

*Poland and Ukraine: A Portrait in  
Divergence*

Christopher A. Hartwell\*

\* CASE - Center for Social and Economic Research and Kozminski University

## Civil Development Forum (FOR)

Civil Development Forum (FOR) is a non-profit **free-market think tank based in Poland** promoting economic freedom, rules of law and ideas of limited government. FOR seeks to contribute to policy-making through fact-based research and public debate.

FOR presents its findings in the form of reports, policy briefs and educational papers. Other FOR projects and activities include, among others, the Public Debt Clock, social and educational campaigns, economic comic books, public debates, lectures, seminars for students and civil society mobilization.

Civil Development Forum was established in 2007 by **Professor Leszek Balcerowicz**. Leszek Balcerowicz has been widely credited with the economic transformation of Poland after the fall of communism. He served twice as deputy prime minister and minister of finance. Balcerowicz was also Governor of the National Bank of Poland. In 2014 Leszek Balcerowicz, who is now Chairman of the Board at the Civil Development Forum, was awarded the 2014 Milton Friedman Prize for Advancing Liberty by Cato Institute.

### **We need your support:**

Truth, common sense and liberty will not defend themselves. They need a well planned and properly executed efforts against special interests, illiberal forces, and sometimes well intentioned but misinformed people. **Your support is crucial to succeed in this mission:**

You can send your donation now: PL 68 1090 1883 0000 0001 0689 0629 (Bank Zachodni WBK SA, SWIFT: WBKPPLPP)

Fundacja Forum Obywatelskiego Rozwoju, Al. J.Ch. Szucha 2/4 lok. 20, 00-582 Warszawa, Poland

In case of questions about FOR and possible ways of support contact Marek Tatala.

### **Contact details:**

Marek Tatala, Executive Board Member

E: [marek.tatala@for.org.pl](mailto:marek.tatala@for.org.pl)

M: +48 691 434 499

### **Contact for media:**

Natalia Wykrota

tel. +48 22 628 85 11, +48 691 232 994

e-mail: [info@for.org.pl](mailto:info@for.org.pl)

[www.for.org.pl](http://www.for.org.pl)

### **Contact the author:**

Christopher A. Hartwell, PhD

President, CASE - Center for Social and Economic Research

M: +48 538 175 826

E: [christopher.hartwell@case-research.eu](mailto:christopher.hartwell@case-research.eu)

Join us on Facebook: [facebook.com/FundacjaFOR](https://facebook.com/FundacjaFOR)

Follow us on Twitter: [twitter.com/FundacjaFOR](https://twitter.com/FundacjaFOR)

# Poland and Ukraine: A Portrait in Divergence

## 1. Introduction

This year marks the 25<sup>th</sup> anniversary of the start of Poland's journey towards becoming a market economy, and it can be said with some certainty that the path has been a successful one. Poland's per capita GDP in 2012 was \$10,573 (in constant 2005 US\$), with the country safely ensconced in the OECD, and the European Union. Rather than lurching from crisis to crisis, Poland saw the creation of a regular and functional market democracy, with free and fair elections, steady economic growth, and, following the global financial crisis of 2007-08, a record of macroeconomic performance that became the envy of Europe.

In contrast, Poland's large eastern neighbor has seen a starkly different path. The turmoil in Ukraine and ousting of President Viktor Yanukovich by popular agitation has only served to highlight the seriousness of Ukraine's underlying economic situation. Despite 22 years of independence, the country's per capita GDP in 2012 was only slightly over US\$2,000, five times less than Poland despite starting from nearly the same initial conditions. In other areas, the country has faltered, with a fiscal situation best described as "bankrupt" and the smallest of transitions economy-wide away from its Soviet, heavy-industry past. This road to transition has been marked by delays in needed reforms leading to severe turbulence, including banking and currency crises in 1998-99 and from 2008 to the present, while the political transition resulted in rampant corruption, cronyism at the highest levels, and a fragile state that has finally collapsed. From the days of 10,000% inflation in 1993 to the plummeting hryvnia and scramble for an IMF loan in 2014, the country appeared to be trapped in a state of perpetual crisis.

But why? How could two countries with such a similar language/culture, shared historical experiences, and (on paper at least) nearly identical initial conditions diverge so widely over 25 years? The purpose of this paper is to examine this differing experience of economic transition in Poland and Ukraine in reference to the development of its institutions, conditioned by the divergent pace of reforms in each country. As we shall see, delayed macroeconomic stabilization, which then led to slow (or non-existent) institutional development, between the two countries was the key factor driving the two apart.

## 2. Initial Conditions and Early Policies: Where Did We Start?

While two separate political entities, with Poland an independent country and Ukraine a part of the Soviet Union, Ukraine and Poland had remarkably similar economic situations at the beginning of transition (Table 1). Apart from the size of the private sector, which was uniformly lower throughout the republics of the Soviet Union, Poland and Ukraine appeared to be on fairly equal footing. Indeed, in GDP statistics alone (although subject to numerous errors and under-reporting of the private sector in Poland), it appeared that Ukraine was almost *better*-situated than Poland, an assessment that could also be made in reference to Ukraine's relatively higher access to natural resources and integration with the resource

infrastructure of Russia. By contrast, Poland had been closed off to the West and the collapse of the COMECON trading block meant that it was adrift without even its traditional markets.

Economically, Poland and Ukraine had seen similar economic performance prior to starting transition (Table 1 shows that Poland’s average GDP growth from 1985-89 was 2.8%, while Ukraine’s was not far behind), a pattern that was repeated somewhat in regards to their political institutions. Both under communist dictatorships, one of the main differences between the two countries at the beginning of the transition process was the length of time under communism, with Poland only being under communist central planning for 41 years, compared to Ukraine’s 74 years. Moreover, the largest difference was obviously Ukraine’s inclusion in the broader Soviet Union, meaning that it was governed not from Kiev, but from Moscow some 758 kilometers away.

Once again, however, to an outside observer it could have appeared that Ukraine still had a possibility to make a successful political transition. While Ukraine did not have an organized opposition as in Poland, Poland had also gone through the trauma of martial law in 1981 while Ukraine avoided the major disruptions seen in other Soviet republics in the late 1980s (as in Armenia, Azerbaijan, Estonia, Georgia, and Lithuania). Indeed, the prospects in 1992 seemed bright for Ukraine to make a full transition politically as well as economically, especially given the signing of the Budapest Memorandum in 1994 that de-nuclearized the country and gave security assurances regarding its territorial integrity.

**Table 1. Initial Conditions in the Two Countries**

	Poland	Ukraine
Transition year	1990	1992
1989 GDP per capita (PPP, constant 1989 US\$)	\$5150	\$5680
Urbanization (% of population) in 1990	62%	67%
Average GDP growth, %, 1985-89	2.8%	2.4%
Exports, % of GDP 1990	26.2%	27.6%
Private Sector as % of GDP, 1989	30%	10%
Share of Industry in total employment, transition year	28.6%	30.2%
Infant mortality rate, 1989, per 1000 live births	15.6	16.8

Sources: EBRD Structural Indicators, World Bank WDI Database, de Melo *et. al* (2001).

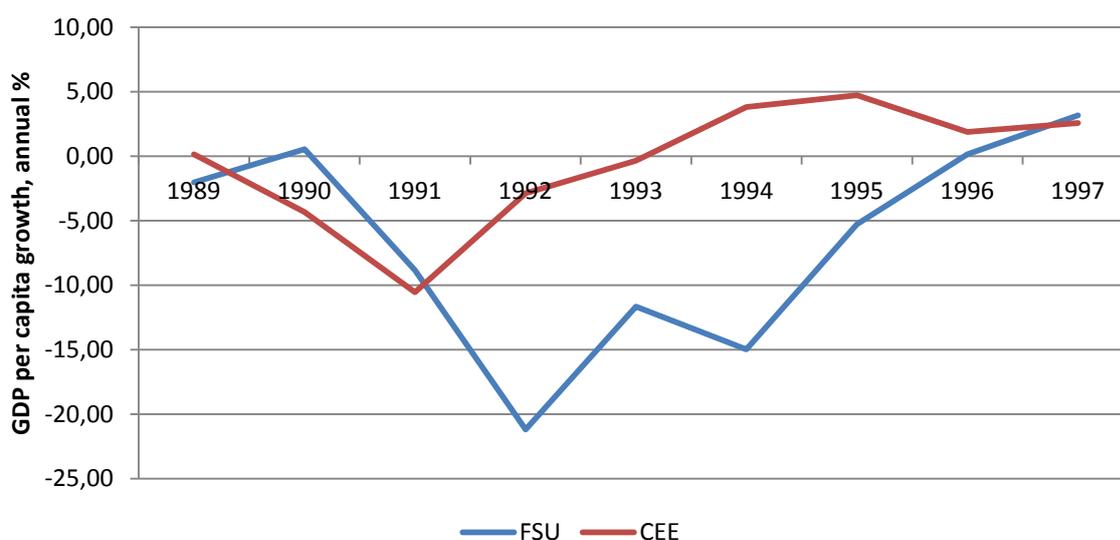
### 3. The Formative Years

Given these roughly equivalent conditions and the favorable state in which Ukraine entered transition, what went so wrong? Any analysis of the divergence of economic outcomes must start with the two decades-long divergence of inputs, in particular the macroeconomic and institutional policies that were put in place at the start of transition to facilitate the market economy.

While there are several theories regarding the drivers of various institutions (including political, economic, social and cultural factors, as well as historical “accidents”), in the transition countries of Central and Eastern Europe (CEE) and the former Soviet Union (FSU), the creation of new institutions was, for the most part, a conscious decision of the governments in charge at the start of transition. Indeed, the entire point of transition was the move from institutions that enabled central planning to those that supported a market economy. Thus, the channels in which the institutions were created were both positive, in the sense that enabling legislation and policies were put in place to consciously create specific institutions, and negative, in that the removal of barriers (such as prohibition of private property) allow for the spontaneous creation of important institutions. And underpinning this entire process was the need for economic stabilization, in order to correct the gross imbalances that the communist economy engendered. Only through stabilization could investment accrue to the private sector and make it sustainable, and only through stabilization could the mediating institutions necessary for the market take root.

Differences in the first phase of this transformation, where the path for institutional development was set, became apparent early on across different countries, including Poland and Ukraine. There was a real divergence in the stabilization and institutional policies between the CEE countries and those of the FSU, conditioned by the liberalization policies undertaken in the early years of transformation. The pace of institutional change in countries that were west of Kyiv appeared to go much faster and much further than those to the east, with real consequences for each country; in particular, the delay of economic stabilization led to slow institutional change, producing large differences in economic performance during these years (as well as determining the path of recovery – see Figure 1). Moreover, the policies implemented in the former Soviet Union that avoided institutional changes in the early years helped to ossify the barriers against future institutional reforms.

**Figure 1. Economic Depression and Recovery in CEE and FSU Countries in Early Transition**



Source: World Bank WDI Indicators. CEE includes Bulgaria, Czech Republic, Hungary, Poland and Slovakia, FSU includes all ex-Soviet republics apart from the Baltic States.

This reality may have been due to the fact that there was a small and rapidly-closing window in which both macroeconomic policies and institutions could have been reoriented, created, or abolished altogether. This time, called “extraordinary politics” by Leszek Balcerowicz, is characterized “among the political elites and the populace at large [by] a stronger-than-normal tendency to think and to act in terms of the common good.”<sup>1</sup> However, markets and attitudes and especially politicians do not stand still for long, with this time of extraordinary politics soon falling prey to the normal jockeying of the political process, meaning that momentous changes such as broad-based institutional reform have only a small time-frame in which to be enacted.

In Poland, small and piece-meal reforms in the direction of a market economy in the late 1980s were supplanted by larger structural reforms once the political dominance of the Communist Party began to wane. A completely new political leadership, committed to fundamental economic and political reform, instituted a broad series of economic stabilization policies that set the basis for institutional reforms, including enacting legislation establishing the right of all ownership forms. Additionally, by 1990 nearly all trade restrictions had been lifted, “giving Poland an extremely liberal trade regime compared both to its past and to world standards.”<sup>2</sup>

Perhaps most importantly, the new individuals involved in developing policies, building off the social and cultural institutions that had survived Communism, focused on reforms that seemed *irrevocable*, thus creating expectations for their success and in turn orienting institutional development towards a world that included these reforms rather than a world that did not (this approach was also adopted in Estonia, which, in one sense, had even more radical reforms than Poland). While political turnover was high in the early governments of the new Poland, there was little sense that communism was a viable alternative or could make a comeback, with survey data from the 1990s showing that the perception of property rights (to take an example of an important institution) was growing throughout the country.<sup>3</sup> Indeed, despite hardship in terms of declining industrial production (a hardship which would have paled in comparison to no reforms), the communist system was left behind as new institutions supplanted communist-era ones. Even with a slow-moving privatization process, new enterprises sprang up that rendered the state-owned concerns irrelevant. The fast-moving reforms of 1989 and 1990 in Poland set the country upon a different path, and institutional arrangements adapted accordingly.

By contrast, Ukraine saw a difficult transition that for the most part avoided institutional change in the early years in favor of “fire-fighting” against continuous political and macroeconomic crises. Liberalization was piece-meal and often reversed, leaving an environment in which unchanged political institutions allowed bad economic policies that

---

<sup>1</sup> Balcerowicz, L. (1995). *Socialism, Capitalism, Transformation*. Budapest: Central European University Press.

<sup>2</sup> Murrell, P. (1993). What is shock therapy? What did it do in Poland and Russia? *Post-Soviet Affairs*, 9(2), pp. 111-140.

<sup>3</sup> Johnson, S., McMillan, J., and Woodruff, C. (2002). Property Rights and Finance. *American Economic Review*, 92(5), pp. 1335-1356.

begat worse institutions. Unlike Poland, which saw large-scale change in its politicians (and rapid turnover in the first four years), newly-independent Ukraine was governed by the same man who led it at the end of communism, Leonid Kravchuk, the head of state for the Ukrainian SSR, and would be until 1994. Indeed, while Poland was moving rapidly forward on a broad front of political and economic change, Ukraine's former communist party members remained in key positions throughout the government; more importantly, the form of government itself (headed by a President) was selected not as a way to break with the past, but as a calculation by communists on the basis of a "situational factor of conceived political power gain."<sup>4</sup>

This lack of political change coincided with a period of stagnation in economic reforms, as "until the end of 1994, Ukraine had not had a sustained attempt at economic liberalization.... state-imposed restrictions, interventions and distortions in the foreign exchange, trade, and pricing regimes, were extreme over much of the late-1991 to 1994 period."<sup>5</sup> In this area of little *policy* change, it was perhaps not surprising that there was almost no *institutional* change. In contrast to Poland, which saw economic and political reforms working hand in hand to shift expectations and thus engender a new institutional reform path, Ukraine retained a system that relied on government planning and intervention, retarding any institutional development in the long-term. Instead of moves towards a market economy, Ukraine pushed the market back into the unofficial economy, with little progress on any of the economic institutions needed to actually start (much less complete) a transition.

#### *Political Institutions*

Given this relative difference at the beginning of the institutional transition, the divergence in institutional change, and thus in economic outcomes, in Poland and Ukraine begin to make more sense. Perhaps the easiest differences to spot between the two countries have been in the political institutions, in their dynamic processes and outcomes in Poland in Ukraine (as the events leading to the ouster of President Viktor Yanukovich and subsequent Russian invasion attest to). Indeed, Ukraine's economy has been a victim of its own self-initiated policy shocks, a path that Poland was able to successfully avoid. Ukraine had a veneer of stability and continuity in its leadership at the top, but this "stability" at the top masked institutional rot below, while foiling the very same macroeconomic policies needed to shift the Ukrainian economy. And while both countries have had regular elections and changes of leadership, the pace of reform has been continuous in Poland and halting in Ukraine, a key example of which can be found in the creation of a new constitution after the fall of communism.

Political scientists and even governments agree that a constitution is a fundamental political institution, laying out the relationship of other institutions to each other and the distribution

---

<sup>4</sup> Christensen, R. K., Rakhimkulov, E. R., and Wise, C. R. (2005). The Ukrainian Orange Revolution brought more than a new president: What kind of democracy will the institutional changes bring? *Communist and Post-Communist Studies*, 38(2), pp. 207-230.

<sup>5</sup> Kaufmann, D., and Kaliberda, A. (1996). Integrating the unofficial economy into the dynamics of post-socialist economies. In Kaminski (ed.), *Economic transition in Russia and the new states of Eurasia*, Vol. 8, New York: M.E. Sharpe.

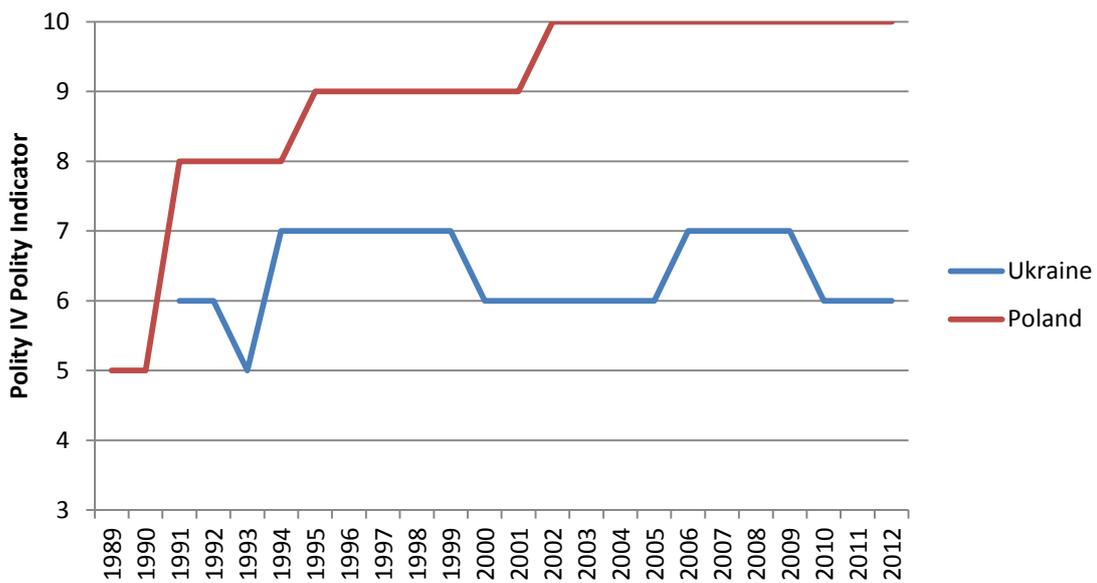
of political power in the country. In transitioning from a one-party to a pluralist democracy, it was thus imperative to change this “founding document” as quickly as possible. Of course, constitutional change is merely an expression of deeper political factors, a reality that surfaced in both countries (and it is undeniable that institutional changes occurred independent of constitutional change). Regardless, the change of the constitution in both countries exposed some of the political and economic fault-lines to come.

For example, in Poland, constitutional change meant a series of constitutional amendments in 1989 and 1990 that changed the name of the country, reinstated various legislative mechanisms, and generally removed the communist character of the document. The old Soviet-era constitution was substantially replaced by the so-called “Small Constitution” of 1992, which further defined legislative and executive relations, and a final new Constitution was put in place in 1997, building off of these reforms.

In contrast, Ukraine was governed until 1996 by the 1978 Soviet constitution of the Ukrainian SSR, with amendments mainly to state that Ukraine was independent and scrub all mentions of the Soviet Union. In 1995, then-President Kuchma signed a “Constitutional Agreement” which laid the basis for the 1996 constitution; however, the continuous political struggle in Ukraine led to a new constitution in 2004 during the “Orange Revolution” which was promptly reversed in 2010 after a challenge by the ruling Party of the Regions. In turn, the latest turmoil has led to a restoration of the 2004 constitution. Volatility in the most basic of political institutions can be expected to have deleterious effects throughout the political system (as well as the economy).

An illustration of this political volatility can be seen in Figure 2, which compares the development of the broader political institutions of the two countries from 1989 to 2012. In particular, Figure 2 shows the much-utilized Polity IV “polity” ranking, an indicator that places a country on a scale from -10 for a full autocracy to a 10 for a full democracy; the Polity IV ranking is generally used to show the openness of the political process and how actors can influence the system. As the Figure shows, Poland is currently ranked as a full democracy and has been 2001; perhaps more importantly, Poland made consistent strides towards a more open political system throughout its transition. While Ukraine is not that far behind, consistently between a 6 and a 7, the volatility and vacillations of its overall political institutions do not show the same steady progress as in Poland. For every leap forward, as in 1993 at the onset of transition, there has been backtracking, as in 1999 and 2009; in short, there was no consistent move towards democracy and instead a history of political uncertainty.

Figure 2. Polity IV “Polity” Score



Source: Polity IV Database

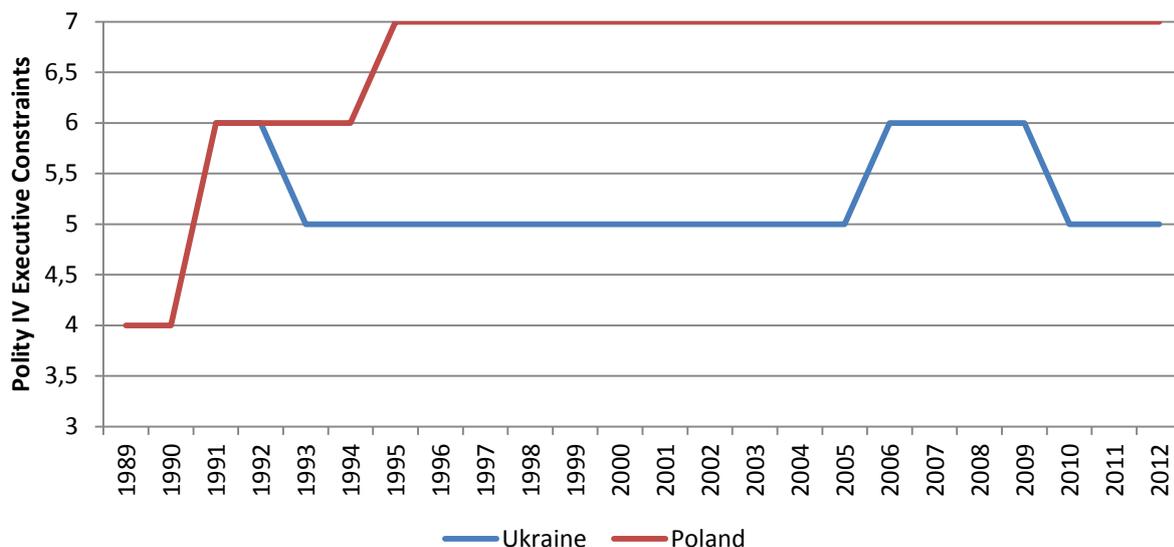
This political volatility in Ukraine can be traced to the basic political system put in place by the original constitution of 1996, known as a “semi-presidentialist” system. In such a system, the president is elected by popular vote, but does not form the government directly; instead, the president asks for parliamentary authority to confirm the Prime Minister, who then in turn forms a cabinet. This system is designed to ensure checks and balances even within the executive branch, and has been popular as a political basis post-communism (indeed, Poland and Ukraine both share this type of government). However, for the system to avoid despotism, there must already be a democratic basis on which to draw on, a trait that was nascent in Poland and absent in Ukraine. As Ian McMenamin of Dublin City University put it, “Before the introduction of semi-presidentialism in November 1990, Polish elites had already established a firm consensus on democracy, which was buttressed by consensus on the economic system and international relations. Therefore, the conflicting legitimacies generated by semi-presidentialism delayed but did not prevent, or seriously threaten, democratic consolidation in Poland.”<sup>6</sup>

In Ukraine, however, with no memory of democracy to call on, the semi-presidential system became a basis for political volatility, as President Kuchma (1996-2004) used the divided nature of parliament to strengthen his own rule and place in power prime ministers who followed the will of the president, rather than the will of the legislature.<sup>7</sup> In practice, the “dual executive” became a concentrated presidential system, a reality that abated somewhat after the “Orange Revolution” and the ascendance of Viktor Yuschenko (and the changes to the constitution), but reverted to form in 2010 with the election of Viktor Yanukovich.

<sup>6</sup> McMenamin, I. (2008). Semi-Presidentialism and Democratisation in Poland. Working Papers in International Studies, Centre for International Studies. Dublin City University, No. 2. Available at: [http://webpages.dcu.ie/~cis/PDF/publications/2008\\_2.pdf](http://webpages.dcu.ie/~cis/PDF/publications/2008_2.pdf).

<sup>7</sup> Protsyk, O. (2003). Troubled Semi-Presidentialism: Stability of the Constitutional System and Cabinet in Ukraine. *Europe-Asia Studies*, 55(7), pp. 1077–1095

**Figure 3. Executive Constraints, 1989-2012**



Source: Polity IV Database

This vacillation of power distribution is shown clearly in Figure 3, which details the Polity IV sub-indicator “executive constraints.” The executive constraints indicator catalogues “the extent of institutionalized constraints on the decision-making powers of chief executives” on a scale from 1 to 7, with higher numbers meaning more constraints.<sup>8</sup> Poland once again moved forward in constraining the executive levers of government, while Ukraine regressed, stagnated, saw a glimmer of hope during the Orange Revolution, and then finally settled at a level that Polity IV characterizes as “substantial limits.” In this category, the executive still is much more powerful than the legislature, with an imbalance beyond that seen in normal parliamentary systems. This tracked the reality of the expansion of executive power under Yanukovich, the continued fractionalization of the parliament, and of course the use of the powers of the state by the executive for personal enrichment.

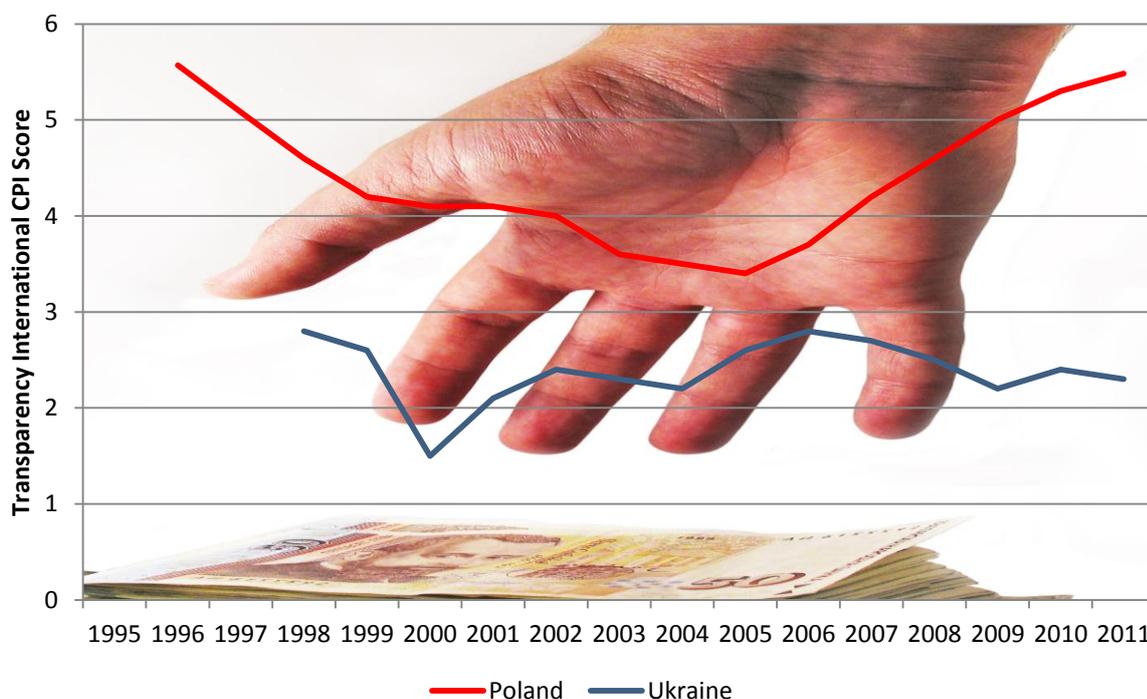
The result of the continuous squabbling at the top about the direction of political reform in Ukraine meant that, at the lower levels of bureaucracy, administrators found their own, more nefarious, way to cope. This translated into widespread corruption in Ukraine’s public administration becoming the default option, rather than an aberration; as Keith Darden of Yale University noted in 2001, the all-pervasiveness of corruption in Ukraine actually reinforced the move towards presidential control of the economy and helped President Kuchma consolidate power.<sup>9</sup> This can be seen in the data, as Figure 4 shows the well-known Transparency International Corruption Perceptions Index (CPI) for both Ukraine and Poland (with higher scores indicating less corruption). While Poland suffered in the mid-2000s an increasing perception of corruption (and a decreasing reality of corruption), it never reached the depths of Ukraine, which has consistently been ranked one of the most corrupt countries

<sup>8</sup> See the Polity IV user’s manual, available on-line at: <http://www.systemicpeace.org/inscr/p4manualv2012.pdf>.

<sup>9</sup> Darden, K. (2001). Blackmail as a Tool of State Domination: Ukraine under Kuchma. *East European Constitutional Review*, 10(2/3), pp. 67-71.

in the world (and certainly the most corrupt country in Europe). Corruption was so entrenched that, as Bloomberg news notes, not even Swedish chain Ikea could enter Ukraine due to the immense bribes expected.<sup>10</sup> This breakdown of the state and emergence of the predatory bureaucracy was one of the few political institutions that did not, unfortunately, exhibit volatility during Ukraine’s halting transformation.

**Figure 4. Transparency International Rating of Corruption in Ukraine and Poland**



Source: Transparency International

In sum, Poland’s legacy of political institutional development, including moving quickly on restoring democratic mechanisms and updating the country’s legal basis, may have appeared “radical” at the time, but in reality, it was a more sustainable route than the Ukrainian experience. Indeed, the lesson perhaps to be derived from this examination is that political progress needs to be continual, as half-measures can create their own serious obstacles to completing reforms. Even today, Poland suffers from a number of bad laws and constraints that, unfortunately, have become harder to remove. However, this pales next to the example of its neighbor. In particular, half-hearted political reform as was done in Ukraine can entrench interests, leading to more difficulties in carrying out the next set of reforms or an easier time in backsliding; if you haven’t left the past that far behind, it’s easier to throw the car in reverse and reach it once again. Moreover, as was seen in Ukraine, gradualist reform measures taken at discrete moments in time lead to the system becoming so ossified that periodic bursts of street protests are needed to break the elites’ hold on the political process. This is a cycle that does not engender political stability, nor does it lead to

<sup>10</sup> Lovasz, A., “Dashed Ikea Dreams in Ukraine Show Decades Lost to Corruption,” Bloomberg News, March 31, 2014, available on-line at: <http://www.bloomberg.com/news/2014-03-30/dashed-ikea-dreams-in-ukraine-show-decades-lost-to-corruption.html>.

development of appropriate economic institutions.

*Economic Institutions: The Basis of a Market Economy*

Even though the divergence of political institutions has been the most visible manifestation of Poland and Ukraine's widening gap, the more fundamental divergence has occurred in regards to the economic institutions needed to create a market economy. In large part this was due to the delayed (and in some areas, never-enacted) economic stabilization that the country has so desperately needed. As Georges de Menil and Wing Thye Woo have noted, "Ukraine offers a pure case study of what happens to a transition economy when reform is delayed. Between December 1991 and the autumn of 1994, a succession of [economic] reform plans fell victim to political stalemate."<sup>11</sup> With the political system subjected to random and internally-generated shocks, it became difficult for economic institutions to develop to their fullest.

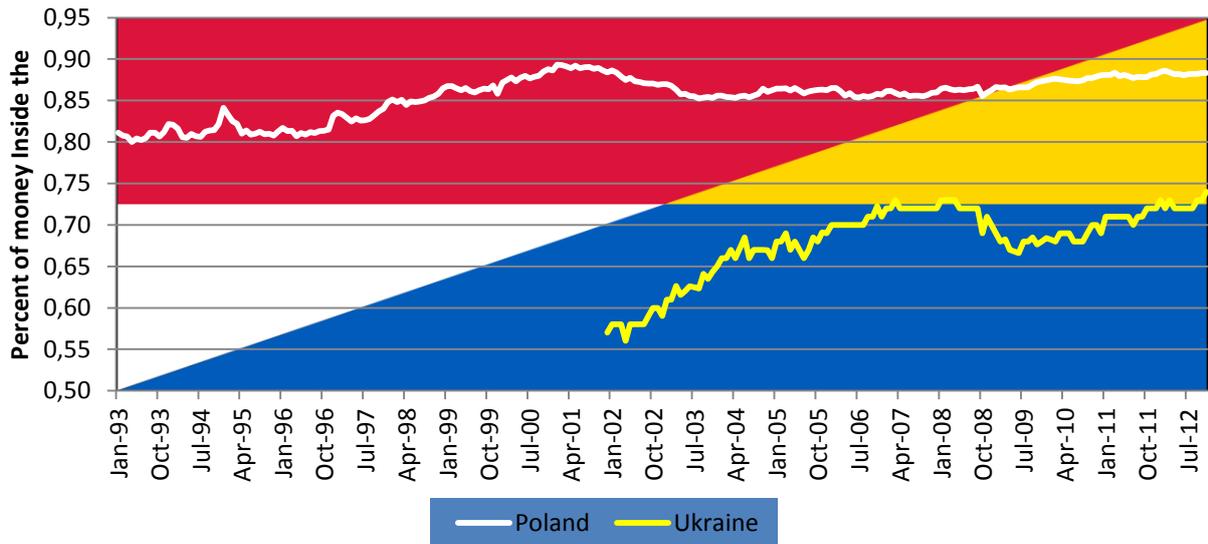
And nowhere was this divergence of institutions more evident than in property rights, the fundamental basis of a market economy and the key reform needed to move from communism to capitalism. Using the amount of money held inside the banking sector (as a proportion of all money) as a proxy for property rights (on the assumption that more secure property rights mean people are happier to keep their money in banks), we can see that Poland's performance has been consistently better than Ukraine (Figure 5). In fact, despite 22 years of independence, Ukraine's realized property rights are still below the level that Poland's was in January 1993, when this data series began. Simply put, holding everything else equal, Ukrainians have not trusted the government or the economic system enough to keep their money in Ukrainian banks, preferring to keep it under the mattress or (for those with the means), outside of the country. And despite some minor improvement after the Orange Revolution, loss of confidence and the global financial crisis put the country back to where it was in early 2005 by July 2009.

By any metric, Poland has tended to its economic institutions much better than Ukraine. As Figure 6 shows, using another measure of property rights, Poland continues to be in front. The "investor protection" score shown here is tabulated by the International Country Risk Guide (ICRG) and measures the security of property in a country (including threat of expropriation and the judiciary) on a scale from 0 to 12; apart from some decline in Poland recently due to moves regarding expropriation of private pensions, the legal framework in Poland has consistently been better than Ukraine. In some part, this can explain the difference in investment ratios in the two countries as well (Figure 7); Ukraine's investment plummeted once the Soviet Union dissolved, while Poland's investment ratio has been consistently higher.

---

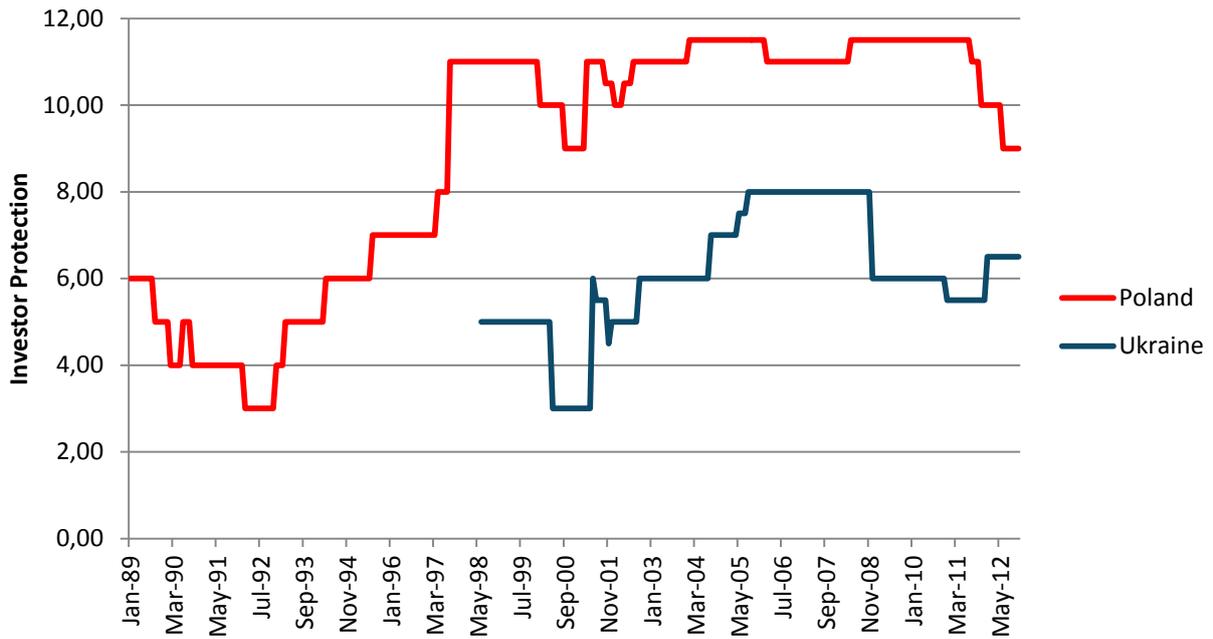
<sup>11</sup> de Menil, G, and Woo, W.T. (1994) Introduction to a Ukrainian debate. *Economic Policy*, 9(supplement), pp. 9-15.

**Figure 5. Property Rights in Poland and Ukraine as Measured by Money in the Financial Sector**



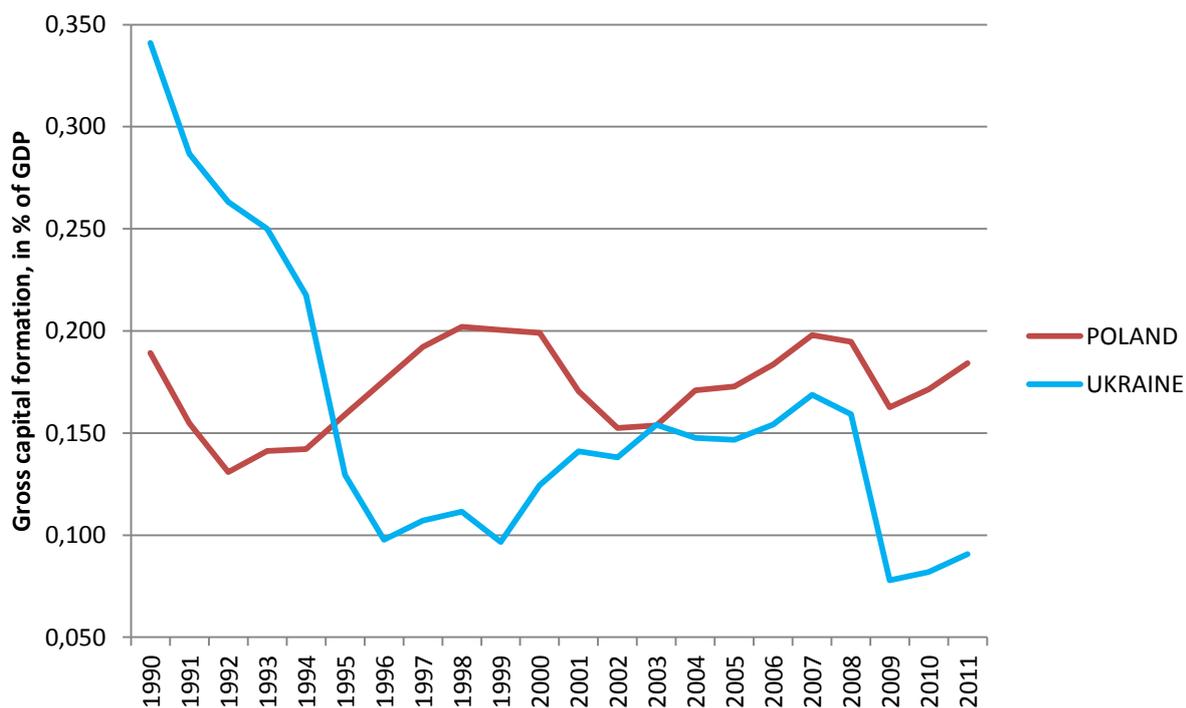
Source: Author's calculations based on IMF International Financial Statistics data

**Figure 6. Property Rights in Poland and Ukraine: Investor Protection**



Source: ICRG Database

**Figure 7. Investment Ratios in Poland and Ukraine, 1990-2011**



Source: Penn World Tables 8.0

Property rights are of course the most important institution in a market economy, but an examination of other economic institutions in Poland and Ukraine over transition show just how Poland has gotten, for the most part, the basics right. On every transition indicator measured by the European Bank for Reconstruction and Development (EBRD), Poland has an absolute advantage in cumulative outcomes over Ukraine (Table 2). Moreover, the change in institutions from the year before transition began also shows that Poland has gone faster in its reforms; where the cumulative change in Table 2 has been bigger for Ukraine, as in small-scale privatization and price liberalization, this is only because Poland had already begun some tentative liberalization before formal transition began. Thus, Poland may not have gone as far because it already had begun the journey. But even in financial sector institutions, where Poland has always been a laggard behind other transition countries (such as the Czech Republic or Estonia), there is a clear difference between the journey traveled by the two countries. And while these differences may appear small given the scaling of the indicators (from 1 to 4.33), it is important to note that, if they were normalized on a scale of 0 to 100, Poland's difference in large-scale privatization and bank reform would be 22% better than Ukraine, while governance and enterprise restructuring would see an absolute difference of 30% more improvement in Poland than Ukraine.

The cumulative changes in economic institutions may obscure the dynamic economic changes occurring in both countries, but here too Poland comes out on top. Figure 8 shows the path of large-scale privatization in Poland and Ukraine, scaled by transition year, that is, with both countries re-scaled to show the progress in comparable time from transition. Poland began its process of privatization in the first year of transition, while for Ukraine it did not begin until

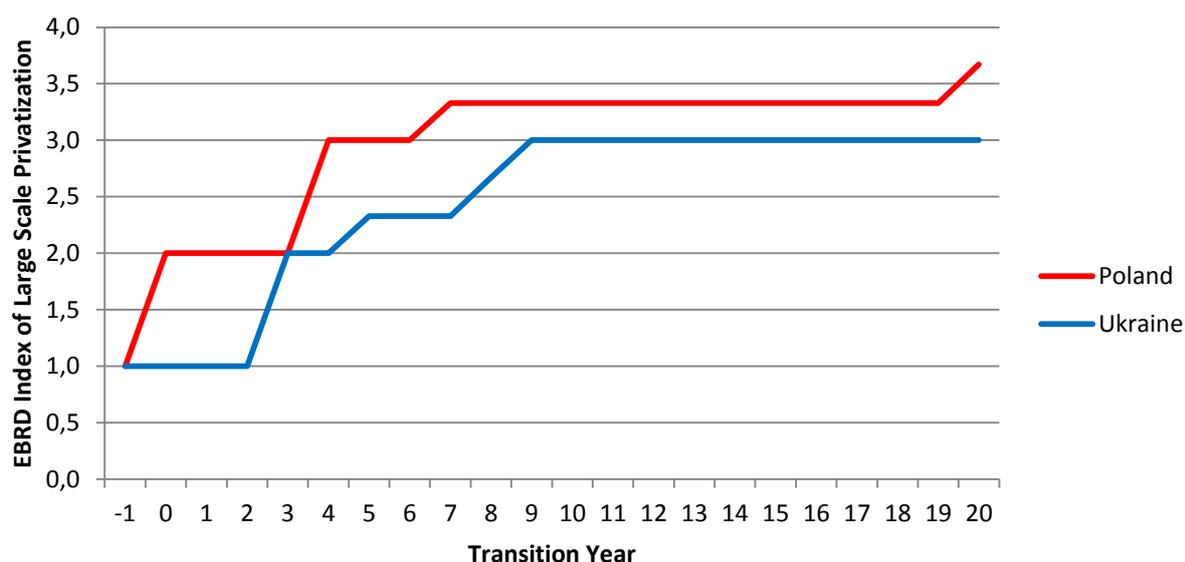
year 3, when it caught up to Poland's level. However, in year 3 of transition, Poland initiated another round of privatization that pulled it further away from Ukraine. The gap narrowed after the 9<sup>th</sup> year of Ukraine's transition, but, proving the dynamic nature of institutional development, Poland once again undertook privatization reforms in its 19<sup>th</sup> year of transition, leading to another widening gap with Ukraine. Thus, after early quick steps to reform state-owned enterprises, a long period of consolidation in Poland led to more reforms. By contrast, Ukraine's delayed reforms led to smaller, incremental gains over a longer period, while even the gains of the Orange Revolution did not translate to any progress in these economic reforms.

**Table 2. EBRD Transition Indicators, 2012 and Change over Transition**

	Poland		Ukraine	
	2012	Change	2012	Change
Large scale privatization	3.67	2.67	3.00	2.00
Small scale privatization	4.33	2.33	4.00	3.00
Governance and enterprise restructuring	3.67	2.67	2.33	1.33
Price liberalization	4.33	2.00	4.00	3.00
Trade & Forex system	4.33	3.33	4.00	3.00
Competition Policy	3.67	2.67	2.33	1.33
Bank Reform and Interest Rate Liberalization	3.67	2.67	3.00	2.00

Source: EBRD. "Change" refers to the change in the indicator from the year before transition began (Poland = 1989, Ukraine = 1991) through 2012. Each indicator is measured on a scale from 1 to 4.33.

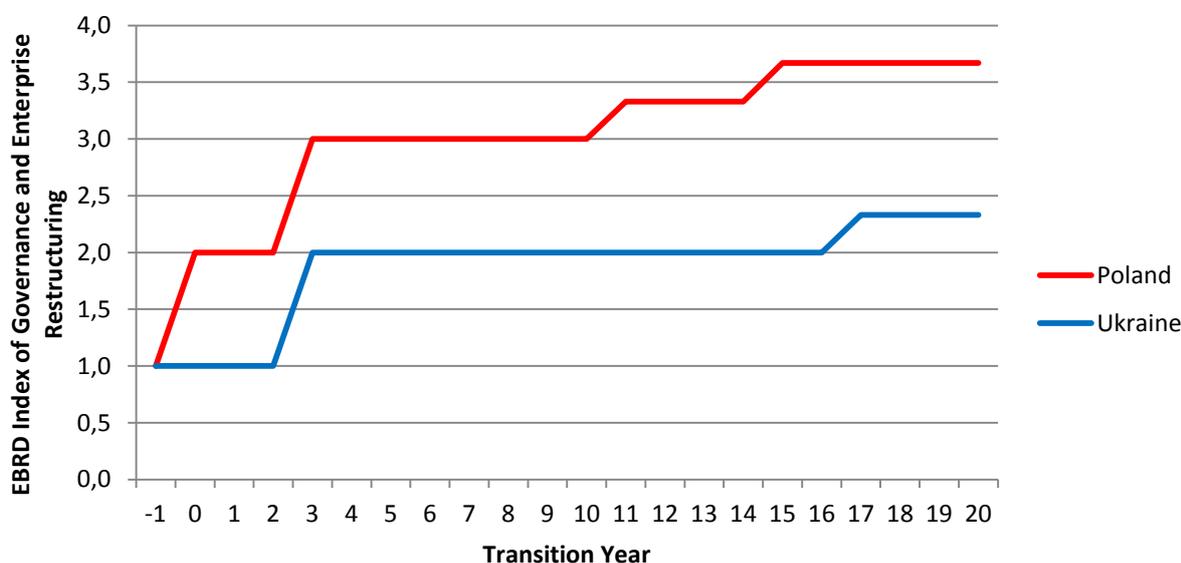
**Figure 8. Large-Scale Privatization in Poland and Ukraine**



Source: EBRD Transition Indicators

The extent of institutional paralysis in Ukraine, both political and economic, can be seen in Figure 9, which shows a similar relationship in governance and enterprise restructuring (based on the EBRD indicator of the same name). Once again scaled to reflect transition year, Poland actually saw widespread governance reforms before the economy formally undertook its transition, showing perhaps the influence of informal institutions as the formal institutions began to break down. But the Figure shows the reality that Poland moved ahead in reforms earlier and sustained them faster, while Ukraine’s first set of reforms in the 3<sup>rd</sup> transition year remained in place for well over a decade before any other changes were made. With large-scale uncertainty about the direction of the economy, and continuing capture of the commanding heights by political elites and bureaucracy, needed structural reforms at the enterprise level stalled.

**Figure 9. Enterprise Restructuring in Both Countries**



Source: EBRD Transition Indicators

#### 4. Conclusions and Lessons

The divergence in economic outcomes between Poland and Ukraine can be traced almost exclusively to the development of both political and economic institutions since the beginning of transition. Poland pursued a strategy that was predicated on swift macroeconomic *and* institutional reforms, while Ukraine delayed on both. This reality manifested itself in increased corruption in Ukraine, halting progress towards both political and economic reform, and a populace that now finds it being increasingly manipulated by outside powers simple because the alternatives have not been seen as ever achievable. For the researchers such as Joseph Stiglitz who once claimed that institutions were “neglected” in transition, they have only to look at Ukraine’s experience to find some vindication for this view. Where Poland worked to quickly put in place the building blocks of what would become market institutions, Ukraine instead resisted the difficult transition of institutions in favor of incremental tinkering of the Soviet apparatus. Not surprisingly, with institutions neglected, cultural and societal attitudes remained mired in the communist past.

An important point to note at this juncture is that swift reforms themselves are no guarantee against either bad policy or reversals; they just make the likelihood of bad policy becoming the default option less likely. A germane example is the recent pension “reform” in Poland, which comes after 20 years of a successful market economy but is a direct threat to the idea of property rights. Despite all of the progress Poland has made, this policy is still poised to become law, showing that there are no ironclad checks and balances. But in a more volatile and slowly (or barely) reformed state like Ukraine, the political and economic institutions of the country were already shaped by an environment of distortions, proving how difficult it is to shape institutions that facilitate the market economy without being subjected to that same market economy. Put simply, institutions reflect their external environment, and without the incentives for institutions change, they would not. This is the true tragedy of Ukraine: not that bad policy occurred, but that, due to the institutional stagnation, it was the default.

Finally, a word must be said about the European Union, for, after all, it was Yanukovich’s failure to sign the cooperation agreement with the EU that triggered the protests that led to his downfall. The EU may have some (serious) issues with its own institutions, as well as the way it influences institutional development in member countries, but the EU’s relative wealth provided Poland with a target to achieve. Ukraine’s accession to the EU was always less assured, if simply for the fact that EU accession was not incorporated into the economic policymaking in the early years of transition. The exact contribution of the EU to institutional development in both countries is impossible to quantify, but, as the events of December 2013 show, they still held symbolic power. And most importantly, the desire to approximate “best” (if not actually perfect) practice in institutional reform may have been a signal of the willingness to reform overall. It is this desire that can explain the neglect of market institutions in Ukraine and their relatively more successful implementation in Poland.

When all of these factors are taken into account, it is plain to see that the economic divergence of Poland and Ukraine was not pre-ordained. The choices made by the government and people of Poland made a huge contribution to the country’s successful transition, forcing institutional change and the reform of the building blocks of a market economy. This transition is still incomplete in Ukraine, and if there is any positive outcome from the current turmoil, it will be that 25 years from now Ukraine’s and Poland’s institutions will have converged again for the better.