Ukraine’s system of crony capitalism

The challenge of dismantling ‘systema’

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Summary

— Ukraine’s *systema* – commonly described as *oligarkhiya* in Ukraine – grew out of a specific form of crony capitalism that took root in the late 1990s. It has proved impressively resilient and adaptive to political and economic disruption since the 2004–05 Orange Revolution. It allocates resources inefficiently and in ways that do not benefit society, and increases economic costs by reducing competition. At the same time, it weakens institutions and perpetuates high levels of inequality and corruption. As such, it is the underlying obstacle to the development of fully functioning democratic institutions and rule of law.

— *Systema* has proved particularly hard to dislodge because it rests on a firm alignment of interests between big business and the political class in favour of rent seeking over wealth creation for the public good. Across the state sector, and at different levels, it has spawned an extensive supporting structure of beneficiaries that service those interests.

— *Systema*’s structures are in place not just in Kyiv but across the country. The same operating principles are replicated at regional level for the benefit of powerful local elites and their accomplices in regional governments and councils.

— The influence of *systema* across the banking, energy, transport and healthcare sectors rests on the same foundations, and achieves broadly similar results for its stakeholders, even if some reforms have significantly reduced opportunities for the levels of rent seeking seen before the Revolution of Dignity in 2014. The agricultural sector is anomalous partly because of the absence of the main financial-industrial groups (FIGs) and because the issue of land reform resonates strongly with society and has limited the ambitions of some of the influential players.

— The main FIGs dominate the media sector because ownership of media assets is vital for influencing politics and thereby preserving their influence. Over time, however, a combination of regulatory changes, digital disruption, and the appearance of new channels and new models of media business may erode their control of the sector.

— Although *systema* has undoubtedly suffered setbacks since the Revolution of Dignity, it still has considerable residual strength, and the ability to undo some of the most important achievements of the reforms undertaken since 2014.
— Systema has left Ukraine with a serious lack of expertise in government that contributes to weak state capacity. The major FIGs attract and retain much of the best talent in the country, putting it to work to make governing institutions work for them. This imbalance is likely to take many years to correct.

— Reducing the influence of systema requires changing the calculus of the main players. Rent seeking needs to become more difficult, to carry greater risk and to be less profitable than wealth creation through the establishment of well-managed, transparent businesses that attract investment and generate employment.
Introduction

Ukraine’s system of crony capitalism reflects the absence of a strong state, and an enduring relationship between big business and the political class that puts their own interests before those of society.

The form of crony capitalism that emerged in Ukraine in the late 1990s has proved impressively resilient and adaptive to political and economic disruption since the Orange Revolution in 2004–05, followed by the Revolution of Dignity in 2014. It functions based on a deeply integrated network bound by shared interests described here as *systema*, but known more commonly in Ukraine as *oligarkhiya*. Breaking its grip is essential for the consolidation of democratic institutions and the development of rule of law.

*Systema* is by no means a uniquely Ukrainian phenomenon. Variations of the same model exist to different degrees around the world, including in ‘old’ EU member states such as Greece and Italy as well as ‘new’ ones such as Bulgaria, Croatia and Romania. Unlike its Russian analogue, which rests on a centralized structure of power, Ukraine’s *systema* reflects the absence of a strong state. The common features of these governance models are high concentrations of capital in the hands of a small number of politically connected business owners in environments characterized by institutions that siphon public money for the benefit of the few, low levels of transparency, limited accountability and weak rule of law. To different degrees, the effects include the undermining of democratic governance, the distortion of economies, and the promotion of criminality and corrupt practices through the influence on public policy of a dominant group’s business interests. In short, these systems seriously hinder the functioning of an autonomous state for the public good.

Analysts often describe the ability of Ukraine’s major financial-industrial groups (FIGs) to penetrate parliament and the agencies of government in order to put their interests before those of the country as ‘state capture’, or ‘regulatory capture’. However, what is happening is not the one-way process that these terms imply. There is a symbiotic relationship between big business and politicians and officials in which each needs the other to sustain a system that allocates...
resources for their benefit. The FIGs depend on politicians, who are sometimes their direct representatives, to pass favourable laws and ensure the state apparatus implements them. Major business owners such as Rinat Akhmetov, Viktor Pinchuk and former president Petro Poroshenko have even served in parliament themselves, as Poroshenko does again now. At the same time, large numbers of politicians depend on the FIGs to finance their campaigns and to deploy media assets in support of their combined interests. Both sides benefit from their ability to influence the judicial system. ‘Shadow state’ is perhaps a more accurate description of such a model in which institutions are co-opted and subverted rather than ‘captured’.

This pernicious fusion of interests on the part of big business and a ‘service’ class creates systema. While its effects are visible in Ukraine’s poor economic performance for much of the period since independence, and in its disturbingly high levels of inequality, much of the fabric of systema is non-transparent and lives in the shadows.

Ukraine typifies what some social scientists describe as a ‘limited access order’, in which a ruling class artificially restricts political and economic competition to amass wealth and protect itself. Since the Revolution of Dignity in 2014, systema’s stakeholders have shown their ability to continue to manipulate public institutions not just in the face of the deepest set of reforms undertaken since independence, but also in conditions of war. Putting their own interests before those of society, they have shown their determination to allow as little change as possible to the functioning of systema.

They have sustained an economic model of rent seeking that prevents the creation of a level playing field by granting benefits to some companies over others. Not only does a system of this kind allocate resources inefficiently and in ways that do not benefit society, it increases economic costs by reducing competition. A further damaging side effect is the co-optation by its participants of the law enforcement agencies and the judiciary to safeguard their assets and revenue streams as well as to ensure their immunity from prosecution. Over the years, this has limited possibilities for reforming the police, the security services, the Prosecutor’s Office and the judiciary. It is hardly surprising, therefore, that Ukraine continues to score poorly in the World Justice Project’s Rule of Law Index. In 2020, it ranked 72nd overall out of 128 countries and jurisdictions assessed – albeit six places higher than the previous year. However, it ranked 110th in the category ‘absence of corruption’, and 90th in ‘criminal justice’.

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2 Rent seeking in this paper refers to the transfer of public resources to politically connected companies through subsidies, tax exemptions and procurement contracts resulting in social loss.
The subversion of the legal system also creates possibilities for organized crime to operate alongside business. The problem deepened under Viktor Yanukovych’s presidency in 2010–14: mafia structures in Donbas colluded with government agencies, including the Security Service. There is no evidence to suggest that the problem of organized crime in Ukraine has diminished. It is part of a deeply rooted social culture that goes back to the 19th century, materializing in the form of a brotherhood of ‘thieves’ with its own laws and morals. The revolutionary environment of 2014 and its aftermath created increased opportunities for organized crime, particularly people-trafficking and drug-smuggling, as the new authorities focused on containing the uprising in Donbas.

The power of systema is reflected in the concentration of economic assets. According to 2015 data, politically connected businesses accounting for less than 1 per cent of companies in Ukraine owned more than 25 per cent of all assets and accessed over 20 per cent of debt financing. In the capital-intensive mining, energy and transport sectors, politically connected businesses accounted for over 40 per cent of turnover and 50 per cent of assets.

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Since the second half of the 1990s, when systema originally took root under President Leonid Kuchma, these businesses have used their political relationships to pursue a wide range of rent-seeking opportunities, including rigged public procurement tenders and privileged access to state aid, tax benefits, soft loans and debt guarantees from state banks. Several of these practices have continued since 2014 despite the closure of some of the largest schemes, notably in the banking, energy and healthcare sectors. However, political influence still translates into the capacity to gain business advantage by encouraging monopolistic practices. This is particularly visible in the

9 Ibid., p. 5.
energy industry. It is no coincidence, for example, that Ukraine ranked 128th out of 190 countries for ‘getting electricity’ in the World Bank’s 2020 Ease of Doing Business rankings.10

Systema has proved particularly hard to dislodge because it rests on a firm alignment of interests between big business and the political class in favour of rent seeking over wealth creation for the public good. Across the state sector at different levels, it has spawned an extensive supporting structure of beneficiaries that service those interests. Including dependents, this interest group comprises millions of people. This translates into a sizeable constituency in Ukrainian society that wishes to preserve this model and sees danger in reforms that could undermine it.

It is unclear to what extent President Volodymyr Zelenskyy and his team have ever felt able to disrupt systema in order to achieve their declared goals of rapid economic growth and reduced levels of corruption. On the face of it, Zelenskyy’s election mandate in 2019 gave him an unprecedented opportunity to use his popularity and his parliamentary majority, based on first-term MPs, to start developing a new model of governance – one that prioritizes society’s interests over those of the ruling class. However, his performance so far, exacerbated by the impact of the COVID-19 crisis, suggests that he cannot govern without systema and will bow to its interests.

A number of significant developments in 2020 pointed to the renewed influence of interest groups opposed to changing the established rules of the game. First, in March 2020, was the dismissal of the government of prime minister Oleksiy Honcharuk, followed, a day later, by the removal from office of the reformist prosecutor-general, Ruslan Ryaboshapka. Then, in April, came the Constitutional Court’s blocking of judicial reforms, and a ruling by the same court, in October, that effectively paralysed the work of the National Agency for Corruption Prevention. Evidently, the Revolution of Dignity did not bring about the dismantling of these old networks, which also oppose Western influence on the reform agenda and, in some cases, propagate anti-Western disinformation. In the case of the Constitutional Court, four of the 15 sitting judges in October 2020 were holdovers from the Yanukovych era who had taken up their positions before the start of post-revolutionary judicial reform and the adoption of a new anti-corruption strategy. Those appointed later were part of the same ‘judicial corporation’, with its own interests and culture.

This paper shows how Ukraine’s systema remains in place across the main sectors of the economy, and identifies the main mechanisms of control that enable its stakeholders to preserve their privileges and divert public resources. It also considers the factors that may change the behaviour of systema’s participants.

The analysis deliberately avoids the terms ‘oligarchs’ and ‘undue influence’, as both mischaracterize the underlying governance problem facing Ukraine. One challenge for reformist forces is to develop a new vocabulary in Ukrainian and English that will more accurately describe certain features of systema and the obstacles to reducing its influence.

Ukraine is not an oligarchy in the classic sense because it is not ruled by a small group of individuals. As noted above, while the owners of the largest business groups hold considerable sway over aspects of economic policy, they depend on a wider group of government officials, members of parliament, policy experts and managers of state companies to exercise their power. Some among this ‘service class’ are direct representatives of FIGs, but the majority are not. They have their own interests and influence channels. Competing regional interests further complicate the picture. Thus, to this extent, power is shared. Adopting policies requires consensus building and trading of positions with individuals that these business owners do not always directly control.

‘Undue influence’ is a misnomer for two reasons. First, the main stakeholders are more than just influencers. They are often actors in their own right, as systema allows them to participate directly in decision-making on state policy outside formal institutions. Zelenskyy’s request, in March 2020, to leading businesses to support the government’s efforts to tackle the impact of the COVID-19 pandemic is a recent example of how this can happen openly.11 Poroshenko’s appointment of two leading businessmen, Igor Kolomoisky and Serhiy Taruta, in 2014 to run southeastern regions is another. Second, Ukraine’s system of governance has not yet evolved to the point at which it is possible to describe key stakeholders’ influence as ‘undue’ or excessive. In a limited access order, this is the norm.

02 Systema’s four pillars

Despite their privileges, the companies controlled by the Ukraine’s major financial-industrial groups – the primary stakeholders in systema – are less productive and slower to increase growth and create jobs than are non-politically connected companies.

Four pillars support systema in Ukraine and provide it with considerable stability:

— Deep penetration of government decision-making processes via senior officials who favour the interests of big business and benefit from these connections;

— Influence over the legislative process including through paid-for support of MPs who either have direct business interests or stand to benefit indirectly from their support of the business interests of others;

— Influence over the judiciary and law enforcement agencies through the appointment of loyal individuals, as well as the use of bribery and other incentives to protect systema’s interests; and

— Control of the media through ownership of the main outlets that provide a platform for selected politicians to develop their careers and for big business to shape public opinion in systema’s favour, including by attacking those who stand in its way.
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Figure 1. The four pillars supporting systema

The major FIGs in Ukraine have dominated the economy over the past two decades through their ownership of vertically integrated businesses across multiple sectors, including agriculture, banking, energy production and transmission, media, mining and steel. These are systema’s primary stakeholders. Despite their privileges, the companies controlled by the FIGs are less productive and slower to increase growth and create jobs than are non-politically connected companies. Preservation of this model has depended on keeping a large section of the economy in state hands. This has allowed the stakeholders to benefit either by managing state-owned enterprises (SOEs) to extract gain through preferences granted to them by the state, or by working closely with SOEs to do so. Not surprisingly, corporate governance reform has held little appeal for these groups, while privatization has advanced at a snail’s pace, and discriminatory conditions have often excluded foreign investors.

Three decades on from the collapse of the Soviet economy, Ukraine still has around 3,700 SOEs. With the notable exceptions of PrivatBank and the national oil and gas company Naftogaz, the business operations of the FIGs have proved sustainable, despite the costs to society, because they have continued to create value for their owners.

The FIGs compete with one another for influence and access to rents, but have a strong motivation to coexist according to a set of informal rules. The Yanukovych ‘clan’ violated these rules in its dash to place rent seeking under its centralized control. In the process, it destabilized systema and forfeited the support of other players who concluded that they were better off without it despite the disruption of revolution. Some were quick to find their balance again in the post-revolution world in which systema still held sway, others less so.

Rinat Akhmetov, one of Ukraine’s wealthiest business figures, was able to find an accommodation with President Poroshenko after 2014 that allowed him to rebuild his business after suffering serious losses because of the conflict in Donbas. His business interests do not appear to have suffered under Zelensky’s presidency, and his television channels have shown the president in a positive light.

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Ihor Kolomoisky, one of Akhmetov’s rivals at the top table of business owners, initially allied himself with the Poroshenko administration, and as governor of Dnipropetrovsk region he played a key role in 2014 in mobilizing resistance against Russian efforts to destabilize southeastern Ukraine. He left the country following a rift with Poroshenko, only to make a triumphant return after Zelenskyy’s election, determined to contest the nationalization of PrivatBank, the centrepiece of his business empire, that had taken place under the Poroshenko administration.

Analysts were quick to point to the influence of the major FIGs in the parliament that was elected in 2019. Volodymyr Pesenko, one of Ukraine’s top political commentators, noted in September of that year that Kolomoisky could count on the support of up to 30 MPs, Dmytro Firtash, a prominent player in the energy and chemicals sectors on 15, and Akhmetov on six. It is widely believed in Kyiv that Akhmetov’s direct influence on the government has increased since the 2019 elections, even if he controls far fewer votes in parliament. Prime Minister Denys Shmyhal previously held a senior position at Akhmetov’s energy company DTEK, while Olha Buslavets, the acting energy minister from April–November 2020, had a professional background in Donetsk’s coal industry, which is dominated by Akhmetov. She denied reports of having ties to DTEK. Meanwhile, the influence of Firtash appears to have waned, as demonstrated by the recent decision of Ukraine’s Security and Defence Council to impose sanctions against him. Kolomoisky’s influence in parliament may have diminished in recent months, after the US authorities imposed sanctions, in January 2021, on his close associate in parliament Oleksandr Dubinsky. The earlier fracturing of Zelenskyy’s parliamentary majority had allowed Kolomoisky to control closer to 40 votes from the Servant of the People party.

Below these top-level FIGs are smaller groups that operate according to the same principles of rent seeking, but whose owners are not as visible and as networked in politics at the national level. They tend to have a local presence and to own local media outlets. Some of the bigger players in the agricultural and pharmaceutical industries fit into this category. Similarly, the biggest beneficiaries of Ukraine’s unreformed customs system, for example, are lower-level companies that avoid paying taxes through smuggling. They use some of the same mechanisms as the entities involved in large-scale rent seeking: penetration of the government system, including through collusion with law enforcement bodies, support in parliament, and use of the media to attack reformers.

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The striking feature of Ukraine’s systema is the depth of its penetration and replication in national and regional decision-making processes and within the bureaucracies that implement decisions across the country.

The rent-seeking machinery in Ukraine operates at three levels. At the top, big business takes the largest cut. In the middle, systema’s enablers such as senior to mid-level government officials, MPs and managers of state-owned enterprises receive rewards from above and below as the largest and smallest players pay their dues. At the bottom are the low- to mid-level officials who collect bribes. They keep a portion for themselves but pass the greater part to their superiors. This is consistent with equivalent models of systema around the world. However, the striking feature of the Ukrainian version is the depth of its penetration in the national decision-making process and within the bureaucracy that implements decisions.

Systema’s structures are in place not just in Kyiv. Across the country, the same operating principles are replicated at regional level for the benefit of powerful local elites and their accomplices in regional governments and councils. This can sometimes mean that cities and regional administrations, because of their political power, are able to defy the authority of national agencies. This has been evident during the COVID-19 crisis, when some cities have chosen not to comply with restrictions issued by the central government.

Systema’s regional dimension gives it considerable additional stability through a hierarchy of interest groups below the biggest FIGs at the top. The decentralization reform begun after 2014 has strengthened regional and local elites. As the local elections in November 2020 showed, in Kharkiv and Odesa especially but in other major cities as well, mayors have built power bases that rest on their popularity as local leaders rather than on the appeal of national parties. The mayors of Kharkiv and Odesa have significant business interests.
At lower administrative levels, the combination of political connections and wealth can also lead to local interests buying influence in regional centres and in Kyiv.

The motivations of the largest business owners often come into conflict over the distribution of rents, but such disagreements have not proved sufficiently disruptive to threaten systema’s foundations. These key business figures share an interest in having a common set of red lines that determine the level of reforms they are prepared to accept. Even if they find themselves marginalized or excluded, they seek a way back into systema rather than trying to transform it. Most know that their businesses would struggle to survive, let alone prosper, in a non-rent-seeking environment, and that they could not easily protect themselves in a law-governed state.

The consequences of this convergence of interests among FIGs are clearly visible in the form of a vicious circle of restricted competition in Ukraine’s politics and its economy, which results in permanently weak institutions, poor legislation and the absence of rule of law. Inevitably, this feeds corrupt practices at all levels, which provide the lubrication to keep systema’s wheels turning.

Systema succeeds in being self-sustaining because it keeps the barrier for entry into top-level politics particularly high for independent actors. This is partly due to Ukrainian politics being a competition of money rather than of ideas. For example, with no cap on campaign finance, only political actors with high levels of monetary support could compete in the 2019 presidential election. Indeed, according to the Centre for Democracy and Rule of Law, a Ukrainian NGO, the three highest-polling candidates each spent between $5 million and $21 million, mostly on TV advertising. By comparison, in Poland, where GDP per head is almost four times higher, campaign spending by candidates in the presidential election of 2015 together amounted to some $4.8 million. The high levels of election spending in Ukraine are partly attributable to the fact that campaigns start earlier than officially permitted, as well as the fact that there are no restrictions on campaign spending. A further problem that restricts competition is that under the current rules, political parties can hide their sources of financing by using intermediaries. At the same time, they do minimal public fundraising.

Transforming a limited access order into an open access order typically takes decades, because of the complexity of changing the calculus of the main players while simultaneously nurturing independent institutions. In the case of Ukraine, however, the evidence of the past six years points to two contradictory patterns of development.

First, despite the exigencies of the armed conflict with Russia, which have revealed many of the country’s weaknesses, there is still no consensus within Ukraine’s ruling class about the need to change the way it is governed. Instead, the main FIGs have continued to compete for influence: Kolomoisky returned to Ukraine in 2019 on the eve of the presidential election; Viktor Medvedchuk (who was President

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18 Memo provided to Chatham House by the Centre for Democracy and Rule of Law, March 2020.
Kuchma’s chief of staff) and Poroshenko were re-elected to parliament – although in May 2021 Medvedchuk was charged with high treason and placed under house arrest; and Akhmetov is once again in favour in the President’s Office. Even so, some reforms supported by Western countries have dramatically reduced certain opportunities for rent seeking and undercut the interests of some of systema’s beneficiaries. The IMF’s insistence on making financial assistance dependent on enacting specific anti-corruption reforms and other measures, including judicial reform, threatens to change the status quo irreversibly to the disadvantage of systema.

Second, while these reforms remain incomplete, and there have been increasing signs that parts of systema have seen Zelenskyy’s presidency as an opportunity to recover ground lost during the Poroshenko years, that a president was chosen from outside the elite group demonstrates a striking rejection of the status quo by the electorate. This represents the most powerful challenge to systema over the past 20 years, one that it has moved fast to interrupt by replacing a reformist government and trying to upend the anti-corruption reforms begun after 2014. To function effectively, however, systema requires political leadership that is accepted by society. The dramatic fall in Zelenskyy’s approval ratings between mid-2019 and early 2020, subsequently magnified by the challenges of the COVID-19 pandemic, carries dangers for systema’s main players. Zelenskyy’s reduced popularity could easily translate into a loss of authority and trigger new elections – although at the time of writing there was growing speculation that he may seek to run for a second term.

To date, there is no single body of research available in or outside Ukraine on how systema maintains its grip on power, let alone any detailed prescriptions for how to reduce or break it. The research conducted so far has tended to focus on specific individuals and their businesses, rather than on systema as a whole. The issue defies easy analysis because the numerous networks in operation extend across different economic sectors, and they reach deep within the machinery of the state and influence public opinion via different channels. It is easier to feel the presence of these networks than to see them because they are not just hidden, they are also fluid.

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To understand how *systema* functions, the chapter that follows identifies the structure of ownership in four main sectors of the economy – banking, energy, transport and healthcare – and the mechanisms of influence used by the principal players in each to protect and advance their interests. They show a consistent pattern of influence that derives from the pillars on which *systema* rests. The ability to control the legislative process, deploy media and law enforcement tools, and rely on an amenable government system to implement decisions is clearly visible. However, the example of land reform – an issue that is particularly sensitive for the public, and which is supported by Ukraine’s international partners – suggests that sectors where the largest FIGs are not present are less susceptible to *systema*’s influence.
Systema in the banking, energy, transport and healthcare sectors

The ability of big business to control the legislative process, deploy media and law enforcement tools, and rely on an amenable government system to implement decisions is clearly visible across multiple economic sectors.

Banking

Ownership

State-owned institutions today account for around 60 per cent of Ukraine’s banking sector assets. PrivatBank, Oschadbank and Ukreximbank are the biggest, with combined assets exceeding UAH 1 trillion. Close to 20 banks with foreign ownership have combined total assets of over UAH 500 billion, followed by nearly 50 domestically owned banks with total assets worth around UAH 250 billion.22

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The clean-up of the banking sector after 2014, by a reformist team at the National Bank of Ukraine (NBU), was far-reaching, and ended a large number of the extensive schemes associated with related-party lending\(^23\) that had operated for many years. Around 100 banks, most now closed, stand accused of siphoning abroad a total of $15 billion of taxpayers’ money.

**Influence of systema**

The authorities have so far put little effort into recovering these and other funds stolen from the state during the Yanukovych years, and there is evidence to show that parts of *systema* succeeded in obstructing attempts to do so.\(^24\) Under the Poroshenko administration, not only did the Prosecutor General’s Office fail to take appropriate action; the Deposit Guarantee Fund also dragged its feet, despite its power to initiate civil proceedings against individuals responsible for losses to banks. The president nominates the heads of both agencies.\(^25\)

PrivatBank provides a particularly good example of residual resistance to reforms. It was nationalized in 2016, after the discovery of a $5.5 billion hole in its balance sheet. Its former owners started an unprecedented legal campaign to challenge the nationalization in the courts, initiating hundreds of cases and threatening the credibility of banking sector reform as a whole.

The NBU’s assault on many of the old schemes for misappropriating public money has met with resistance not just from the former owners of PrivatBank. Parliament’s initial hesitation in 2018 in adopting IMF-backed legislation to establish independent supervisory boards for state banks reportedly demonstrated the power of some of the biggest holders of non-performing loans.\(^26\) These actors were able to lobby parliament from within because they were also sitting MPs.\(^27\)

The legislation was, however, eventually approved in July 2018. Subsequently, in early 2020, a small group of MPs tabled 16,000 amendments to a draft law on banking insolvency that was required by the IMF as a condition for future lending. This was clear evidence of the influence of external interest groups that wanted to block legislation intended to prevent the former owners of insolvent

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\(^{23}\) Related-party lending in this case describes a transaction between a lender and a borrower where there is a pre-existing close relationship leading to loans issued on advantageous terms to the borrower, to the detriment of the lender.


banks from regaining control of them. However, the urgent need for IMF support because of the economic problems caused by the COVID-19 pandemic undermined their campaign. Parliament passed the legislation, and Zelensky signed it into law in May 2020.

The campaign against the NBU’s management in late 2019 and early 2020, and the highly personal targeting of former governor Valeria Hontareva, are reminders that some of the opponents of banking reform are prepared to go to extreme lengths to protect their interests. The listing of Hontareva as a suspect in a criminal case ostensibly unconnected with PrivatBank raises suspicions about manipulation of the legal process. Media owned by Kolomoisky and others have played an important role in depicting the NBU as acting against Ukraine’s interests. The NBU issued a statement in November 2019 that held Kolomoisky responsible for attacks on its reputation, including alleged paid-for demonstrations outside its building.28

In July 2020 Zelensky forced the resignation of Yakov Smolii as NBU governor. After leaving his position, Smolii referred to ‘systematic political pressure’ on the bank, and did not rule out a coincidence of interest between the President’s Office and Kolomoisky.29 He said that the President’s Office wanted to replace the NBU’s leadership with people it could control. Smolii’s resignation came shortly after Ukraine had received the first tranche of a new $5 billion IMF stand-by arrangement. A key condition for continued IMF support was the independence of the NBU, and the IMF had made it clear that it held Smolii and his team in high regard.

Energy

Ownership

The energy sector has been the source of the largest rents in Ukraine over the past nearly three decades. For this reason, energy companies form the foundation of the business empires of many of the country’s wealthiest business figures. For example, Rinat Akhmetov remains the biggest player in the coal industry. In 2017, his company DTEK accounted for 86 per cent of Ukraine’s total production of 28 million tonnes of thermal coal.30 Akhmetov also has interests in the production of gas and renewables, as well as in electricity production and distribution.

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Influence of *systema*

The major FIGs exercised powerful influence over the energy industry from the time of the Kuchma presidency (1994–2005) until 2014 – particularly over arrangements for the supply of gas, which favoured imported gas from Russia over domestic production. Illegal arbitrage schemes exploiting the difference between subsidized gas prices for households and market prices for industry were a source of enrichment for large sections of the ruling class. Gas traders ‘captured’ the national regulator to create this differential. Such practices not only distorted the gas market and discouraged households from restricting consumption; they also had profound national security implications by creating a dangerous dependency on Russian gas. By 2014, Naftogaz had amassed a deficit equivalent to 5.7 per cent of GDP.

The gravity of the situation brought about the most serious reversal of a FIG’s influence seen so far. The reforms undertaken at Naftogaz led to the cessation of gas supplies from Russia, the removal of the previous arbitrage margins and a dramatic improvement, through corporate governance reforms, in the transparency of the company’s dealings. By common consent, the biggest loser of these reforms was Dmytro Firtash, who not only no longer had access to cheap Russian gas but also could no longer profit from the arbitrage business. Even so, he retained control of most of Ukraine’s regional gas companies, a part of the sector still considered highly opaque.

However, if Firtash could no longer shape the gas sector to the same extent as before, another group was able to dictate policy in the coal and electricity sectors. In 2016, the National Energy Regulatory Commission (NERC) took the controversial decision to set wholesale electricity prices at levels favouring domestic coal producers, following the ‘Rotterdam +’ formula that favoured Akhmetov’s DTEK. Commentators viewed this as the product of a reconciliation between Akhmetov and President Poroshenko, after a deterioration in relations between the two following the Revolution of Dignity. In return for NERC’s decision, it seems that Akhmetov offered Poroshenko the support of MPs loyal to him. Akhmetov’s main business partner, Vadim Novinsky, and several of the senior managers in his companies entered parliament in 2014 as representatives of Opposition Bloc, a remnant of Yanukovych’s Party of the Regions.

The secretariat of the Energy Community was scathing in its 2018 review of the NERC’s performance, noting that its members were apparently ‘under the pressure of certain political and business groups which actually influence the outcome of the decisions’. The resignations of several members of the NERC after Zelenskyy became president reportedly took place under political pressure.

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31 The Energy Community brings together EU and neighbouring countries with the goal of creating an integrated pan-European energy market built on EU rules and principles.

While it is still too early to say whether the NERC will function differently with its changed membership, it seems likely that the same lobbying tactics on the part of the FIGs will continue. The core problem that weakens the possibility for independent regulation is a shortage of expertise and the absence a cadre of specialists who can stand up to business interests. This is particularly visible in the Ministry of Energy and Environmental Protection and in parliament’s Energy and Utilities Committee. The greatest energy expertise is not in the public sector; instead, it is in the FIGs, where salaries are much higher and there are better opportunities for professional development.

Planned efforts to de-monopolize household gas supply, for example, are likely to run up against Firtash’s interests. As he demonstrated after 2014, he was able to deploy powerful lobbying capacity to protect his businesses. The embargoes on fertilizers produced in Russia helped his company Ostchem to reinforce its monopoly on the domestic market. The cessation of imports from Russia disadvantaged Ukrainian farmers by denying them access to cheaper fertilizer supplies. However, Zelenskyy’s imposition of sanctions on Firtash in late June 2021 suggested that his position had weakened significantly.

The core problem that weakens the possibility for independent regulation is a shortage of expertise and the absence a cadre of specialists who can stand up to business interests.

If necessary, the FIGs are also able to use the media to support their position against the government, as well as funding friendly trade associations or Ukrainian and foreign think-tanks. They have also successfully used the courts in the past to challenge NERC decisions on tariffs. There has been speculation, too, that the blocking of efforts by the Honcharuk government to change the management of Centrenergo and three regional energy companies was a key factor in its dismissal.

During 2020, there was significant political pressure on Naftogaz and the gas transmission system operator that was unbundled at the beginning of the year. The deep reforms of the gas sector to cut energy dependence on Russia and align Ukraine’s gas market with the free-market principles enshrined in EU energy legislation have helped the country to integrate rapidly into a wider EU market, but they have not been popular in some quarters in Ukraine. In May of that year, 47 MPs from former prime minister Yulia Tymoshenko’s Fatherland party and Medvedchuk’s Russia-friendly Opposition Platform – For Life jointly called on the Constitutional Court to examine the legality of the unbundling of the transmission system. The government’s decision, in January 2021, to regulate

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33 For example, Akhmetov’s SCM and Zlochevsky’s Burisma were both donors to the Atlantic Council in the US in the 2019 fiscal year; Atlantic Council (2019), ‘Honor roll of contributors’, https://www.atlanticcouncil.org/support-the-council/honor-roll-of-contributors-2019 (accessed 8 Mar. 2021).

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household gas prices for the rest of the heating season may have had an economic justification to limit continued price-gouging by companies associated with Firtash that control 75 per cent of the retail gas market. Yet among the supporters of the government’s move were forces hostile to Western-style reforms and thus happy to damage Ukraine’s relations with the IMF. The fund had previously insisted on Ukraine raising domestic gas prices to market levels as a condition for its continued support.

Transport

Ownership

The transport sector is largely state-owned, but provides a stark example of how the interests of major FIGs can distort an SOE’s functioning for their own purposes. Direct losses to the sector from FIG-led schemes amount to an estimated $5 billion per year. Exceptionally, Ukraine International Airlines (UIA) is a private company, owned by offshore entities affiliated with Ihor Kolomoisky.

Influence of ‘systema’

Influence over pricing mechanisms for use of the transport system are crucial for the FIGs that operate commodity-producing businesses. This is particularly visible in the case of the railways. The cheapest and most efficient means of transporting bulk commodities such as coal, iron ore, steel, corn, wheat and sunflower oil is by rail, in part because of the unsatisfactory quality of roads. However, the FIGs’ strategy of driving down costs for rail use has left the railways in a deplorable state. Poorly maintained infrastructure and a shortage of rolling stock, particularly locomotives, have created costly bottlenecks for the system as a whole.

FIGs have succeeded in keeping in place a system of tariffs established in the 1960s that makes it cheaper to transport raw materials than finished goods. As a result of hryvnia depreciation, tariffs are 10 times lower than their equivalents in Poland or Hungary. According to one analysis, the main beneficiaries of the tariffs are SCM (owned by Rinat Akhmetov) and Ferrexpo (owned by Kostyantin Zhevago). The FIGs have also profited from their participation in tenders to supply goods, fuel and maintenance services to Ukrainian Railways (Ukrzaliznytsia). For example, Akhmetov’s Metinvest supplies rails, while Viktor Pinchuk’s Interpipe is a supplier of wheels for locomotives and rail cars. Companies connected with Petro Poroshenko and his associate Ihor Kononenko have supplied fuel.

In some cases, business interests have hijacked certification procedures within


The government sold a 61.6 per cent stake in UIA to three existing shareholders in 2011.


Ibid.
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Ukrzaliznytsia to allow only purchases from monopoly suppliers.39 A company connected with Yaroslav Dubnevych, the former chairman of parliament’s Transport Committee is alleged to have supplied components to Ukrzaliznytsia at inflated prices.40 In October 2019 parliament revoked Dubnevych’s parliamentary immunity, and prosecutors arrested him on suspicion of stealing UAH 93 million through corrupt procurement schemes. He was later released on bail. In April 2020, the Specialized Anti-Corruption Prosecutor’s Office reported that it was filing charges against Dubnevych and forwarding the case to the High Anti-Corruption Court for review.41

FIGs also exercise influence over the operations of the 13 seaports managed by the Ukrainian Sea Ports Authority (USPA) to obtain logistical and other advantages, including customs privileges. The ports are vitally important to these groups for their exports of metals and grain as well as imports of coal and oil products. Access to limited port capacity is a key issue. One analysis notes that the FIGs influence port operations through the law enforcement agencies, MPs and the top management of the USPA.42 An indication of the latter is that, in 2018, 11 of 13 heads of seaports were ‘acting’ rather than permanent appointments. This is a mechanism used in other areas such as customs to induce officials, concerned for their job security, to be more receptive to certain interests.

In the aviation sector, Kolomoisky exercises influence through appointees in the management of Kyiv’s Boryspil airport.43 As a result, UIA reportedly benefits from privileged conditions there. Although Kolomoisky’s lobbying of the government and legal action were not sufficient to prevent the entry of the low-cost carrier Ryanair into the market, before the COVID-19 crisis his oil products business had benefited from the growth of demand for aviation fuel. Around 30 per cent of the volumes supplied in Ukraine came from Kolomoisky’s Kremenchug refinery.

In the road-building sector, there are strong suspicions that the interests of FIGs influence decisions at the state agency Ukravtodor to favour their businesses by determining which roads should be built, the routes these should take, and which roads should be prioritized for repair.44 In addition, according to one report, in 2018 and 2019, three companies won one-third of all contracts from Ukravtodvor,45 one of them allegedly connected with the mayor of Odesa, Hennady Trukhanov.

39 Ibid.
42 Ibid
44 Interview with former Ukrainian senior government official, February 2020.
who has been subject to multiple investigations by the National Anti-Corruption Bureau related to suspected embezzlement of state property, money laundering and other offences. None of these has so far resulted in a criminal conviction.

**Healthcare**

**Ownership**

The healthcare market is competitive, with no single company accounting for more than 6 per cent. The largest FIGs are absent from the sector. The owners of healthcare companies are often significant donors to political parties, and have their representatives in parliament’s Public Health Committee. The pharmaceutical sector as a whole accounted for only 1 per cent of GDP in 2018, according to NBU data. This almost certainly explains why it is not a sector that is attractive to the main FIGs.

**Influence of systema**

Before 2015, manipulation of the tendering process through collusion between government officials and companies supplying equipment and medicines led to purchases at vastly inflated prices. The two sides shared the proceeds. In some cases the prices were two to three times higher than those paid for the same medicines in Poland.

According to one 2017 estimate, 40 per cent of the Ministry of Health’s spending on procurement of medicines was ‘black cash’. In 2014, six companies, four of them controlled by the same person, supplied 95 per cent of the drugs for treating AIDS, cancer, hepatitis and tuberculosis. Under the leadership of Ulana Suprun as acting minister from 2016 to 2019, the Ministry of Health succeeded in closing down much of the space for these practices by outsourcing the procurement of medicines to international specialists. Manipulation of the process for registering medicines produced abroad in favour of domestic manufacturers and distributors was another major problem confronting Suprun’s team.

The backlash from the interest groups that lost out because of the removal of these schemes was immediate and sustained. Representatives of the Accounting Chamber visited the Ministry of Health on several occasions to investigate the new procurement process. Government agencies suddenly also showed an interest, including the Security Service, the Prosecutor General’s Office and the National Police. Parliament’s Public Health Committee contained several individuals who were on the payroll of pharmaceutical companies. Glib Zahoriy, the owner of one of the largest such companies, Darnitsa, was an MP from Poroshenko’s party.

He lobbied against changes to the procurement process in parliament and tried unsuccessfully to appoint a close associate to head the State Expert Centre that was responsible for registering medicines.48

At the same time, there were intense media attacks on Suprun and her team as well as efforts using the Prosecutor General’s Office to intimidate two prominent health reform NGOs by opening criminal cases against them for alleged mismanagement of foreign grants. In February 2019, a Kyiv court instructed the State Bureau of Investigations to open a criminal case against Suprun for interfering in the work of the court.49 She has said that at one point, her team faced up to 20 court appearances a week that was part of an effort to waste their time and slow down the reforms.50

The current chairman of parliament’s Public Health Committee is Mykhaylo Radutsky, the former owner of the Boris network clinics, who was elected on the Zelenskyy’s Servant of the People list. Due to his close relationship with the president, he reportedly received carte blanche from the President’s Office to reform the health service. According to some sources, Radutsky was in effect running the Ministry of Health at the beginning of 2020.51 In addition, an alliance of pharmaceutical companies and distributors lobbied the government not to extend the system for outsourcing procurement of medicines to international agencies that was due to end in 2020. Their efforts failed as a result of a dispute between the Ministry of Health and its own procurement agency that required the government to call again on the services of international partners at the beginning of 2021, amid urgent efforts to procure vaccines against COVID-19.52

Ukraine’s procurement practices during the COVID-19 pandemic point to efforts to bypass the Prozorro electronic auctions system to purchase protective equipment for medical staff. This has resulted in the state paying more than double the cost than in other countries for equipment meeting the same quality standards.53

As noted above, Zelenskyy convened a meeting in March 2020 with the country’s leading business owners and demanded their financial assistance and other support in providing urgently needed medical supplies. This was recognition that the government had neither the financial nor the organizational resources to manage the crisis on its own.

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50 Interview with the author, February 2020.
51 Interviews with former Ukrainian senior government officials, February 2020.
Agriculture: a counterexample

Despite the size and influence of Ukraine’s major agro-holdings, the politically sensitive issue of land reform has exposed some of their weaknesses.

Ownership

Agriculture is an exceptional case in Ukraine, in that it is a large sector of the economy not controlled by the top-tier business interests that dominate sectors such as banking, energy, metals and transport. Agricultural lands used for commercial farming are held by private individuals in the form of communal property. Commercial farmers lease these and operate at the level of large agro-holdings, mid-sized farms and small farms, with around 50,000 legally registered entities active in the agricultural sector. In addition, there are an estimated 1–4 million unregistered small farms cultivating around a third to half of the country’s arable land (up to 20 million hectares). These have no access to state subsidies or bank finance.

Influence mechanisms

The reluctance of successive governments to permit the free purchase and sale of agricultural land has favoured the development of large agro-holdings controlling 50,000 hectares and more in the absence of a legal limit on the amount of land they can lease. Some have been able to secure access to land on decades-long leases. Even though the agro-holdings control less than 25 per cent of Ukraine’s agricultural lands, they have exercised decisive

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In a sector blighted by ‘corporate raiding’, the big companies have their own security guards but often work closely with local law enforcement agencies to protect their assets – and in some cases to increase their land holdings by using various tactics to put other farmers out of business.
Zelenskyy signed it into law. Some observers consider that the government chose to disregard the lobbying of big business because of the sensitivity of the issue with the public and fear that it could have a negative impact on upcoming local elections. Others point to the risk that some of the large companies may succeed in persuading lessors that they are better off leasing land than selling it.57

The land reform issue is an important example of how dominant business interests were unable to win the day in a sector in which the biggest FIGs, with their lobbying and media tools, are absent. Although the law adopted is not as liberal as some reformers had hoped, the pressure of the IMF and the strength of public feeling proved more important for the government than any gains it may have received by supporting the position of the agro-holdings. Ultimately, these business groups do not command the same level of authority as the main FIGs which – with their representatives in government and parliament as well as their media channels – have far greater resources to influence decision-making.

57 Interviews with Ukrainian agricultural experts, March–April 2020.
The place of the media in systema

The financial-industrial groups’ dominance of Ukraine’s main media outlets – and their ability to subsidize their losses – ‘captures’ politicians who rely on media access to develop the profile needed to win votes.

Control of the mainstream media is critically important for the biggest stakeholders in systema because of its political power. The largest FIGs are the dominant players in the media market. Four groups own the 15 most popular nationwide television channels, as well as the most popular newspapers, radio stations, regional TV channels and internet media sources. They are StarLight Media (owned by Viktor Pinchuk), Media Group Ukraine (owned by Rinat Akhmetov), 1+1 Media (owned by Ihor Kolomoisky, Viktor Medvedchuk58 and Ihor Surkis), Inter Media Group (owned by Dmytro Firtash, Valeriy Khoroshkovskii and Serhiy Lyovochkin). According to one estimate, these groups together reach over 75 per cent of Ukraine’s TV audience.59 Ownership in the sector has experienced a remarkable degree of stability over the past decade. During this time, the top 10 media owners (by size of audience) have remained almost unchanged. This is a powerful indicator of systema’s durability.

The FIGs’ ownership of the main media outlets and their ability to subsidize their losses – for example, Inter lost $70 million in 201260 – ‘captures’ politicians who rely on media access to develop the profile required to attract voters. This relationship leads to inevitable politicization of media coverage, particularly during election campaigns, and provides a platform to challenge unwelcome reform efforts. Elected politicians also seek to use media to maintain voters’ trust.

58 In February 2021 Zelenskyy ordered the closure of three TV channels broadcasting pro-Kremlin content believed to belong to Medvedchuk.
59 Andrusiv, Ustenko, Romanenko and Tyshkevich (2018), The Future of the Ukrainian Oligarchs, p. 53.
Political advertising, especially on TV, consumes a large part of campaign budgets because of its perceived effectiveness, and contributes to a distortion of the media market in favour of FIGs’ interests. There are currently no restrictions on campaign spending on advertising. Media owners are also able to use their outlets to protect their businesses from competitors and politicians, particularly during pre-election campaigns when they can shape national news reporting.⁶¹

In some regional centres, subsidiaries of the major FIGs or local business groups have stakes in local media and exercise influence over coverage in the same way as happens at national level.

Suspilne, the public broadcaster launched in 2015, is starting to make inroads into the audiences of FIG-controlled media as the quality of its programming has improved, but it cannot compete with their offering. There are signs, too, that it is suffering from political interference and underfunding that limit its effectiveness. Similarly, independent media are in no position to match the major channels’ ability to attract advertising for television and digital channels. FIGs also have a strong presence in the digital media sector, where they own three of the top 10 news websites (in terms of audience reach: obozrevatel.com, segodnya.ua and tsn.ua).⁶²

Government regulation of the media remains open to political influence. The president and parliament appoint, by equal quotas, the members of the regulator, the National Council of Television and Radio Broadcasting. Similarly, the president nominates the head of the licensing body, the State Committee for Television and Radio Broadcasting, and parliament approves the appointment. The draft media law that has been under discussion in parliament since early 2020, and which had not yet had its first reading at the time of writing this paper, is the work of several individuals in government and parliament connected with media groups controlled by the FIGs. It is hardly surprising that the major media companies have no need to lobby against its provisions.

For now, the FIGs’ dominance of the major media channels remains unchallenged. Over time, a combination of regulatory changes, digital disruption, and the appearance of new channels and new models of media business may erode their influence. For example, increased transparency of ownership and funding of digital media, as envisaged by the draft law, could make it harder to use digital media for political purposes.

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Conclusions

Dismantling Ukraine’s system of crony capitalism will require a combination of deep structural reforms, preventive and repressive measures to restrict corruption, and civic activism to hold politicians, officials and business owners accountable.

Systema as whole in Ukraine has suffered setbacks since the Revolution of Dignity, but it still has considerable residual strength – and the ability to undo some of the most important achievements of the reforms undertaken since 2014. Its four pillars of support provide possibilities for using different mechanisms in different combinations and at different intensity to advance its interests. The greatest disruption to the interests of systema stakeholders has been in the banking, energy and healthcare sectors. Yet in all three cases, there are clear dangers of regression.

Reformist forces have not yet achieved a final victory against the former owners of PrivatBank, as underlined by the resignation of the NBU governor in July 2020, and by the fact that the Constitutional Court is due to rule on the legality of the Deposit Guarantee Fund. This fund is responsible for liquidating insolvent bank assets. If its creation is ruled unconstitutional, this will call into question the entire clean-up of the banking sector during the Poroshenko years.

The arrest of the former deputy CEO of PrivatBank in February 2021, as he tried to flee the country,\(^63\) suggests that the net may be tightening around Ihor Kolomoisky and his associates, particularly as the US authorities imposed sanctions against Kolomoisky for ‘significant corruption’ shortly after.\(^64\) However, there are also serious concerns about the independence of the national gas transmission operator MGU and the oil and gas company Ukrnafta. There are fears, too, that corporate governance reform could further regress, particularly given

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the summary dismissal of the CEO of Naftogaz, Andriy Kobolev, in April 2021. To enable his removal from office, the government temporarily suspended the company’s supervisory board, all members of which subsequently resigned in protest at this blatant manoeuvre. The decision by Ukrnafta’s supervisory board, in May 2020, to cancel the process for the independent selection of a new CEO was also discouraging. Signs that the big players in the pharmaceutical industry are positioning themselves to reverse changes in the procurement system in their favour are a disturbing reminder of the institutional weakness of parts of government and their susceptibility to manipulation by narrow interests.

By contrast, the agriculture sector appears to offer an example where reform in an area that is particularly sensitive for the public, and which is supported by Ukraine’s international partners, can limit the lobbying capacity of large companies. In this case, too, the IMF made its $8 billion loan package conditional on land reform, among other requirements. Nonetheless, it is important to note that the largest FIGs, and their lobbying capacity, are not present in the sector.

Meanwhile, the stranglehold of the largest FIGs on the media remains the critical factor that preserves the fusion of business and political interests. For example, Zelensky could not have launched himself as a presidential candidate without Kolomoisky’s 1+1 channel showing his ‘Servant of the People’ series. At the same time, he and the government depend on favourable media coverage to maintain their authority.

Reform of the judicial system and the law enforcement agencies has suffered significant difficulties, partly because of internal resistance and institutional capacity but mainly because of the interest of systema in maintaining the status quo.

Reform of the judicial system and the law enforcement agencies has suffered significant difficulties.

Since 2014, Ukraine has shown that it has a very active and increasingly capable civil society, and that its population respects democratic values. The 2020 Ukraine in World Values Survey found that more citizens want a greater say in important government decisions today than was the case in 2011. At the same time, large shares of the population perceive state authorities (72.2 per cent) and civil service providers (67.1 per cent) as corrupt. This points to the resilience of systema. Critically, the electorate still has to confront the fundamental issue of why its leaders govern for the few, not the many. Civil society’s focus has been on addressing problems created by systema, and limiting its capacity in certain areas rather than on dismantling it. However, some parts of civil society are starting
Consider the problem more broadly. Low standards of living, poor public services and stubbornly high levels of petty corruption are problems largely created by the overall model of governance and the incomplete state of reforms. Zelenskyy’s electoral success in 2019 and the election at that time of a large number of first-time MPs suggest that parts of society are genuinely seeking change. However, the lack of real political parties rooted in society and committed to deep reforms does not allow the translation of these aspirations into reality.

Since the Revolution of Dignity, Ukraine has enjoyed unprecedented attention and assistance from its Western allies. The EU and other major donors as well as international financial institutions (particularly the IMF, the World Bank and the European Bank for Reconstruction and Development) helped to launch important structural reforms by using their political leverage to impose conditionality. The EU has deployed many of the tools it has used successfully in Central Europe to promote good governance and the rule of law, as part of an overall process of political association and ‘legal approximation’ enshrined in the Association Agreement signed with Ukraine in 2014. Weak state capacity explains in part the limited progress on implementing the agreement, but there appear to be other reasons too. Efforts to improve the quality of regulations and their implementation by strengthening the regulatory authorities have, in some cases, been undermined because systema’s major players do not see the benefits and have the capacity to resist change through their influence on lawmaking and government decision-making. For example, despite long-standing efforts supported by the EU and other donors to give it teeth, the Anti-Monopoly Committee (AMCU) still requires further reform to enforce competition rules, including stronger safeguards to ensure its independence.

Zelenskyy appeared to side with systema in the spring of 2020 when he criticized the number of foreigners on supervisory boards of state companies, and in pushing for the resignation of the head of AMCU. Some observers have suggested that an alliance of forces associated with Kolomoisky and Medvedchuk as well as former prime minister Tymoshenko is working to reverse the progress made on corporate governance in state companies. Amos Hochstein, a US businessman, resigned from the supervisory board of Naftogaz in October 2020, alleging ‘sabotage’ of its good governance reforms by the government and ‘oligarchs’ seeking to enrich themselves. Shortly before this, the highly regarded Swedish

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Economist and Eastern Europe expert Anders Åslund had similarly resigned from the supervisory board of the national railway company, claiming that the working conditions of supervisory board members had been made impossible, and that Zelenskyy and his ‘loud MPs’ do not believe in good corporate governance.73

By June 2021, however, after the Ukrainian authorities had introduced sanctions against Medvedchuk’s assets in February and placed him under house arrest on charges including treason, Zelenskyy felt sufficiently emboldened to table draft legislation to curb the influence of big business on politics and the economy. He threatened to hold a referendum on the issue if parliament failed to support the new law.74

The challenge of reining in systema goes much deeper than forcing the wealthiest businesspeople to declare their assets and disclose their contacts with officials as the draft law intends.73 Systema has left Ukraine with a serious lack of expertise in government that contributes to weak state capacity. The major FIGs attract and retain much of the best talent in the country, putting it to work to make governing institutions work for them. This imbalance is likely to take many years to correct. The EU’s considerable efforts to encourage public administration reform will inevitably take time to produce results because of the long-term nature of change programmes of this kind.

Similarly, efforts by Western donors to promote rule of law and anti-corruption initiatives through measures such as strengthening of regulatory bodies, judicial reform and the creation of new investigative and prosecutorial agencies, as well as the requirement for unprecedented levels of transparency of assets held by officials, have so far produced only modest results. This is not surprising, since the experience of transition in Central European countries has shown that reforms in these areas are typically met with strong resistance and require considerable effort over many years. However, there have also been clear examples of success on the anti-corruption front, including the cleaning up of Naftogaz and reforms in administrative services, banking, the patrol police, procurement and taxation. Decentralization has also created new opportunities for citizens to hold local authorities accountable for managing public resources.76

Recognizing the importance of accountability for high-level corruption crimes in an effort to promote the rule of law, Ukraine’s international partners have placed heavy emphasis on establishing new anti-corruption bodies, including the National Anti-Corruption Bureau (NABU), the Specialized Anti-Corruption Prosecutor’s Office and the High Anti-Corruption Court. NABU and the Specialized Anti-Corruption Prosecutor’s Office have suffered from the absence of a properly functioning judicial system, and NABU has come under increasing political pressure from systema interests concerned about its investigations. Judicial reform conducted in parallel has encountered obstruction from within the judiciary itself.

76 Lough, J. and Dubrovskiy, V. (2018), Are Ukraine’s Anti-corruption Reforms Working?.
As a small ‘island’ surrounded by hostile systema interests, the anti-corruption infrastructure developed since 2014 is likely to face further efforts to limit its effectiveness.

There is also a risk that some forces could try to use the anti-corruption infrastructure to conduct politically motivated investigations and prosecutions against rivals. It will be important for Ukraine’s international partners to monitor developments closely, and to step in if necessary to protect the independence of these institutions. The country has bitter experience of politicized justice from the Yanukovych years. Efforts by opponents to bring criminal charges against Poroshenko through the Prosecutor’s Office are an indication that this risk is real. Oversight by its international partners remains essential at this stage of the reforms when rule of law is weak and Ukraine has still to develop a set of reliable checks and balances for investigative and prosecutorial bodies to function without abuses.

A vicious circle is at work: the largest FIGs have a clear interest in ensuring that they can continue to enjoy access to rents and limit competition, since most of them do not have another business model.

Systema has also retained the capacity to fight against measures designed to improve the law enforcement agencies and free the courts from external interference, because the reforms conducted so far in other areas have not weakened it at its core.

The reforms that have most heavily affected systema’s interests are those that have closed down major schemes for diverting public funds. In the case of the banking and gas sectors, there was a national security imperative to do so. The healthcare sector was different: a determined reform team at the Ministry of Health successfully faced down the pharmaceutical industry with the backing of Prime Minister Volodymyr Groysman as well as Western governments and the international organizations that took over procurement of medicines and delivered huge savings. The owners of the pharmaceutical companies and distributors did not have the institutional strength at the time to cancel these measures.

The operation of the electronic public procurement platform Prozorro, developed by civil society and reformers in government together with business, has helped to close down well-established corruption schemes that were prevalent in the Yanukovych era. Punitive measures are also a necessary means to deter corrupt practices and must accompany efforts to restrict the space for corruption, although they must not become a substitute for other efforts to reduce systema’s influence.

A vicious circle is at work: the largest FIGs have a clear interest in ensuring that they can continue to enjoy access to rents and limit competition, since most of them do not have another business model. To do so, they have an incentive to remain politically connected and maintain control of the media to shape the political agenda and influence the execution of government policy. For their part, a large
number of politicians and senior officials have an interest in continuing to benefit as the FIGs’ enablers. In turn, the layers of bureaucracy below them have a strong incentive to continue operating the machinery that keeps the system functioning because they receive income from the corruption that it spawns. Consequently, the instigators and enablers of rent seeking have an interest in limiting their accountability before the law. This clearly places a serious brake on judicial reform and the establishment of reliable courts.

What can Ukraine’s international partners do?

Other countries that have attempted fundamental governance reform can provide useful reference points for thinking about what may limit the power of systema in Ukraine. For example, South Korea’s successful experience of reducing the influence of its chaebols and Chile’s exceptional achievements in becoming one of the least corrupt countries in Latin America deserve attention. There is also much relevant experience closer to home: in Bulgaria, Greece and Romania.

There is no universal model for achieving a transition from a ‘limited access order’ whereby rent seeking is the norm to a politically and economically competitive ‘open access order’ where the needs of society come first.77 Every country is different, and progress may sometimes be the by-product of other changes rather than the direct result of reform measures. Antitrust legislation can over time be part of a framework to create a competitive economic environment, but it cannot be a solution on its own to addressing the wider problem of systema, particularly when Ukraine lacks an independent judiciary and other institutions that could enforce new rules. A combination of deep structural reforms, preventive and repressive measures to restrict corruption, and civic activism to hold politicians, officials and business owners accountable are necessary to address the problem as a whole.

As a general principle, reducing the influence of systema requires changing the calculus of the main players. Rent seeking needs to become more difficult, to carry greater risk and to be less profitable than wealth creation through the establishment of well-managed, transparent businesses that attract investment and generate employment. Economic growth will then create new players and diversify the asset-owning class. The reduced appeal of rent seeking will encourage greater political competition through the diversification of constituencies. Regulating further the use of media for electoral campaigning purposes and developing a properly resourced independent public broadcaster could be part of this process, along with further efforts to regulate and control campaign financing.

Some systema interests may be strengthened, and others weakened, as the economic crisis triggered by the COVID-19 pandemic plays out. Some FIGs may find themselves rewarded by the government for their support, while others may lose ground because of the conditions of future IMF support.

It is notable that during the 'lockdown' period from March to May 2020, large companies were able to continue working, while small and medium-sized business could not. FIGs and their affiliates benefited, as did their employees.

Privatization of state companies, and improving the corporate governance of the remaining ones, offers considerable opportunities to reduce traditional rent seeking and force some of the FIGs to reconsider their business models. However, this presupposes that the process of privatization is competitive, and not prone to the type of insider dealing seen in the past. The possibility, under legislation adopted in March 2018, to apply English law to large-scale privatization sale and purchase agreements\(^78\) is an encouraging development in view of the failure so far to improve the delivery of justice in Ukrainian commercial courts.

Judicial reform is a long-term process that requires sustained support from Ukraine's international partners, but with their acceptance that the principles of the Council of Europe do not easily translate into local reality. The attempt to respect the principle of judicial independence by leaving the unreformed High Council of Justice in charge of the reform process has produced predictably meagre results. International support to civil society and investigative journalists should continue, since they play an important watchdog role in monitoring reforms – for example, by exposing the rigging of judicial appointments and drawing attention to disciplinary proceedings in the case of allegations of malfeasance. The international partners must distinguish between cosmetic and substantial reform of the judiciary. A reminder of the state of the judicial system is that Kolomoisky’s defence against claims by state-owned PrivatBank looks much weaker in foreign jurisdictions than it does in Ukraine. International partners also need to tie financial and other support to real judicial reform. Strict IMF and EU conditionality made it possible to create the new anti-corruption infrastructure, and should make it possible to conduct deep judicial reform. Ukraine is likely to need significant financial support over the next two years to service its foreign debt and cope with the economic impact of the COVID-19 crisis and a shortage of foreign investment.

Ukraine’s international partners must distinguish between cosmetic and substantial reform of the judiciary.

The most powerful tool for challenging systema is the greater part of Ukrainian society that does not benefit from it nor from preserving the status quo.

Sustained calls by the public to stop specific rent-seeking practices will put pressure on the FIGs and their enablers in government and parliament. An alliance of reformist politicians, business figures and civil society has the potential to play an important role in this process, but only if backed with appropriate support by Ukraine’s international partners. Dismantling systema and replacing it with robust, competent institutions will be a long-term process.

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that is unlikely to be linear because of the political battles that will need to be fought along the way, and because of the need to co-opt the progressive-minded part of the elite that sees the need to look beyond maintaining the status quo. To drive this effort, civil society will need to broaden its capabilities and expand beyond the biggest cities, while the public must have better access to balanced reporting via independent media.

Finally, Western countries must show much greater resolve to investigate suspected money laundering by the beneficiaries of rent seeking and corruption in Ukraine. There is abundant evidence of the latter’s ability to use banks in EU countries and in the UK to buy real estate, educate their children and protect their assets in rule-of-law jurisdictions. Some of these individuals bear heavy responsibility for Ukraine’s weak institutions and the national security problem that they have created. Continued failure to deter these practices will not only sustain systema. It will also increasingly lead to accusations of Western double standards and tarnish the EU’s image in Ukraine as a community of law-governed states that is genuinely committed to upholding democratic values and supporting reform in the country.
Ukraine’s system of crony capitalism
The challenge of dismantling ‘systema’

About the author

John Lough is an associate fellow of the Russia and Eurasia Programme at Chatham House. He began his career as an analyst at the Soviet Studies (later Conflict Studies) Research Centre, focusing on Soviet/Russian security policy. He spent six years with NATO, and was the first Alliance representative to be based in Moscow (1995–98). He gained direct experience of the Russian oil and gas industry at TNK-BP as a manager in the company’s international affairs team (2003–08). From 2008 to 2016, he ran the Russia & CIS practice at BGR Gabara, a public affairs and strategy consulting company. Alongside his work with Chatham House, John is a consultant with Highgate, a strategic advisory firm.

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