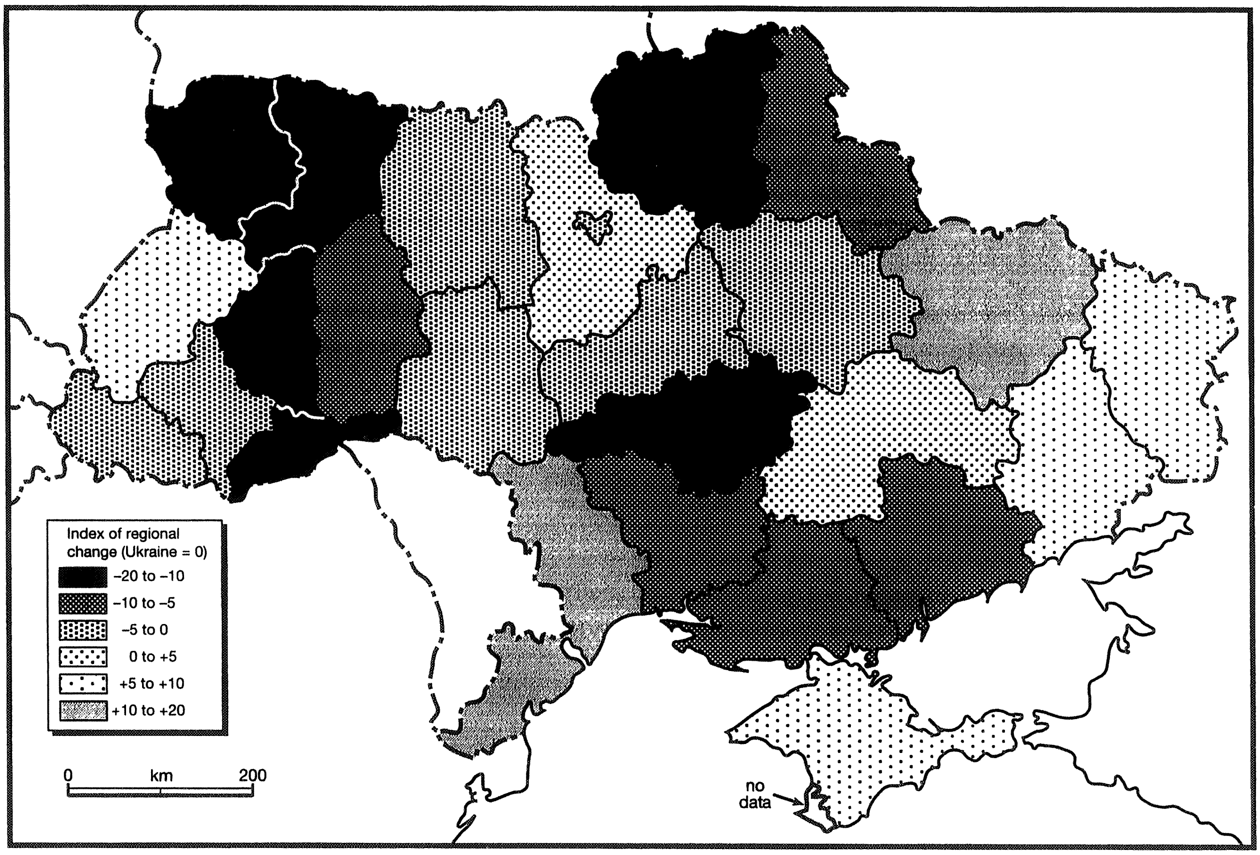

Figure 1.2 Index of regional change in GVA per capita, 1990–1995

Source: World Bank 2003a.

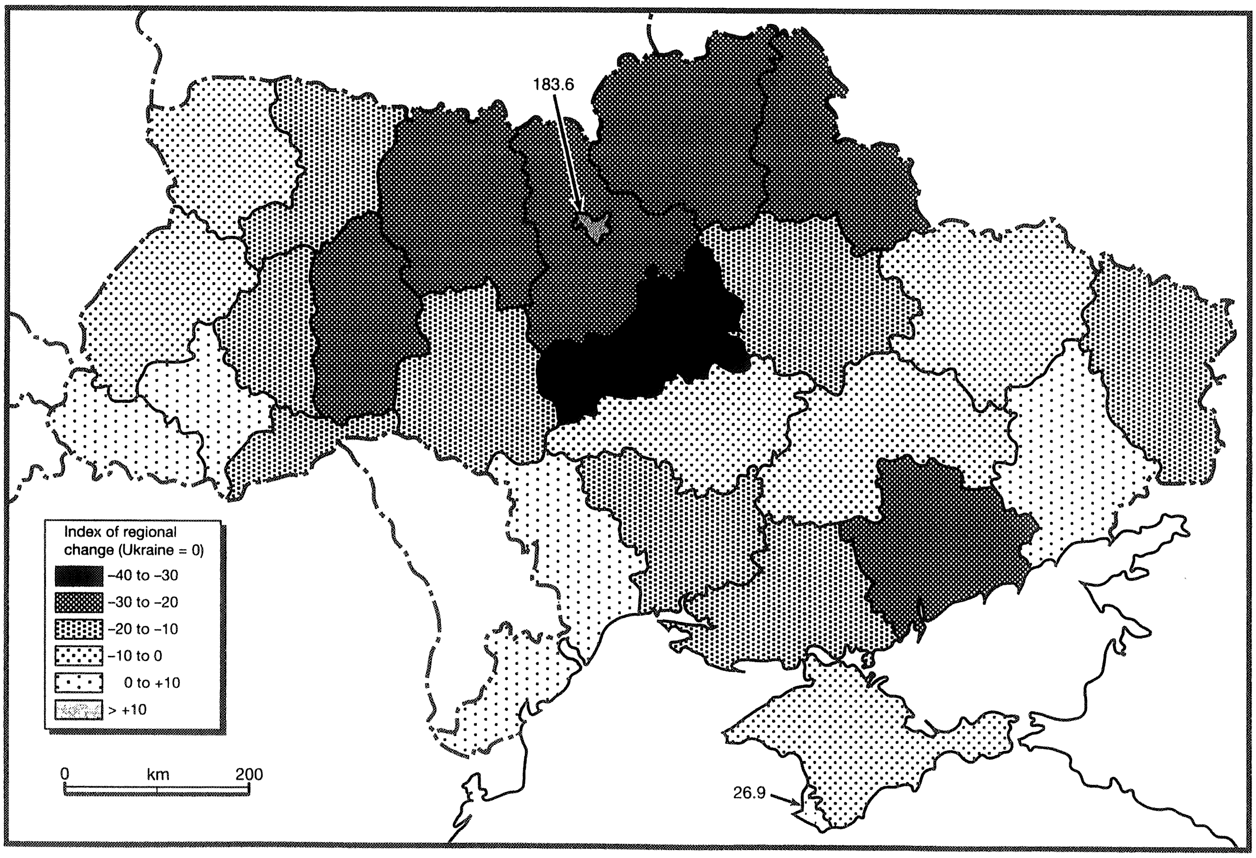

Figure 1.3 Index of regional change in GVA per capita, 1996–2003

Source: Authors' own calculations on the basis of Ukraine State Statistics Committee 2004b: tab. 2.10, 2005a.

of Kyiv and Sevastopol performed best compared to the national average. This can largely be accounted for by Kyiv being the capital city (the location of government and headquarter functions) and the presence of the well-endowed Russian navy in and around Sevastopol. In addition, estimates of per capita GDP or GVA in (any metropolitan centre like) Kyiv do not take into account large numbers of commuters, who reside in an extensive travel-to-work area outside the administrative city boundaries, thus inflating the GDP per resident count. Only four oblasts, Zakarpattia and Ivano-Frankivsk in the west, Odesa in the south and Donetsk in the east, performed better than the national average. Whereas the two oblasts in the west benefited from cross-border trade and the temporary emigration of inhabitants to find work abroad, and Odesa from the growth of trade at the ports, Donetsk's performance reflects expansion of the industrial economy there after 1999. The relatively worst performing oblast was Cherkasy, whilst there was a general pattern of oblasts in the centre of the country performing relatively poorly.

By the end of 2003 the regional pattern of GVA per capita revealed a country with great regional imbalances (Figure 1.4). In broad terms there was a clear south-east/centre-west division as well as a division between key cities and rural areas. GVA per capita in Kyiv was more than three times the national average and more than six times the lowest ranked, Ternopil oblast. Other territories with a GVA per capita above the national average were Donetsk, Dnipropetrovsk, Poltava, Zaporizhzhia and Odesa, mostly in the south-east of the country. In contrast the least developed territories were Chernivtsi, Ternopil, Zhytomyr and Zakarpattia, predominantly in the west of the country. The west and centre of the country were less developed than much of the east and south of the country, with the exception of two noticeable effects. These were the spill-over effects of Kyiv city on Kyiv oblast and the regional effect of Lviv in the west of the country. The regional pattern of unemployment in 2004, calculated according to the standard Labour Force Survey (LFS) methodology developed by the UN International Labour Organization (ILO unemployment), mirrors the GVA data (Figure 1.5). The highest unemployment rates were in four oblasts in the west of the country (Chernivtsi, Ternopil, Khmelnytsky and Rivne) and in Cherkasy and Zhytomyr oblasts in central Ukraine. The lowest unemployment rates were in the cities of Kyiv and Sevastopol, followed by Dnipropetrovsk, Odesa, Crimea, Poltava, Donetsk, Kharkiv and Zaporizhzhia – all regions in the east and south of the country, except for Kyiv and Poltava.

In summary there was a clear division between Kyiv city, with a very high GVA per capita and a very low rate of ILO unemployment, and the rest of the country. There was also a pronounced imbalance between the east of the country plus several southern regions (Odesa and Sevastopol), with high GVA per capita and low rates of ILO unemployment, and the west and centre of the country with lower GVA and higher unemployment. Moreover, whilst the restructuring of the space-economy during transition had been complicated, the data suggest a broad pattern of divergence between the west and the east of the country. However, within the east of the country some oblasts, such as Zaporizhzhia and Luhansk fared less well than other oblasts such as Donetsk and Dnipropetrovsk.

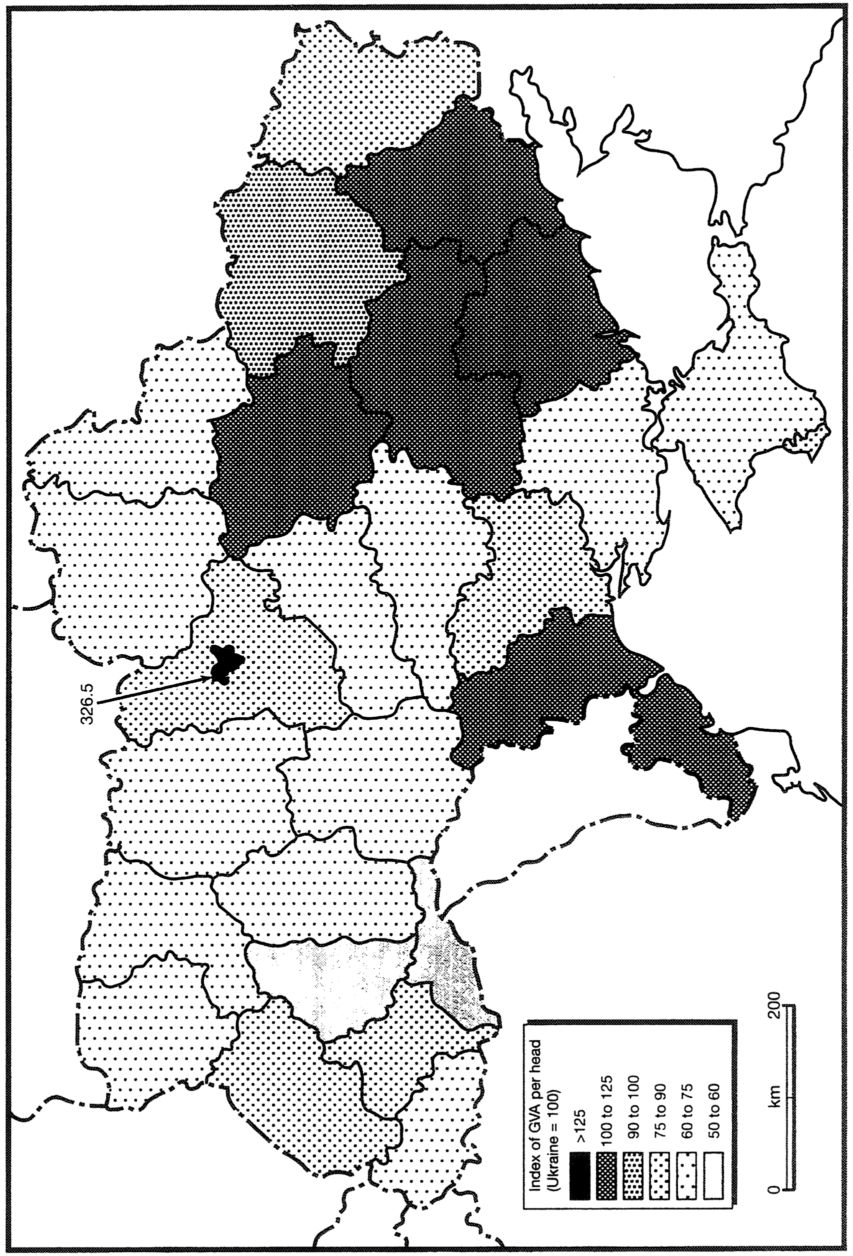

Figure 1.4 Index of GVA per capita by oblast, 2003

Source: Authors' own calculations on the basis of Ukraine State Statistics Committee 2005a.

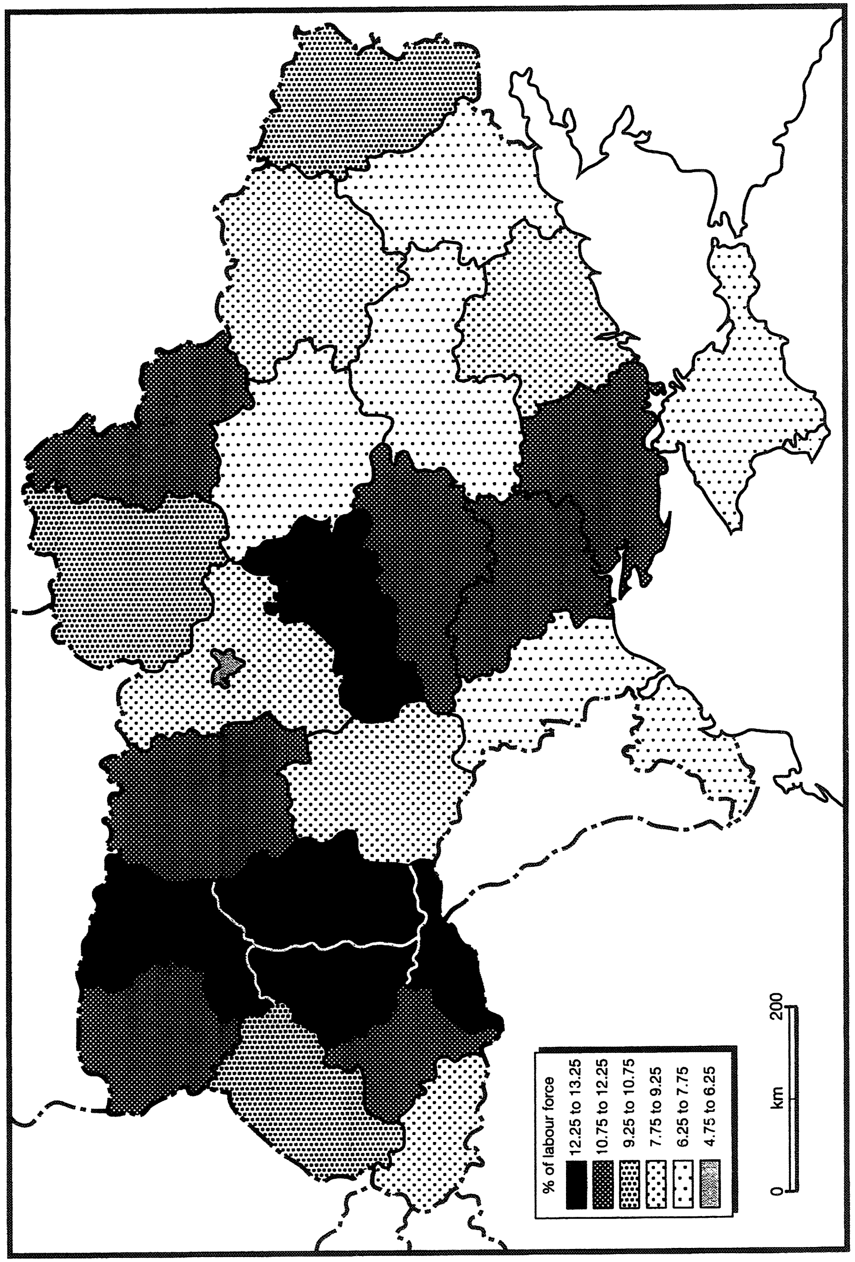

Figure 1.5 Unemployment rate, 2004 (LFS-based methodology)

Source: Ukraine State Statistics Committee 2005c.

Regional development in the Donbas

The Donbas comprises two heavily industrialised and urbanised oblasts, including four large cities with a population of more than 250,000 in Donetsk oblast (Donetsk city, Makiivka, Mariupol and Horlivka) and one in Luhansk oblast (Luhansk city) (Figure 1.6). The strategic role the region played in the USSR meant the region

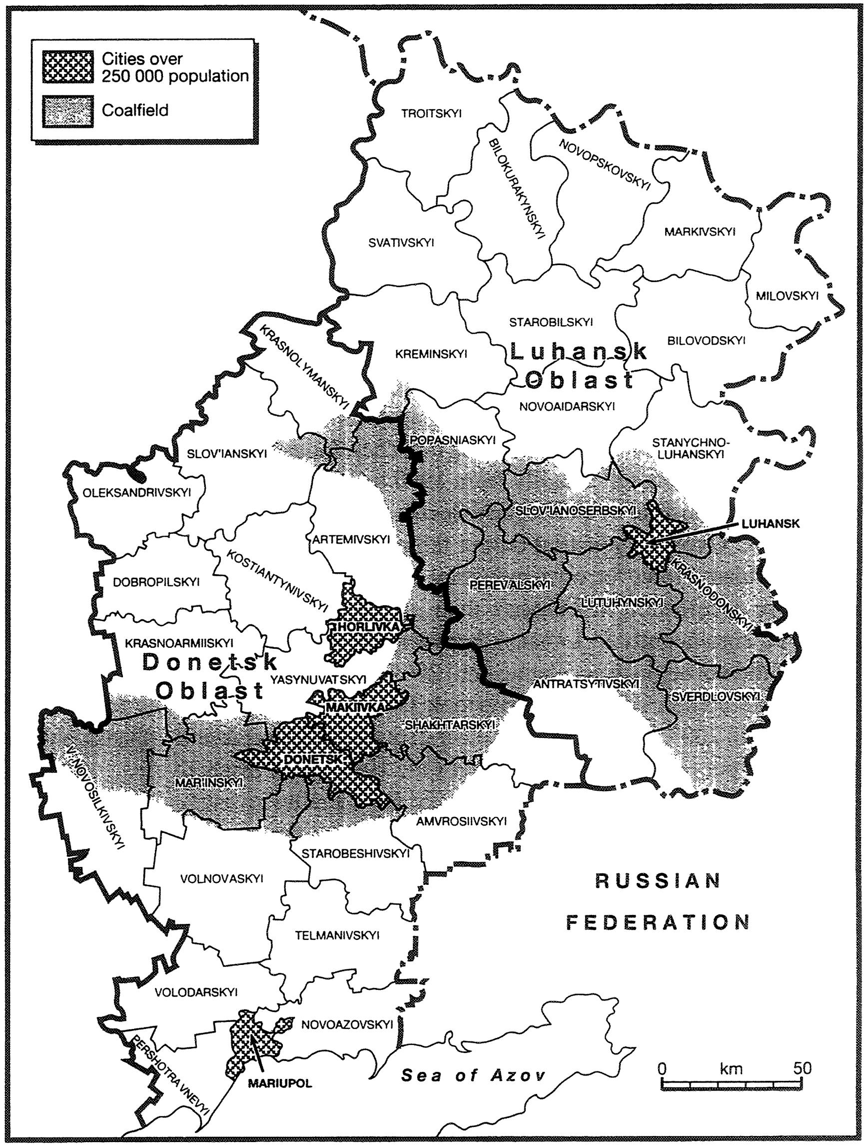

Figure 1.6 A map of the Ukrainian Donbas

possessed a good road and rail infrastructure as well as a large port in Mariupol on the Sea of Azov. In response to a long period of industrial stagnation, an independent miners' movement emerged in the Donbas during *perestroika*. This movement and the region played an important role in the disintegration of the USSR and the Soviet system (see, for example, Friedgut 1994). However, as the region depended on a small number of key sectors, such as coal mining and iron and steel production, controlled by all-union branch ministries and integrated into pan-USSR production networks, the disintegration of the USSR had a particularly pronounced effect on the region (see Mykhnenko 2005).

Statistics on GVA per capita, from 1995 to 2004, provide an insight into the performance of the economy in the region (Table 1.1). (It should be noted that in 2004 Gross Regional Product (GRP) per capita replaced GVA. It was too soon to assess the full impact of the 'Orange Revolution' on the Donbas economy.) GVA per capita shows that the economy in both oblasts bottomed out in 1998 and that the contraction which took place in the 1990s was greater in Luhansk than in Donetsk. Between 1998 and 2000 GVA per capita grew gently in both oblasts before accelerating in Luhansk between 2000 and 2001 and in Donetsk from 2002. In 2004 GRP per capita stood at 146.6 per cent and 149.2 per cent compared to 1995 in Donetsk and Luhansk oblasts respectively. For a region dominated by industrial production, the performance of the regional economy was largely determined by the primary sector (coal and energy) as well as steel, heavy engineering, petrochemicals and other manufacturing branches. Industrial output in both Donetsk and Luhansk oblasts fell steadily from 1990 to 1993 and then rapidly until 1995. At that point industrial output began to level off in Donetsk but continued to decline in Luhansk. Overall, industrial output fell considerably more in Luhansk than in Donetsk oblast. However, once industrial output began to grow in 1999, the upturn was more accelerated in Luhansk than in Donetsk. Whereas industrial output increased significantly in Luhansk between 1999 and 2001, industrial output in Donetsk did not begin to accelerate until 2002. As a result, in 2001 industrial output in Luhansk compared to 1990 overtook Donetsk oblast before the two oblasts converged in 2003. Thus by 2004 industrial output in Donetsk and Luhansk oblasts stood at 78 per cent and 79.3 per cent of the 1990 figure respectively.

As industrial output collapsed so too did fixed capital investment. In 1997 fixed capital investment in Donetsk oblast stood at 22.7 per cent compared to 1990. Thereafter fixed capital investment grew slowly until 2002 before accelerating to reach 55.5 per cent in 2005 compared to 1990. The collapse was even greater in Luhansk oblast where fixed capital investment fell to 16.5 per cent in 1999 compared to 1990. Thereafter fixed capital investment gradually increased until 2002 before accelerating to 47.4 per cent in 2005 compared to 1990. Given that the regional economic accounts data for 2005 will become available only in mid-2007, it is not possible to assess in full the economic impact of the turbulent political events of 2004–2005 on the economy of the Donbas at this stage. However, one does not fail to notice that in 2005, in the aftermath of the Orange Revolution, industrial growth significantly decelerated in Luhansk oblast, whereas Donetsk registered an absolute decline of industrial output for the first time since 1998. This,

Table 1.1 Regional economic change in Donetsk and Luhansk oblasts, 1990–2005

		1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*
GVA per capita (1995=100)	Donetsk						100.0	94.3	92.2	88.5	91.6	97.6	110.3	115.0	130.9	146.6*	…
	Luhansk						100.0	88.5	89.0	84.8	87.8	93.6	113.7	122.8	136.1	149.2*	…
Industrial output (1990=100)	Donetsk	100.0	93.2	86.9	74.4	54.2	49.4	46.4	47.0	43.6	46.6	52.4	55.6	58.1	69.4	78.0	71.9
	Luhansk	100.0	92.5	86.6	71.7	51.0	38.2	34.2	35.5	33.4	36.2	47.1	61.4	64.0	71.6	79.3	80.5
Fixed capital investment (1990=100)	Donetsk	100.0	…	…	…	…	34.6	28.2	22.7	25.5	25.2	27.1	31.8	31.7	38.3	50.0	55.5
	Luhansk	100.0	…	…	…	…	29.1	20.9	21.1	18.8	16.5	17.6	20.5	21.7	28.4	38.6	47.4
Cumulative FDI (US$m)	Donetsk	…	…	…	…	…	52.2	76.3	106.2	166.2	259.4	305.3	334.8	389.4	434.2	501.7	586.0
	Luhansk	…	…	…	…	…	…	…	27.8	28.2	27.6	31.4	39.3	51.6	58.2	146.2	269.5
Cumulative FDI per capita (US$)	Donetsk	…	…	…	…	…	10.0	14.9	21.0	33.2	52.6	62.4	69.2	81.6	92.0	107.4	126.5
	Luhansk	…	…	…	…	…	…	…	…	…	10.5	12.1	15.4	20.6	23.5	59.9	111.4

Sources: Ukraine State Statistics Committee 1996, 2000, 2004b, 2005a, 2005d, 2005e, 2005f, 2006a; Donetsk Oblast Chief Statistical Department 2004a; Luhansk Oblast Chief Statistical Department 2004; and authors' own calculations.

Note: *Gross regional product; … = no data.

however, did not seem to alter capital investment decisions made by local economic agents, as fixed capital investment continued to grow.

One of the features of the upturn in the regional economy since 1998 has been the attraction of foreign direct investment (FDI). In 1999 the Ukrainian government passed a law that created a special investment regime for domestic and foreign investment located in designated 'depressed' and 'priority development' areas in Donetsk and Luhansk oblasts. Table 1.1 shows that cumulative FDI in Donetsk oblast began to grow rapidly in the late 1990s reaching $586 million by 2005. By comparison, cumulative FDI in Luhansk oblast remained less than $60 million until 2004 when it more than doubled in one year to reach $270 million in 2005. However, these figures need to be treated with a degree of caution for two reasons. First, Ukrainian FDI statistics include foreign loans to local companies and the value of imported capital goods. Second, a significant proportion of FDI was routed through offshore financial centres, such as the British Virgin Islands or Cyprus, and may simply reflect the recycling of money that previously flowed out of the region. Although Donetsk attracted several high-profile foreign investors, including the US-based multinational giant Cargil, which established a 'greenfield' sunflower crushing plant just outside Donetsk city, and ISTIL Group, which acquired a stake in the Donetsk Iron and Steel Works, FDI had a relatively small impact on the regional economy. Cumulative FDI per capita in Donetsk oblast reached $126.50 in 2005 and $111.40 in Luhansk oblast – where the figure had nearly doubled in one year.

The 'transitional' depression and the consequent industrial renaissance of the Donbas economy have had a profound effect on labour. Table 1.2 shows changes in the emergent labour market from 1985 until 2005. The table includes data both on employment, which includes all people in formal work, and on the number of employee jobs, which includes only waged/salaried employees of large industrial and agricultural enterprises and excludes employers, the self-employed, employees of small firms (with less than 50 staff and annual sales of less than EUR500,000), private farmers and seasonal labourers. Employment in the two oblasts fell from 4.09 million in 1985 to 3.18 million in 2005 and most severely in Luhansk. The fall in employment has been caused by enterprise closures and lay-offs in the early and mid-1990s, by people leaving the (formal) world of work, and also through population decline. In both oblasts the number of employees has fallen more sharply than employment as people have moved from the traditional state sector into service activities and self-employment. The data also show that only a small proportion of people leaving formal employment registered as unemployed. Registered unemployment only began to increase in the mid-1990s and peaked at almost 96,000 in Donetsk in 2000 and at almost 58,000 in Luhansk in 2001 before gradually declining. However, registered unemployment did not accurately reflect the real level of joblessness. Since 1999 unemployment as defined by the ILO (using the LFS method) has been collected for both oblasts. These data show that ILO unemployment peaked in Donetsk oblast at around 240,000 (10.3 per cent of the labour force) in both 1999 and 2001 and in Luhansk at around 152,000 (13.3 per cent) in 2001. As the two regional economies rebounded in the early 2000s, ILO

Table 1.2 Labour market change in Donetsk and Luhansk oblasts, 1985–2005

		1985	*1990*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*
Present population (000s)	Donetsk		5,339.6	5,266.9	5,198.5	5,125.4	5,064.4	4,987.3	4,932.4	4,893.6	4,834.7	4,774.4	4,720.9	4,671.9
	Luhansk		2,866.9	2,827.1	2,788.5	2,719.0	2,684.4	2,652.7	2,628.6	2,607.4	2,542.5	2,507.3	2,472.6	2,440.3
	Total		8,206.5	8,094.0	7,987.0	7,844.4	7,748.8	7,640.0	7,561.0	7,501.0	7,377.2	7,281.7	7,193.5	7,112.2
Index of present population (1990=100)	Donetsk		100	98.6	97.4	96.0	94.8	93.4	92.4	91.6	90.5	89.4	88.4	87.5
	Luhansk		100	98.6	97.3	94.8	93.6	92.5	91.7	90.9	88.7	87.5	86.2	85.1
	Total		100	98.6	97.3	95.6	94.4	93.1	92.1	91.4	89.9	88.7	87.7	86.7
Employment (000s)	Donetsk	2,652.8	2,589.6	2,480.7	2,427.9	2,314.6	2,310.8	2,197.3	2,125.6	2,078.3	2,033.3	2,074.2	2,086.0	2,124.9
	Luhansk	1,434.9	1,410.4	1,259.5	1,218.1	1,117.7	1,068.8	1,050.9	999.2	950.0	968.8	978.7	1,019.8	1,054.4
	Total	4,087.7	4,000.0	3,740.2	3646.0	3,432.3	3,379.6	3,248.2	3,124.8	3,028.3	3,002.1	3,052.9	3,105.8	3,179.3
Index of total employment (1985=100)	Donetsk	100	97.6	93.5	91.5	87.3	87.1	82.8	80.1	78.3	76.6	78.2	78.6	80.1
	Luhansk	100	98.3	87.8	84.9	77.9	74.5	73.2	69.6	66.2	67.5	68.2	71.1	73.5
	Total	100	97.9	91.5	89.2	84.0	82.7	79.5	76.4	74.1	73.4	74.7	76.0	77.8
Number of employees (000s)	Donetsk	2,568	2,420	1,953.7	1,713.2	1,598.2	1,619.5	1,552.7	1,477.0	1,410.3	1,349.6	1,312.6	…	…
	Luhansk	1,389	1,318	1,008.2	928.0	825.0	787.0	761.0	711.6	669.3	637.4	631.0	…	…
	Total	3,957	3,738	2,961.9	2,641.2	2,423.2	2,406.5	2,313.7	2,188.6	2,079.6	1,987.0	1,943.6	…	…
Index of number of employees (1985=100)	Donetsk	100	94.2	76.1	66.7	62.2	63.1	60.5	57.5	54.9	52.6	51.1	…	…
	Luhansk	100	94.9	72.6	66.8	59.4	56.7	54.8	51.2	48.2	45.9	45.4	…	…
	Total	100	94.5	74.9	66.7	61.2	60.8	58.5	55.3	52.6	50.2	49.1	…	…

continued

Table 1.2 (continued)

		1985	*1990*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*
Number of registered unemployed (000s)	Donetsk			4.6	8.5	25.5	50.7	79.6	95.6	95.1	72.1	74.5		
	Luhansk			...	...	...	...	44.9	53.4	57.9	48.4	46.0		
	Total							124.5	149.0	153.0	120.5	120.5		
Registered unemployment (%)*	Donetsk			0.30	0.90	1.80	2.90	3.50	3.50	2.70	2.80	2.60	2.40	
	Luhansk	0.20	0.50	1.70	3.10	3.70	3.90	3.30	3.20	3.10	2.70	2.30		
ILO unemployment (000s)	Donetsk			...	...	...	...	242.6	231.7	241.6	218.3	179.7		
	Luhansk			...	...	...	...	132.8	129.1	152.0	137.0	99.7		
	Total							375.4	360.8	393.6	355.3	279.4		
ILO unemployment (%)**	Donetsk							10.30	9.60	10.30	9.40	8.00	7.30	6.60
	Luhansk							11.40	11.20	13.30	11.90	9.20	9.20	8.20

Sources: Ukraine State Statistics Committee 1996, 2000, 2001, 2002, 2004b, 2004c, 2005g; Donetsk Oblast Chief Statistical Department 2000, 2002, 2004a; Luhansk Oblast Chief Statistical Department 2004; and authors' own calculations.

Notes: * Percentage of population of working age; ** Percentage of population aged 15–70); ... = no data.

unemployment fell to 6.6 per cent and 8.2 per cent in Donetsk and Luhansk oblasts respectively, with the Ukraine average in 2005 of 7.8 per cent.

In summary two key points should be highlighted. The first is that the economy in Luhansk was more severely effected that in Donetsk by 'transition'. Its economy contracted more than in Donetsk and, although its rebound was more accelerated, it continued to suffer greater structural problems. This was evidenced by a greater collapse in employment and in the number of employees in Luhansk than in Donetsk as well as higher unemployment and lower levels of FDI. Second, the Donbas regional economy began to recover in 1999; GVA per capita began to increase again, as did fixed capital investment and FDI, whilst unemployment began to level off and then fall. The only trend that continued even after economic growth began was the decline in the number of employee jobs. This indicates that economic growth was driven, at least in part, by greater productivity as well as by considerable structural changes involving the expansion of small and medium business and the consequent growth of self-employment.

Sub-regional inequalities

Central planning resulted in the creation of labour settlements orientated to one sector and often to one enormous enterprise. These 'company towns' depended almost entirely on the economic situation of the local enterprise, which in turn depended on its age, size, ability to access labour and so on, and on the relevant industrial branch, such as the capacity to find markets, access to investment capital and so on. Consequently in addition to the general pattern of deindustrialisation, which was more severe in Luhansk than in Donetsk, there was a very uneven micro-geography within the region. One of the most important factors affecting sub-regional inequalities has been the restructuring of the coal industry (see Chapter 7; Chapter 8; Swain 2006). The coalfield, which covers the central and eastern half of Donetsk oblast and the southern half of Luhansk oblast (Figure 1.6), has been affected by the closure of more than 50 coal mines since 1996. In contrast, the southern part of Donetsk oblast, with the exception of the city of Mariupol, and the northern half of Luhansk are more rural and agricultural. Figure 1.7 shows that there was an enormous variation in the change in industrial output between 1990 and 2003 by towns and districts in the two oblasts. The figure shows that this variety was greater in Donetsk oblast's urban areas than in Luhansk, and that the variation was especially pronounced in rural areas compared to urban areas, especially in Luhansk oblast. This indicates that rural areas were more likely to be dependent on the performance of one or two industrial enterprises whereas urban areas were more diversified.

The complex map of administrative boundaries within the two oblasts means it is difficult to map sub-regional data. We have overcome this by combining official statistics for rayons with data for towns located within those rayons and by mapping data for the large five cities.[6] To examine the impact of 'transition' at the sub-regional scale it is possible to map present population change from 1989 to 2004 (Figure 1.8). With the exception of Pershotravnevyi, adjacent to Mariupol on the

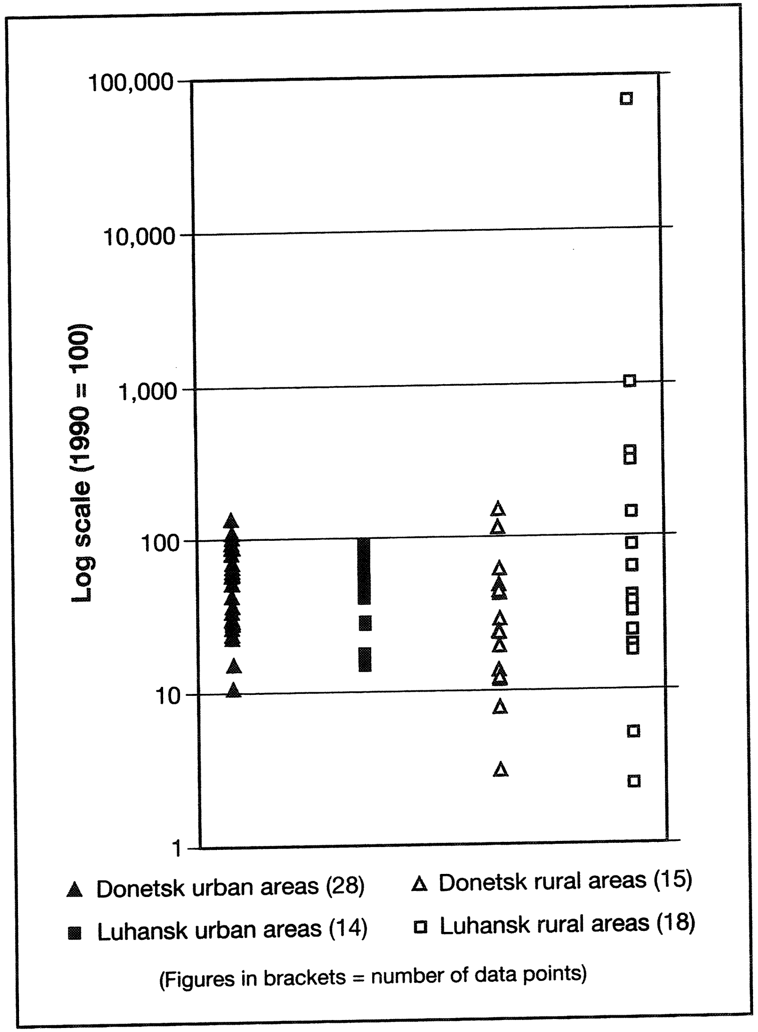

Figure 1.7 Index of change in industrial output by town/rayon in Donetsk and Luhansk oblasts, 1990–2003

Source: Authors' own calculations on the basis of Donetsk Oblast Chief Statistical Department 2004a: tab. 5.6; Luhansk Oblast Chief Statistical Department 2004: tab. 5.1.

coast, all territories saw a decline in population. However, the greatest declines were seen in the more industrial areas and especially in those rayons, such as Shakhtarskyi in Donetsk, and Antratsytskyi and Sverdlovskyi in Luhansk, where coal mines have been closed. Figure 1.9 shows the change in the number of salaried employees, which indicates the extent to which the traditional state-owned industrial and agricultural economy has declined, between 1995 and 2003. This map reveals that the number of employees decreased most in large cities, such as in Makiivka

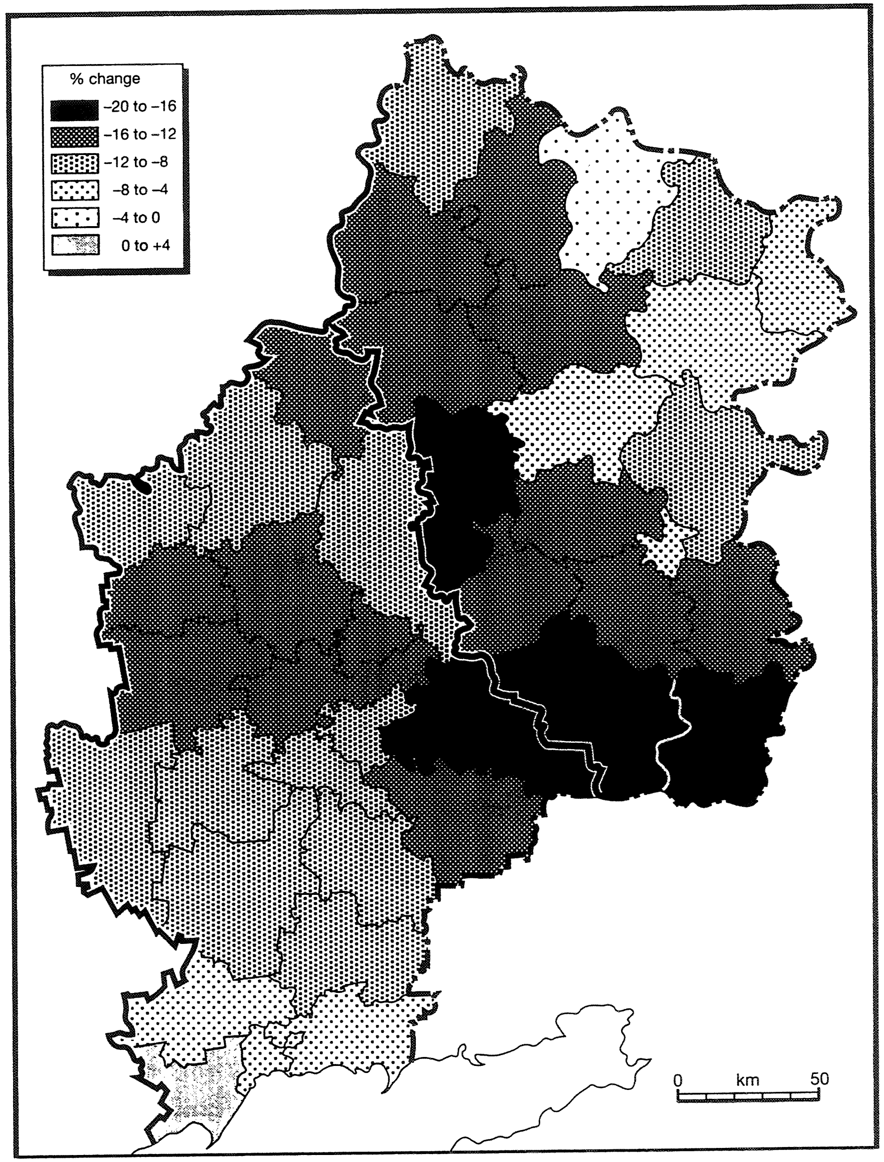

Figure 1.8 Present population change in Donetsk and Luhansk oblasts, 1989–2004

Sources: Authors' own calculations on the basis of Ukraine State Statistics Committee 2004a; Donetsk Oblast Chief Statistical Department 2004a: tab. 15.4; Luhansk Oblast Chief Statistical Department 2004: tab. 15.2.

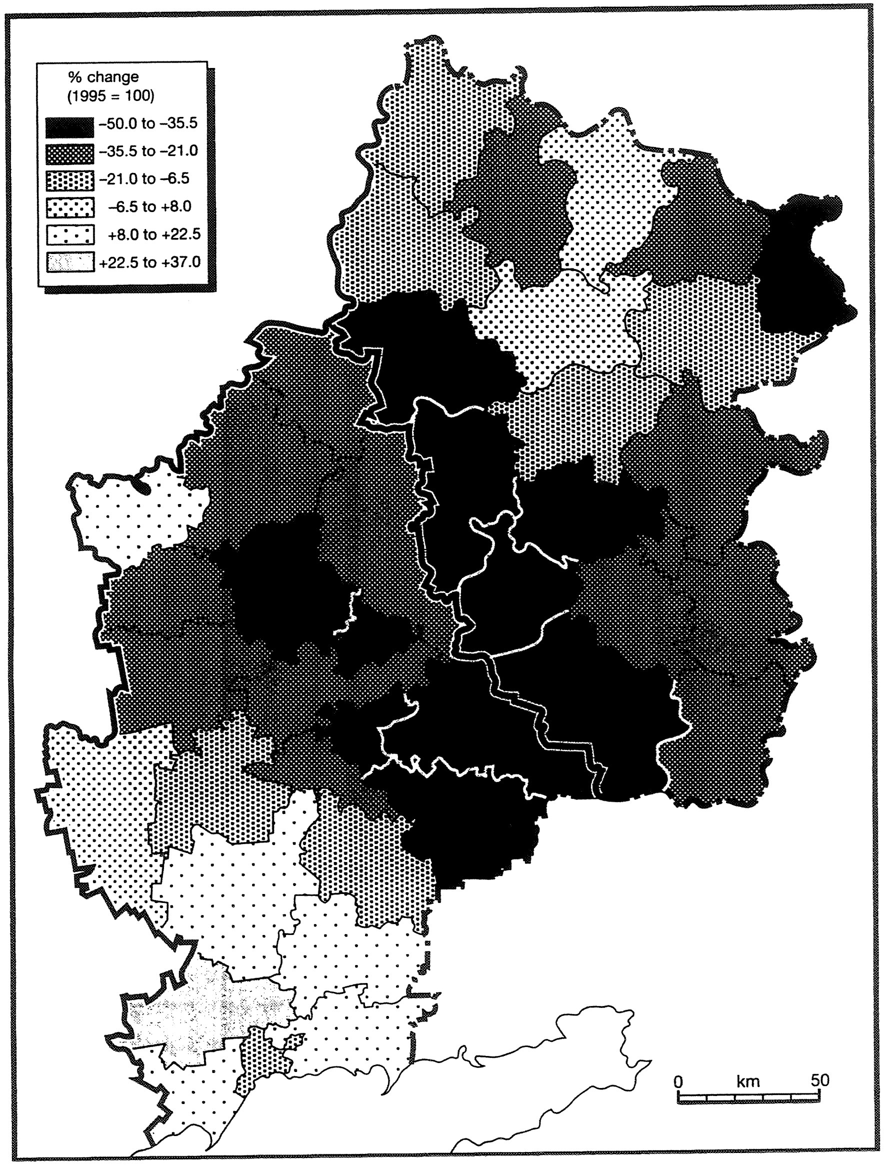

Figure 1.9 Change in the number of employees in Donetsk and Luhansk oblasts, 1995–2003

Sources: Donetsk Oblast Chief Statistical Department 2004a: tab. 16.9, 2004b; Luhansk Oblast Chief Statistical Department 2004: tab. 16.7.

and Horlivka, which depended on steel and coal and machine building and chemicals respectively, and/or individual plants that did not benefit very much from the rebound in the industrial economy after 1998. The number of employees also fell most precipitously in territories where coal mines had been closed. Elsewhere

in the more rural and agricultural area to the south of Donetsk oblast and the north of Luhansk oblast, the number of jobs fell least and in some cases even increased, especially in the coastal areas.

Figure 1.10 shows that industrial output in 2003 was geographically concentrated in the larger cities and in territories that lie on the coalfield. The map shows that industrial output in Donetsk oblast was highest in Mariupol because of the presence of two huge steel works, Azovstal and Illich, as well as a very large machine building factory and the port. The next highest concentration of industrial output was in Donetsk city itself, followed by Yasynuvatskyi rayon which includes one of the largest coke coal factories in Europe in the town of Avdiivka and a large steel works in Yenakieve. Industrial output in Luhansk oblast is concentrated in Popasnianskyi, with its large number of coal mines and petrochemical enterprises in and around the cities of Kirovske, Stakhanov, Severodonetsk, Lysychansk and Pervomaisk, in Perevalskyi (the location of a huge steel works in Alchevsk city and coal mines in and around the town of Brianka) and in Luhansk city.

Another means of mapping sub-regional inequalities is provided by mapping employment in small firms (those with fewer than 50 employees and annual sales of less that EUR50,000) as a percentage of total average employment (Figure 1.11). The map reveals that large employers remain very important to the regional economy and shows that employment in small firms is highest in cities, such as Donetsk city and Luhansk city, and lowest in coal mining areas. There also seem to be two further factors. First, areas like Pershotravnevyi appear to benefit from spill-over effects from Mariupol and the impact of tourism along the Sea of Azov coast. Second, areas such as Milovskyi and Bilokurakynskyi along Luhansk's northern border with Russia appear to be benefiting from cross-border trade activities.

In summary this section highlights that there are important geographical imbalances within the region. Industrial output in the Donbas is geographically concentrated in Mariupol and Donetsk city where many of the region's most important companies are located or where their head offices are situated. Donetsk city in particular plays an important role as the location of not only headquarters but also government functions and financial institutions. For these reasons the city is a hub with spokes radiating outwards to large industrial enterprises around the region, especially in Mariupol and in industrial areas of Luhansk oblast (e.g. Alchevsk). This entails the transfer of value from the enterprises to Donetsk city and has produced a high level of inequality at the sub-regional scale, with localities where small and old coal mines were located being most severely affected by deindustrialisation.

Explaining regional development in the Donbas: transitional neo-patrimonial capitalism?

In the first part of this chapter we outlined three broad theories of post-Soviet economic development. The Donbas has been analysed as exhibiting the

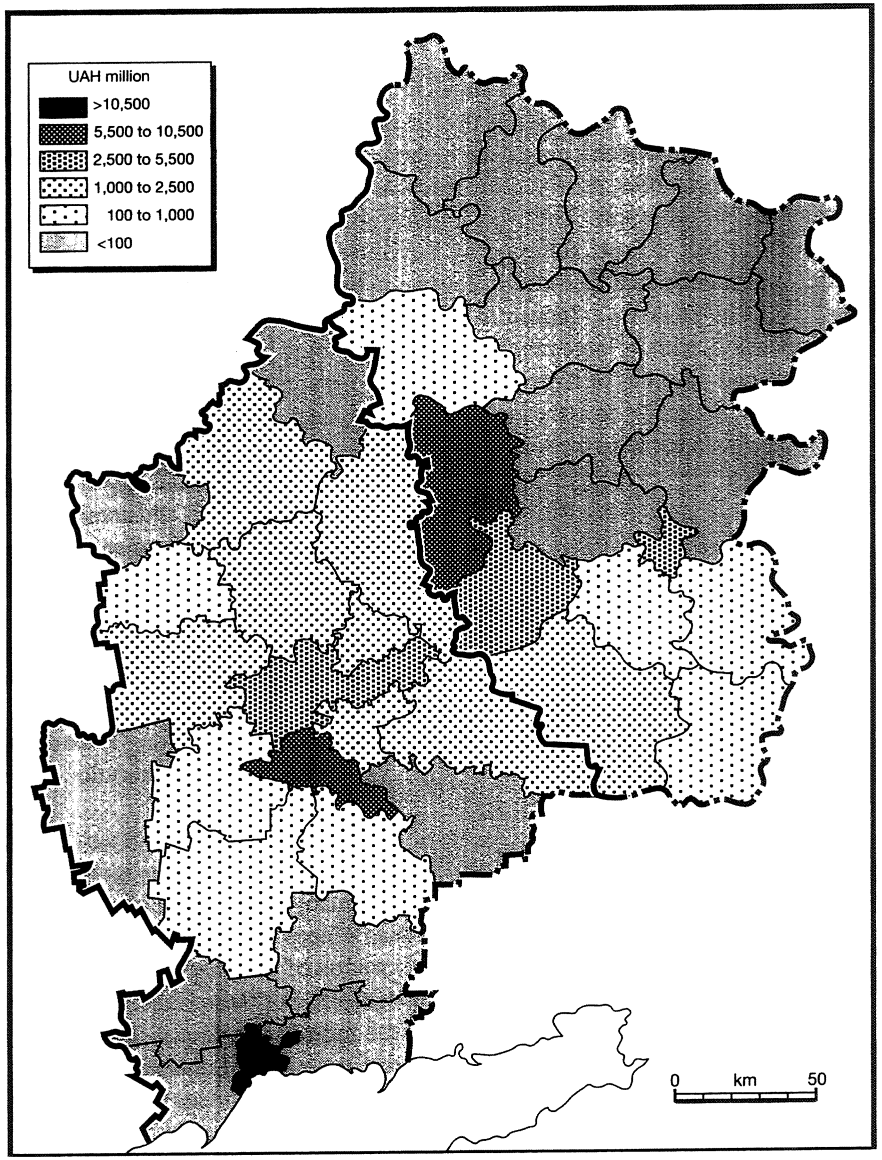

Figure 1.10 Industrial output in Donetsk and Luhansk oblasts, 2003 (UAH million in current prices)

Source: Authors' own calculations on the basis of Donetsk Oblast Chief Statistical Department 2004b; Luhansk Oblast Chief Statistical Department 2004: tab. 5.4.

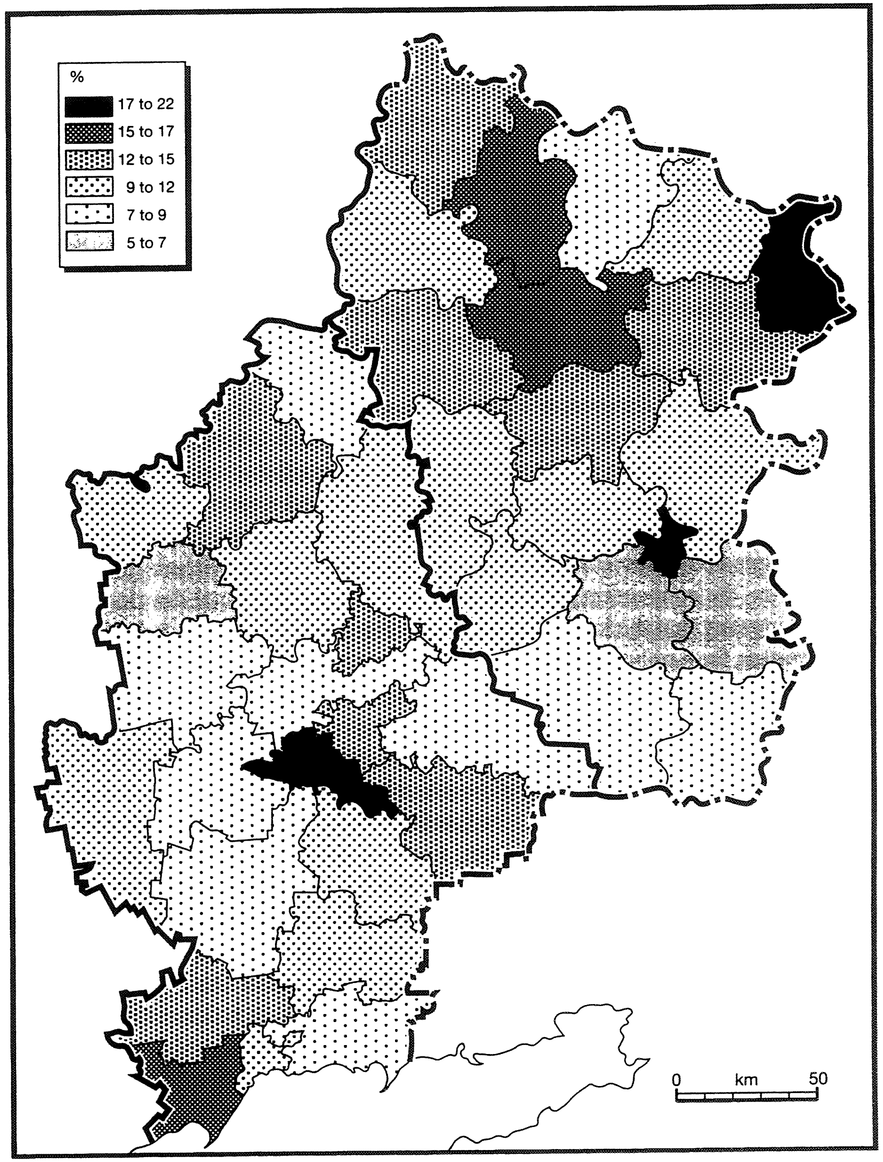

Figure 1.11 Employment in small firms as a percentage of total average paid employment in Donetsk and Luhansk oblasts, 2003

Sources: Donetsk Oblast Chief Statistical Department 2004a: tab. 13.5; Luhansk Oblast Chief Statistical Department 2004: tab. 13.4.

characteristics of an inauthentic/virtual economy, such as less-than-transparent price formation initially through barter transactions and subsequently through opaque cash transactions within FIGs, but fundamentally as a *transitional* capitalism, namely neo-patrimonial, in structural decline (van Zon 2005; Zimmer 2004; see also Zimmer 2005a and 2005b). Contra this analysis it has recently been argued that the Donbas has undergone a process of 'informal marketisation' which has resulted in the emergence of an indigenous and distinctive regional capitalism with the potential to adapt to international competition (see Swain 2006). Hans van Zon (2005) argues that the Donbas possesses a virtual capitalist institutional landscape but is in reality embedded in an informal neo-patrimonial institutional environment that is a legacy of the tsarist and Soviet eras. He argues that political and economic power is centralised (with dissent not tolerated) and that economic practices are reminiscent of the USSR. However, he contends that as Western models of democracy spread across the region the emergence of a civil society will demand new forms of political authority and result in the end of neo-patrimonialism. Kerstin Zimmer (2004: 343) argues that neo-patrimonialism in the Donbas has resulted in what she terms a 'captured region'. Her contention is based on Joel Hellman's argument that oligarchic business interests have captured and corrupted post-Soviet states (see page 12). However, she extends the argument to examine the connection between the local state and regional development and also by arguing that the local elite used its control over the region to lobby central government for a policy regime suited to its business interests.

Zimmer argues that the Donbas is an exaggerated example of a so-called 'old industrial region' (OIR) found in western Europe, such as the Ruhr or north-east England. OIRs are regions 'locked in' to a path of structural economic decline owing to their dependence on traditional industrial sectors, such as the coal and steel industry, that are no longer at the forefront of capitalist economic development. She suggests that the Soviet system, together with 'transition', has produced an exaggerated OIR (Zimmer 2004: 233–4). She argues that the Soviet planning system, in which industrial enterprises responded to the central planners located in Moscow, resulted in a form of functional lock-in even more profound than that found in market economies. She maintains that the role of the Donbas as a core industrial region, first in the USSR and subsequently in independent Ukraine, produced clientelist relations not only between the region and Moscow and then Kyiv, but also within the region. Moreover, she suggests that post-independence privatisation – which she terms '*nomenklatura* privatisation' – reinforced rather than transformed inherited social relations. Privatisation encouraged a neo-patrimonial regime in which the boundaries between different functional arenas of social action, such as the economic and the political, and between different institutions, for example legislative, executive and judiciary, were not clearly drawn. Thus, she maintains that relations amongst economic and political actors in the Donbas and between them and the weak central state in Kyiv reinforced patrimonialism at both the national and the regional scale. Accordingly, Zimmer concludes that the Donbas is functionally, politically and cognitively 'locked in' to an exhausted model of economic development (see also Chapter 5).

Van Zon and Zimmer agree that neo-patrimonialism in the Donbas is based on five economic and political practices: clan behaviour, rent seeking, orientation towards traditional economic sectors, collusion between economic and political actors, and the projection of power beyond the region.[7] We will now examine each of these five practices in turn. First, a regional economy emerged that was dominated by informal 'clans' that sought to rig the nascent market economy by preventing competition, in part by preventing external business interests from establishing a presence in the region. It is suggested these 'clans' emerged prior to independence and articulated legal and illegal economic practices. Gradually, the informal 'clans' evolved to take on a more permanent organisational form resembling the FIGs found in Russia (see page 9). The first FIG to emerge was the Industrial Union of the Donbas (IUD) in late 1995. Formally established by several research institutes, the regional Chamber of Commerce and a number of private companies, IUD was widely associated with figures allegedly linked to the criminal underworld (Kupchinsky 2002a). Following a series of assassinations in the mid-1990s, IUD came under the influence of a young 'oligarch', Rinat Akhmetov, and a local 'red director' and former deputy governor, Vitaliy Hayduk (Kupchinsky 2002b). IUD monopolised the supply of gas to industrial consumers in the Donbas and used the accumulated profits to acquire industrial assets once they were privatised by the state. In 2000, IUD was estimated to have sales revenues of over UAH6 billion (*Kiev Post*, 11 October 2001) and by late 2002 it owned 600 enterprises in Donetsk and Luhansk oblasts and was beginning to acquire assets in other regions (Kupchinsky 2002b). Around the same time IUD was reorganised, which culminated in the emergence of a new FIG, System Capital Management (SCM), owned almost entirely by Akhmetov. It is argued that these industry-led FIGs (see page 13) played a role analogous to that of Soviet branch ministries but combined a territorial focus and control over commodity chains rather than single industrial sectors.

Second, it is argued that the informal 'clans' and later the FIGs predominantly engaged in monopolising economic sectors and recycled monopoly rents by acquiring, first, attractive commercial and property assets and, subsequently, industrial assets. Monopolistic behaviour meant the 'clans' could 'fix' prices initially as part of barter transactions and subsequently through cash transactions. Initially the 'clans' sought to horizontally integrate the supply of key upstream commodities, such as gas, coke coal, and power generation. Once a degree of horizontal integration had been achieved the 'clans' sought to extend their control downstream as part of a process of vertical integration. The rigging of prices meant the informal 'clans' could extend their formal ownership of an enterprise or particular sector in the region to include informal influence on upstream and downstream companies and sectors. In this way the 'clans' could form prices which meant that individual enterprises and sectors cross-subsidised other enterprises and sectors. In short, van Zon argues that prices in the Donbas did not necessarily reflect two independent parties engaging in an economically regulated transaction. Rather prices reflected the control that 'clans' had over a sector and vertical commodity chain. Consequently 'clans' were able to coordinate prices, akin to internal transfer prices within large companies, and allocate profits and losses to different enterprises and sectors irrespective of their fundamental economic performance.

Third, the 'clans' were orientated to a small number of industrial sectors, such as the coal, iron and steel, and heavy engineering associated with 'old industrial regions' (Zimmer 2004). Industrial restructuring in the Donbas since independence increased the regional economy's dependence on these traditional sectors (see Chapter 4). Recent industrial growth has largely been driven by the steel industry and in particular a handful of individual large steel mills, such as Azovstal located in Mariupol and Alchevsk Iron and Steel Works in Luhansk oblast. It is argued that the success of these producers in penetrating export markets is due to a particular set of unsustainable circumstances in which traditional industries have appeared profitable when they may have been in fact value-subtracting. Ukraine's close geo-political relationship to Russia helped to ensure the supply of gas to large industrial consumers at prices much lower than for competitors in, for example, western Europe. In addition the steel industry benefited from the supply of coking coal at prices often considered to be below the cost of production – in part because the state continued to subsidise loss-making coal mines (World Bank 2003b). Equally, producers benefited from the way deindustrialisation generated a plentiful supply of cheap scrap metal that could be used instead of more expensive iron ore. The depreciation of the hryvnia following the Russian financial crisis in 1998 also helped to increase the competitiveness of Ukrainian producers in international markets. The success of Ukrainian producers in winning market share in overseas markets was reflected in the introduction of anti-dumping measures by several countries. Moreover, recent industrial growth in the Donbas may be explained more by the global boom in the demand for steel – fuelled by economic growth in China – than by the modernisation of the industry's energy-intensive obsolete technologies (Mykhnenko 2004). Most steel producers increasingly export low-value-added semi-finished steel products, such as billets, which are re-rolled overseas. In this way Ukraine may be regarded as a major producer of steel as a commodity rather than of steel products. Thus it is argued that the buoyancy of the regional economy is highly dependent upon factors that are politically sensitive and on the fluctuations in global demand for certain types of steel.

Fourth, control over enterprises and sectors depended on the connections of the 'clans' to political authorities in the region. Both van Zon and Zimmer argue that the emergence of the 'clans' is largely explained by their capacity to 'capture' the local state. The local state comprises, first, the regional offices of central state executive bodies based in Kyiv and, second, directly elected mayors and city and regional assemblies. Up until the 'Orange Revolution' the Ukrainian central state executive was effectively territorially organised, with regional offices relatively autonomous from their central offices located in Kyiv. This meant that the offices of, for example, the National Property Fund, the Ukraine Security Service (SBU) (successor to the KGB) or the tax administration often had a stronger allegiance to other regional actors than to their formally higher authorities in central government. The most influential manifestation of the state executive in Donetsk is the oblast governor, appointed directly by the president, and his or her oblast

administration, which has wide-ranging responsibility for economic development, the so-called budget sector and the operation of political processes, such as elections. The appointment of successive governors in the 1990s reflected the relative balance of power between regional and central government actors. Towards the end of the 1990s regional actors effectively exchanged their allegiance to President Kuchma and the independent Ukrainian state in return for relative autonomy in the field of economic and political management of the Donbas (Chapter 3). The most significant governor appointment was of Viktor Yanukovych in 1997, who went on to create a political context in which the 'clans', and specifically IUD and SCM, could expand their operations without fearing punitive and arbitrary interference from the political authorities in Kyiv. The re-election of President Kuchma in 1999 was widely considered to have been in part due to the adept way that Yanukovych aligned pro-presidential forces in Donetsk oblast. This involved an emergent managed democracy in which so-called 'administrative resources' and control over mass media were used to support favoured candidates.

The 'clans' also established a political presence in local and regional assemblies and directly elected positions, such as city mayors. This was in large part by building on and transforming the role that the independent coal miners' movement played in the final years of the USSR and the first years of independence. In the early 1990s the miners' movement became an increasingly regionalist movement demanding political autonomy from the new Ukrainian state. This culminated in a strike in the Donbas in 1993 that was initiated by miners but which spread to most sectors of the economy and resulted in the fall of the government, early elections and the brief appointment of a Donetsk industrialist as prime minister (Borisov and Clarke 1994). Inside the region, the traditional regional elite, the so-called 'red directors', used the strike to re-establish their influence over the workers' movement which it had lost during *perestroika*. By the late 1990s political regionalism had been sacrificed for a narrower form of economic regionalism that was palatable to Kyiv (Swain 2006). Economic regionalism combined with a productivist ideology effaced the Communist Party, which had had widespread support in the region. This transformation culminated in the formation of a regional 'party of power' in early 2001, the Party of the Regions, to which all significant regional actors swore allegiance (Mykhnenko 2003).

The establishment of the Party of the Regions was a significant example of the fifth factor that was central to the recent growth in the Donbas, namely the capacity of the 'clans' to create mechanisms to project their power beyond the region and specifically to Kyiv. Van Zon argues that the Donetsk 'clan' unfairly pressurised the central authorities to establish a favourable legislative regime as a price for securing their political loyalty. Perhaps the clearest example surrounds the formation of special economic zones and territories of priority development in Donetsk and Luhansk oblasts in 1999. The establishment of the zones and territories was linked to securing local consent for the closure of coal mines as part of a World Bank-supported restructuring programme (see Chapter 7; Chapter 8; Swain 2006). Thus, whilst the zones and territories covered a large swathe of the region, they were concentrated in towns most affected by the closure of mines. However, central government's support for the zones and territories was also linked to securing the Donetsk elite's support in Kuchma's re-election campaign. Investment in the designated areas, whether by a domestic or a foreign company, was subject to a preferential tax regime for a specific period of time. Despite a stated aim to encourage diversification and high-technology sectors, it was argued that the zones and territories were simply used to evade taxation and provide cover for illegal economic activities.

Conclusion: an ambiguous transition?

Economic growth in the Donbas since 1999 poses an empirical challenge to the orthodox transition literature. Even though privatisation and macroeconomic stability had been achieved, how can economic growth be explained given the (alleged) absence of structural economic reform or despite the (alleged) presence of rampant rent-seeking 'clans'? Given the comparative inter-oblast analysis undertaken in this chapter, why has the socio-economic record of the Donbas, and Donetsk oblast in particular, been far better than that of other Ukrainian regions, where local economies presumably are not 'locked in' to the excessive 'neo-patrimonialism'? In response it has been argued that growth has in some sense or other been inauthentic, transitory and/or fraudulent. Liberal economists and political scientists have argued that capital accumulation in regions such as the Donbas has resulted from asset sweating, asset stripping and rent seeking in a context of fictitious economic signs. From a leftist Marxist position it would be argued that the region has not been subsumed to the law of capital in a *real* sense and that a form of primitive accumulation is taking place in the region. One has to add the conservative nationalist Ukrainian position which portrays the entire region as pathogenic per se, and its inhabitants and their experiences as deviant, 'Russianised' and untruly Ukrainian in nature. Curiously the diagnosis and prescribed medicine of both the liberals and the leftists are essentially the same: namely that the region requires a dose of technocratic economic rationalism involving the emulation of advanced capitalist countries. Suggestions emanating from the nationalist camp are often of a more harsh nature (Lubkivskyi 2006).

However, drawing on the theorisation of the emergence of varieties of post-Soviet capitalism, there is an alternative way of answering the question. This entails questioning the extent to which structural economic reform really has been absent and highlighting the self-reorganisation that has taken place in the region. We want to conclude this chapter by suggesting that critiques of regions such as the Donbas from both the liberal and the Marxist tradition are at least in part the product of a colonial Western-centric view that renders invisible the actually occurring transformations. Could it be the case that an emergent indigenous capitalism that is not a satellite client of the Euro-Atlantic geo-economic bloc has provoked a process of de-legitimisation or 'othering'? Equally, could it not be the case that the dominant discourses of political and economic 'reform', which conform to the prevailing orthodoxy amongst transnational policy elites, aim to reconstitute 'an economy' as an object which is defined by Western categories precisely so that it becomes a malleable object to the instruments of Western power? (See also Swain 2006; Chapter 8.)

It is our contention that many of the economic and political practices associated with economic development in the Donbas are ambiguous and may be 'read' in different ways. Put more prosaically, is it so bad that steel plants in the Donbas have been able to compete on international markets and earn significant export revenues which have been recycled around the region? Would it have been better if crude economic logic had resulted in the closure of more mines and some steel works with the resultant increases in poverty, energy insecurity and reduced competition for foreign steel companies? Instead of emphasising the strong tradition of paternalist social solidarity that exists in the Donbas, we read of 'authoritarianism' and 'cognitive lock-in'. Instead of highlighting the rise of successful capitalist entrepreneurs we read of 'oligarchs' with questionable backgrounds and supposedly dubious motives. Instead of focusing on the emergence of increasingly diversified international companies out of the ruins of the state-planned industrial economy, we read of opaque 'financial industrial groups' that solely engage in allegedly corrupt practices. Instead of celebrating the way regional corporatism has stimulated economic growth we read of collusion between nefarious private interests and renegade public officials solely motivated by personal enrichment. Instead of revealing the self-reorganisation, we read of asset stripping, asset sweating and rent seeking. Instead of a critical engagement with an indigenous capitalism, involving local capital accumulation and local expanded reproduction, and which has its faults, we read of neo-patrimonialism and regional 'lock-ins'. Local capital accumulation cements the region's position in the embryonic national economy and in the global economy. By not relying on foreign investment, the region limits its exposure to rapidly switching international capital. That the Donbas's family silver has been reserved for locals may be a source of annoyance to predatory Western companies supported by their sponsors in Western governments and international financial institutions, but it is hardly a crime and might even be a cause for celebration.

Notes

1 In an assessment of Ukrainian output developments in 2000–2001, the International Monetary Fund (Berengaut *et al.* 2002) has noticed no major changes in the structural policy environment in Ukraine precipitating the return to economic growth. Instead, the IMF stressed 'an eclectic explanation involving a confluence of factors specific to Ukraine', which were 'at least not inimical to output growth'. In addition to the favourable role of external factors (e.g. export performance, export market growth and real exchange rate), restructuring through 'learning by doing', and reduced real wages, the Ukrainian mix of pro-growth variables according to the IMF also included 'changes in the Oligarchs' Objective Function' from the re-distribution of assets to the engagement in productive activity.

2 'Soft budget constraint' is a termed coined by János Kornai – a dissident Hungarian economist inspired by the libertarian writings of von Mises and von Hayek – to describe the ill-natured 'paternalistic' role of the state towards economic organisation, private firms, non-profit institutions and households (1980, 1992, 1998).

3 Recently Wilson (2005) has extended the virtual economy thesis to include the way non-representative parties in the FSU simply act in ways to support the commercial interests of party benefactors.

4 For similar arguments in central Europe see Staniszkis (1991) on 'political capitalism' and Eyal *et al.* (1997, 1998) on 'managerial capitalism'.

5 We would like to thank the following people for their assistance in compiling the official statistics: Mike Chambers (and his colleagues at Actiondonbass), Alexey Danilin, Svitlana Dem'yanova and Illya Khadzhynov. We would also like to thank Chris Lewis, Cartographic Unit, School of Geography, University of Nottingham, for drawing the maps.

6 References in the text to a specific rayon also include all the cities located within its mapped territory. For example, in Donetsk oblast, we have included the cities of Yasynuvata, Avdiivka, Yenakieve and Yasynuvatskyi rayon itself into the mapped territory of Yasynuvatskyi. Similarly, in Luhansk oblast, Popasnianskyi rayon's data amalgamate both the rayon itself and the cities of Kirovske, Stakhanov, Severodonetsk, Lysychansk and Pervomaisk.

7 As none of the authors of the (neo-)patrimonial approach provides a definition of 'clan', it is rather perplexing to understand whether they refer to a group of people tracing descent from a common ancestor or to a group united by a common interest or common characteristics, or both.

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2 The reform of Ukraine's energy complex and its consequences for Donetsk

Hans van Zon

Introduction

The energy sector is a key factor in the economic development of Ukraine and more in particular of Donetsk oblast. A little over 40 per cent of Ukraine's energy consumption is imported, mainly from Russia (World Bank 2004: 14). In 2003, 37 per cent of Ukraine's imports consisted of energy, while exports consisted 37 per cent of low-quality and energy-intensive steel and 15 per cent of energy. Power and energy production together with steel production accounted in 2001 for 63.5 per cent of the country's industrial production. From an international perspective this is an extraordinary situation and means that the modalities of change in the energy sector determine to a large extent the development of other sectors. In this chapter I analyse reforms in the energy sector and their possible consequences for Donetsk oblast. The chapter is organised in the following way. The problems of energy consumption and domestic trade in energy are analysed first. This is then followed by an examination of domestic energy production, energy imports and Ukraine's energy dependence on Russia. Finally the chapter considers the consequences of market-oriented reforms for the energy economy in Donetsk oblast. This is then followed by some concluding remarks.

Waste of energy

In Soviet times, enterprises and households did not have any incentive to economise on energy consumption. Enterprises consumed huge amounts of energy that was delivered at a very low price because the Soviet Union possessed enormous energy reserves. Moreover, all enterprises operated with soft budget constraints that meant that the state automatically covered any losses. This resulted in the Soviet Union becoming one of the most energy-intensive economies in the world. The situation changed after Ukraine became independent in 1991. Ukraine imported almost half of its energy needs and soon had to pay commercial prices for oil and gas that was mainly supplied by Russia. Although not all delivered energy was paid for and Russia regularly cut supplies, the increase in energy prices had an enormous impact upon the economic situation in Ukraine. Higher energy prices contributed