

Energy Management in the Former Soviet Republics: Ownership Structures,
Oligarchic Powers, and National Identity

Paulina Ziolek

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Abstract

After the collapse of Communism, former Soviet republics were freed from ideological and political constraints of imposed governments. Different paths emerged as some countries concentrated on the road back to Europe and others on the return to the Russian realm of control. Foreign policies largely influenced a country's energy dependency situation and varying international goals affected the ability to effectively handle new freedom. This thesis focuses on the cases of Estonia and Ukraine, and their varying energy management systems. Estonia is completely dependent on Russian gas supplies due to lack of reserves, yet it has been able to conduct a successful energy relationship with no conflicts and infrequent price battles. Ukraine, a country with large gas reserves that is less dependent on Russian imports, has led a failed energy relationship with Russia that has included multiple cut-offs and constant price negotiations. Why does a country that is less dependent on Russian gas lead such a tumultuous relationship full of conflict?

This thesis concludes that three specific variables work together to result in either successful or failed energy management: ownership structures, oligarchic powers, and national identity. Research into these economic and political factors has given us an insight into the foundations for poor energy management. With application to other energy dependent countries, these results can provide a new way to analyze gas conflicts and search for solutions.

Table of Contents

Introduction.....	1
Chapter 1: Theory, Methods, and Literature Review.....	7
Chapter 2: Estonia.....	18
Chapter 3: Ukraine.....	40
Conclusion.....	72
Works Cited.....	77

Introduction

Map 1. Gas Pipelines of Baltic States



Source: “Gas Pipelines of Estonia, Latvia, and Lithuania,” *East European Gas Analysis*, <http://www.eegas.com/estonia.htm>.

Map 2. Gas Pipelines of Ukraine



Source: “Ukrainian Gas Pipelines,” *East European Gas Analysis*, <http://www.eegas.com/ukraine.htm>.

During the time of the Soviet Union, natural gas and oil resources were shared between all of the Soviet regions and republics. Once the European countries gained political

independence from the Soviet Union, they no longer shared the economic wealth and some were left with very little natural resources. While a monopoly-type state control had ended, connected economic systems lasted. These successor states and their economies immediately became dependent on Russia and the energy subsidies it provided. Nations opted for different levels of openness to the world market and during this stage of globalization, newly independent countries had the opportunity to re-establish and re-orient their economies. In the former Soviet Union, we see struggles with dependence management that often ended in national crises and scandal.

Others were able to successfully integrate into the Western market and while dependency is still very high, the ability to manage that dependency overcomes any potential problems with Russia.

Energy policy is one of the most important issues in Central and Eastern Europe, an area that has been energy-dependent for decades. Russia is emerging from a decade of unprecedented economic success, with high steady GDP growth and a fourfold increase in energy prices, and gaining power on the international stage¹. With heavy dependence on Russian gas comes the risk of unexpected scandal, such as gas cut offs and price battles. In using Estonia and Ukraine as case studies, I hope to determine the causes of successful management of energy dependence. As I will show later, Estonia is portrayed as the victorious energy system and Ukraine illustrates the problems that can occur with failed energy management.

Table 1. Post-Soviet States’ natural gas import dependency (in percentages), as of 2011

Ukraine	64.3
Estonia	100.0
Poland	71.3
Belarus	86.9

Source: “BP Statistical Review of World Energy 2011, “ *BP Global* available at <http://www.bp.com> (accessed April 23, 2012). Energy dependency is defined as “Consumption-Production/Consumption.”

¹ Scott Rose and Agnes Lovasz, “Putin Must Beat Own Economic Record as Golden Decade Comes to End,” *Bloomberg*, 22 December 2011, <http://www.bloomberg.com> (accessed 27 Dec. 2011).

As Table 1 illustrates, Ukraine depends on more than 2/3 of natural gas imports. Additionally, Ukraine has its own large natural gas reserves and produces almost 20 billion cubic meters of gas annually.² Estonia, on the other hand, is 100% dependent on Russian natural gas supplies.³ The question that I will answer is why does Ukraine experience frequent political conflicts and economic threats from Russia while Estonia with a threefold higher level of dependence has been able to lead a more productive energy relationship? By examining a successful integration by Estonia with Western ideals and contrasting that with Ukraine's divided energy policy, I will be able to determine what differences are most important in predicting successful and failed energy management.

Before describing my research questions, it is necessary to define a few terms that I plan to use repeatedly. When referring to the energy dependence in these former Soviet Union states, I will be using a definition cited by many other scholars:

“Situation where a) more than one-third of a country's total energy consumption comes from foreign sources; or b) more than 50 percent of a country's annual consumption of a single major energy source for that country comes from foreign sources; or c) a country depends on a single external provider for more than 60 percent of its imports of a major energy source for that country or 45 percent of its consumption of that energy source.”⁴

In addition to energy dependence, I often discuss energy management and how there are successful and failed examples. Energy management can be defined as “the judicious and effective use of energy to maximize profits (minimize costs) and enhance competitive positions.”⁵ While different actors manage the gas industries in Estonia and Ukraine, the goal of any major industry is to minimize the prices without affecting production and quality. The last

² “Ukraine to Start Selling its Own Gas to Europe,” *PR Newswire*, 8 September 2011, <http://www.prnewswire.com> (accessed 26 Dec. 2011).

³ “Internal Market Fact Sheet: Estonia,” *European Commission*, (Brussels, Belgium: 2007).

⁴ Margarita Balmaceda, “Explaining the Management of Energy Dependency in Ukraine: Possibilities and Limits of a Domestic-Centered Perspective,” *Arbeitspapiere - Mannheimer Zentrum für Europäische Sozialforschung* 79 (2004): 1-37.

⁵ Barney Capehart, Wayne Turner and William Kennedy, *Guide to Energy Management* (CRC Press, 1997).

concept that is frequently used is the idea of successful energy management as opposed to a failed case of management. In my research, Estonia serves as the successful example of energy dependence. While I will go into detail what that means specifically in the Baltic region, overall success corresponds with a lack of gas conflicts. When a country can maintain dependence without cut offs or threats from its supplier, it demonstrates a high level of energy security promoted by the government. Scholars define energy security as securing adequate energy supplies at reasonable and stable prices that sustain economic performance and growth.⁶ Before I present my research for both case studies, I will provide evidence to show successful and failed energy management, and illustrate why my countries fall in the categories I provided.

In addition to defining a few terms, I acknowledge the existence of an interdependent relationship between Russia and all of these countries due to external factors. Ukraine is able to fight Russian threats with the power of its pipelines running to Europe. With 80% of Russian gas exports to the European Union shipping through Ukraine, Ukrainian leaders have had slight leverage with the power of pipelines.⁷ From the beginning of independence, Estonia has had at least minor support from its European neighbors. As the country began to draft a new constitution, European states reestablished diplomatic relations with Estonia in 1991 followed by inclusion in an aid program that worked to economically restructure Eastern Europe. A few months later the European Commission and Estonia signed an Agreement on Trade and Economic Cooperation, focusing on further integration, protecting human rights and establishing political dialogue.⁸ Even if it was minor, Estonia had minimal support in their goal of energy

⁶ Asian Pacific Energy Research Centre, "Energy Security Initiative: Some Aspects of Oil Security," *Institute of Energy Economics, Tokyo* (2003).

⁷ Henry Meyer and Daryna Krasnolutska, "Russian Natural-Gas Dispute With Ukraine Threatens New Cutoff to Europe," *Bloomberg*, 22 September 2011, <http://www.bloomberg.com> (accessed December 28, 2011).

⁸ Clyde Kull, "Relations between Estonia and the European Union in the Period Leading up to the Invitation to Accession Negotiations in 1997," in *Estonia's Way into the European Union*, ed. Kaja Tael (Tallinn: 2009), 16-22.

independence. These countries may have some bargaining aspects in an interdependence relationship, but that does not mask the fact that they are heavily dependent on Russian gas.

As mentioned earlier, my first set of descriptive research questions will delve into the world of energy dependence. How did Estonia and Ukraine differ so greatly after the collapse of communism? By looking into the immediate energy policies after newly gained independence, I will be able to determine what conditions contributed to a successful or failed dependence relationship. Next, I will look into the following policies and governments all the way through recent times. Russia began its great re-establishment in the world economy at the beginning of the 21st century, therefore bringing energy issues to the forefront. Even before his term as president, Vladimir Putin had mapped out Russia's journey to superpower status through its natural resources in his graduate school thesis. Citing the need for "creation of large financial-industrial corporations which span several industries on the basis of resource-extracting enterprises," Putin called for state control over these industries.⁹ While dependence in the Baltic and Eastern Europe was already present before Putin's time in power, his aggressive and expansionist energy policies presented more unexpected conditions to test their levels of energy security. Many of the conflicts that contribute to Ukraine's label as an example of failed management happened post-2000.

After this introductory information is analyzed, I will test three main theories that have been put forth by scholars as reasons for varying degrees of dependence. Were the divided oligarch leaders of Ukraine the reason for its tense energy relationship with Russia? What kind of role did partial economic reforms play into the adoption of a non-cohesive foreign policy? Did Estonia's strong national identity pave the way towards a future with no gas conflicts?

⁹ Vladimir Putin, "Mineral and Raw Materials Resources and the Development Strategy for the Russian Economy" (Ph.D. dissertation, St. Petersburg State University, 1999) as cited in *Petrostate: Putin, Power, and the New State*, Marshall Goldman (Oxford: 2008).

Scholars such Erika Luong and Pauline Jones Weinthal, Joel Hellman, Rawi Abdelal and Margarita Balmaceda will provide the basic theories that I apply to my cases in order to determine the variables that directly affect energy management. By applying theories of dangerous partial reform, influential informal networks and unified national identity first to Estonia and then Ukraine, I aim to illustrate how these specific conditions caused energy management to be pushed in one direction or the other.

By looking at the varied policies of Estonia and Ukraine I hope to discover the most powerful source behind successful energy dependency. Many scholars have acknowledged the problems of dependence on Russian gas and have even conducted case studies of individual former Soviet Union states, but few have taken a comparative approach. By comparing and contrasting, I aim to find the differences between successful and failed management. In identifying the reasons for Ukraine's problematic relationship with Russia and Estonia's relative success, I will be able to make a further generalization in the world of energy dependency. What sorts of domestic and international factors can help a country towards more successful management? If a nation is left to be dependent on natural resources due to geography, it should be able to manage its industry in a way that does not bring on conflicts and crises.

I. Theory, Methods, and Literature Review

Of all the energy-poor nations that have battled with their dependence on Russian exports, I choose to focus my research on Estonia and Ukraine. Each country represents a different level of energy dependence management, ranging from highly successful without conflicts to ineffective policies resulting in frequent energy crises. Early on, Estonia decided to endure economic hardships to gain a place in the European Union. Ukraine struggled with divided regions and populations, unable to put forth a united energy policy. Some are unwilling to pay the economic costs of independence from Russia, while others call for the severing of any ties to the Kremlin. In the world of energy literature, scholars have put forth different theories that explain both successful and ineffective energy management policies. I will explain specific theories for each of my conditions, which will then be applied to cases of Estonia and Ukraine.

Ownership Structure

The first variable that I will research is the level of privatization and the kind of ownership present in the gas industries of my case studies. There has been an ongoing discussion on the choice between privatization and state ownership in political science, and my case studies serve as examples of both situations. Ownership structure is important to discuss because it dictates what kind of relationship there will be between government elite and economic actors. Scholars discuss how the collapse of the Soviet system left behind large state enterprises in many countries with no clear plan for the future. The most profitable industries lacked a clear incentive for privatizing, which would include enduring a long process of internal restructuring to adapt to

new market forces. Government control had to be replaced with control by market forces.¹⁰

Governments in former Soviet republics rarely implemented these successful privatization plans because they wanted to maintain much of the wealth coming from large state industries, such as natural gas.¹¹ Rapid privatization in the former Soviet republics could have improved many problems facing newly privatizing companies, such as introducing higher salaries and expanding customer base.¹² However, scholars have noted that in many countries the privatization process was being carried out on a voluntary basis, with one business going through at a time. In addition, various stakeholders of businesses were given veto powers over the entire process, essentially giving enterprises the control of whether or not they wanted to privatize.

Besides agreeing upon the problems in former Soviet privatization, scholars have long concluded that private ownership is more beneficial than state control. Ownership under the government can be successful, if the government maximizes social welfare. However, the main argument for privatization comes from the misrepresentations of the government's objectives. In less democratic countries, political leaders give out financial benefits in order to maintain power in government. State companies serve as the middleman for the government to channel their benefits to certain individuals. Managers have almost unlimited possibilities to hire family connections, influence political decisions and engage in rent-seeking activities. It is difficult to monitor state enterprises and they are held to no standards regarding budget constraints and

¹⁰ Andrei Shleifer and Robert Vishny, *The Grabbing Hand: Government Pathologies and Their Cures*, (Cambridge, MA: Harvard University Press, 1998).

¹¹ Jeffrey Sachs, "Privatization in Russia: Some Lessons from Eastern Europe," *Key Issues of Soviet Economic Reform* 82 (May 1992): 43-48.

¹² Stanley Fischer, "Privatization in East European Transformation," *National Bureau of Economic Research Working Papers Series* No. 3703 (May 1991).

market performance. If a state company is experiencing financial losses year after year, there will be no consequences because the government provides support.¹³

Once a company is privatized, scholars argue that the scope of government control decreases and with it the opportunities for such corruption. Critics claim that privatized companies will not address “social goals” but these can be handled by government regulation, not ownership. Some scholars divide ownership structures into four distinct categories: state ownership with control, state ownership without control, private foreign ownership and private domestic ownership.¹⁴ While rarely implemented in countries with great resource wealth, private foreign ownership would foster institutions that constrain overly powerful leaders, encourage them to invest in institution building, and allow them to respond more successfully to the surges and drops of gas prices.¹⁵ Ultimately, scholars have concluded “private ownership should generally be preferred to public ownership when the incentives to innovate and to contain costs must be strong.”¹⁶

In certain unsuccessful privatization cases, partial reform emerged as a problem. Hellman argues that instead of reform losers such as striking workers, resentful former state bureaucrats and impoverisher pensioners, dictating policies for short-term benefits, businessmen and oligarchs have been causing more damage to the post-Communist reform progress. The reform process is defined by looking at nine dimensions: privatization, enterprise restructuring, price liberalization, foreign trade liberalization, competition policy, banking reform, securities,

¹³ Andrei Shleifer, “State versus Private Ownership,” *The Journal of Economic Perspectives* 12 (Autumn 1998): 133-150.

¹⁴ Paulina Jones Luong and Erika Weinthal, *Oil is Not a Curse: Ownership Structure and Institutions in Soviet Successor States* (New York: Cambridge University Press, 2010).

¹⁵ Pauline Jones Luong and Erika Weinthal, “Combating the Resource Curse: An Alternative Solution to Managing Mineral Wealth,” *Perspectives on Politics* 4 (2006): 35-53.

¹⁶ Shleifer, “State versus Private,” 147.

market reform, and legal reform. If there is uneven progress in these sectors, a country will experience partial economic reform that causes a rapid and unequal redistribution of income. Politicians and businessmen allow only certain reforms to pass in order to harbor as much income as possible for a limited amount of people. Scholars have presented the partial reform equilibrium theory, arguing benefits are collected by only a few while costs fall upon the majority. Winners in postcommunist transitions take all of the benefits and even if the economic situation is not beneficial to others, the winners use their influence the government to deter any transformation.¹⁷ Countries that adopt and fully implement comprehensive reforms at the start have a smaller gap between the incomes of winners and losers from the reforms. If the problems of the partial reform are gradually eliminated over time, then winners will face a reduction in their rents and losers began to share more gains. Winners end up causing more damage to a country's system than losers by maintaining partial reforms, even though short-term costs are higher and overall gains are lower.

Complete state ownership can lead to weak fiscal regimes. Government leaders have the greatest influence in decision-making, and due to unstable tax systems and limitless government expenditures, state ownership affects countries negatively. There is implicit bargaining and bribery in a state ownership situation, and a complete lack of publicity in all official matters. Besides economic impacts, scholars claim that state ownership affects the daily lives of citizens in a country by fostering weak administrative capacities, unbalanced economic growth and authoritarian regimes.¹⁸ Influenced by the lack of strong opposition to protest institutional abuse,

¹⁷ Joel Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions," *World Politics* 50 (1998): 203-234.

¹⁸ Luong and Weinthal, *Oil is Not a Curse*.

the state can manipulate its full ownership capabilities and make decisions solely based on its own goals.¹⁹

By researching the ownership structures in certain countries, one can analyze what aspects of state or private ownership influenced energy management. Partial reform ignites a symbiotic relationship between state and business. Oligarchs need state support for the businesses and political leaders need financial campaign support. If such a partnership exists in a country, it is highly likely that energy management will stay at a primitive level where only a few obtain rents.²⁰ However, if a country completes full privatization and ends political influence in the business world, the economy and natural gas industry will operate successfully with better responses to crises. Reforms will be carried out due to economic needs not political ones. Business managers will have few opportunities to obtain rents and they will focus on the overall performance of their company. With the involvement of foreign companies come higher standards that will have to be met. Overall, privatization frequently leads to successful examples of energy management.

Oligarchic System

Perhaps the largest amount of scholarly research done on the topic of energy dependence blames ineffective anti-corruption measures and the rise of partial winners for failed management. Wealthy businessmen have risen to power through unfinished political and economic reforms, conducting alliances between rent-seekers and rent-givers to deter further

¹⁹ Paulina Jones Luong and Erika Weinthal, "Prelude to the Resource Curse: Explaining Oil and Gas Development Strategies in the Soviet Successor States and Beyond," *Comparative Political Studies* 34 (May 2001): 367-399.

²⁰ Anders Aslund. *How Ukraine Became a Market Economy and Democracy*, (Washington, DC: Peterson Institute for International Economics, 2009).

transitional progress. Many scholars have agreed that the influential presence of strong oligarchs hinders a country's ability to manage the energy industry effectively. Gas businessmen have full access to national wealth and political ministers can consolidate their unchallenged power position.²¹ Drawing attention to the importance of relationships between a country's state leadership and its resource companies, scholars state "it's possible to imagine situations in which the corporate interests of the companies in profit maximization would conflict with the national interest of the state in energy security."²² If this situation would occur, we question whether the corporate or national interest would prevail. This is essentially the question that I aim to explain.

Scholars have cited the definition of an oligarch to be a "businessman who controls sufficient resources to control national politics" and the ultimate controlling party in a complex web of subsidiaries and corporate owners.²³ Development of democracy in countries with concentrated power is hindered, and real competition between economic parties will occur only when the gas industry lowers entry barriers. With such consolidated control among a small group of corrupt oligarchs, countries will not be able to invite foreign investors to help mandate fair business standards.

In addition to the strength of oligarchs, the presence of corruption ties in to the informal networks of these power holders. The fraudulent transactions that leaders participate in further exacerbate the problem of failed management. If a country is already experiencing a tense relationship with their supplier, the lack of a transparent policy for the future does not help transform management practices. Some scholars have focused more specifically on eastern European countries and dependence, stating that many former Soviet Union states have a gas

²¹ Rosaria Puglisi, "The Rise of the Ukrainian Oligarchs," in *52nd Annual Political Studies Association Convention*, Aberdeen, 5 April 2002 (Aberdeen: Political Studies Association, 2002).

²² Erica Downs, "The Chinese Energy Security Debate," *The China Quarterly* (March 2004): 41.

²³ Sergei Guriev and Andrei Rachinsky, "The Role of Oligarchs in Russian Capitalism," *Journal of Economic Perspectives* 19 (2005): 132.

sector that is “marked by an inscrutable network of politics, business and the shadow economy, which includes organized crime.”²⁴ This unclear distinction between state and business means that money and rents are the driving forces behind any policy decisions. Since cooperation and support for Russia typically results in lower prices for resources, oligarchs and corrupt political leaders will always opt for the poor energy management route in order to keep their benefits high.

In Margarita Balmaceda’s research, domestic policies are carefully analyzed and she concludes that several proponents of a country’s government can lead to unsuccessful management. By detailing Ukraine’s history, Balmaceda looked at policy reforms and political changes. Her central argument is that the nature of domestic political arrangements, meaning the roles of the president and parliament, affected Ukraine’s energy management and the ability to develop a consistent energy policy.²⁵ Even in energy dependent countries, there is a large profit to be made in the import and distribution business. Changes in the economic environment, such as price increases, affect different groups of people separately, which in turn cause them to act in corrupt or fair ways. While she does an intensive case study of only Ukraine, her theory of domestic arrangements can be applied to both of my cases. The nature of a post-Communist political system allows for informal networks to take control of politics and business because of the lack of transparency in management and the system of policy-making about energy. Lack of transparency not only allows corruption to form by locking out foreign investors, it also creates opportunities for quick enrichment through energy deals. Another factor that contributes to the corruption in energy industries is the system of policy-making and the roles of different

²⁴ Roland Gotz, “Ukraine and Belarus: Their Energy Dependence on Russia and their Roles as Transit Countries,” in *The New Eastern Europe: Ukraine, Belarus and Moldova*, ed. Daniel Hamilton and Gerhard Mangott (Washington, DC: 2008), 159.

²⁵ Margarita Balmaceda, *Energy Dependency, Politics and Corruption in the Former Soviet Union*, (New York: Routledge, 2008).

government branches. When the president of a country relies on wealth from oligarchs, he must balance different groups in order to maintain power. With a strong executive power, the country's leader is "able to use formal rules and informal power in mutually reinforcing way – using formal rules to exercise informal power, using this informal power to give himself more formal power," continuing a self-reinforcing cycle.²⁶ A strong network of informal rules allows further corruption, particularly if the country's top leaders are participating. If there are no clear formal policies about energy dependency, management will be manipulated through informal networks to benefit only a few. Economists have argued "when institutions are weak, doing business with strangers is dangerous and unreliable."²⁷ Therefore, we can see from previous scholarly research that weak institutions in post-Communist states open the door for other poor political conditions to develop.

National Identity

The last influential variable that will be tested is national identity. Scholars have duly noted the importance of a country's historical past and the dominant role it plays on shaping the future national idea.²⁸ Nations battle with memory wars, using pieces of history that fit into the national image they have decided for themselves. However, these images that are conjured up by history can have both negative and positive results. In Estonia, I will show that decades of oppression unified the people and allowed the government to establish a well-focused energy policy. On the other side of the spectrum, Ukraine has experienced economic and political

²⁶ Balmaceda, *Energy Dependency*, 41.

²⁷ Randall Moreck, Daniel Wolfenzon and Bernard Yeung, "Corporate Governance, Economic Entrenchment, and Growth," *Journal of Economic Literature* 43 (September 2005): 672.

²⁸ Igor Torbakov. "History, memory and national identity understanding the politics of history and memory wars in post-Soviet lands." *Demokratizatsiya*. 19 (June 2011).

inclusion in the Russian sphere of influence but is geographically located right on Europe's doorstep. The struggle for a common national identity among the population has disallowed any strong energy management structure to take hold.

In his book National Purpose in the World Economy, Rawi Abdelal explores nationalism in the economic policies of former Soviet Union states.²⁹ By looking at the example of Lithuania, he argues that the mutual consensus about the country's national identity between political elites immediately after the fall of Communism allowed Lithuania to manage their dependency successfully. The agreement among the electorate to propose pro-European, especially anti-Soviet content, for the nation's identity provides a country the opportunity to move forward with a clear goal. Abdelal argues that the remarkable continuity of a country's national identity, supported by all parties, is the reason a nation can become successfully integrated into the European Union. At the same time, a country can promote a political-economic relationship with its energy supplier on different terms and still maintain a healthy relationship with no conflicts. The presence of a clear desire for a European national identity allows former Soviet Union states to disentangle themselves from within the Russian sphere of influence and establish a successful relationship with their energy dependency.

Abdelal argues that a country's national identity is defined by content and contestation. Content can include definitions of membership in the nation, fundamental purposes of political authority, and states that threaten those purposes. The content behind national identity thus specifies who the nation is, why the nation should be governed in a certain way, and who the nation is most emphatically not.³⁰ The other component is contestation and how widely specific interpretations of national goals are shared. Abdelal argues that the further apart the contending

²⁹ Rawi Abdelal, *National Purpose in the World Economy*, (Ithaca, NY: Cornell University Press, 2001).

³⁰ Abdelal, *National Purpose*, 26.

ideas of national identity diverge, the more the identity is fragmented into conflicting political and economic ideas. Using Abdelal's methodology, I will look more closely at candidates' ideas throughout each country's history and uncover how diverse the policies have been. Abdelal argues that difference in the content of national identities led to varying government preferences for disintegration and reintegration with Russia. The goals of each country depended on who they thought they were on the international stage. If the national identity of a country is contested, Abdelal looks into how strongly parties fight against each other and if there is an ill feeling about the debate. Additionally, it will be important to look at how actively citizens support this national identity presented in terms of civil society.

Nationality connects with the economic policies of a country because all national identities include proposals for certain styles of foreign policy. Abdelal explains that nationalists favor economic policies that emphasize separateness and autonomy from specific states, while exercising cooperation with others. There is a very clear orientation and direction in nationalistic economic policies. This unified direction of identity creates a national community, making a society more willing to bear the economic costs of pursuing the goals of its identity. In a failed case of national identity, divided nations limit sacrifice, separate economic activity from national purpose, and shorten time horizons. There is no collective national purpose, so individuals are interested only in short-term gains.³¹

In conclusion of my review of the scholarly literature, there are multiple theories that try to answer the question of energy management and what factors lead to success or failure. While certain arguments pertain to specific geographical areas, broad theories regarding institutions and benefit distribution can be applied to any case. Many have agreed that weak institutions lead to the rise of oligarchs, resulting in wealth from a corrupt system. These few people in power will

³¹ Abdelal, *National Purpose*, 32-33.

maintain a weak management system because of the riches they are guaranteed. Combined with a lack of strong national identity and a divided population, a country may fall into the cycle of failed management: ideologically hoping for independence but economically inept. Individual studies have been done on the Baltic States and the Eastern European nations, but few have organized these countries into “successful” and “failed” examples. By the end of this research, I will be able to confidently present multiple reasons for why a country is struggling with ineffective management of their energy dependence.

II. Estonia

This chapter will analyze the economic and political path that Estonia took in order to achieve a situation of successful energy management. In order to understand the reasons for Estonia's choice energy management, I must first outline the history that brought this Baltic country to the economic, political and social positions encouraging a profitable relationship with Russia. I will show how Estonia's past is composed of reinforcing actions that helped the country transition smoothly into a free market democracy. The strong desire from every citizen to live in an economically stable and politically free country affected the way Estonia has dealt with its gas dependence. By establishing realistic policy goals from the beginning of independence, I will illustrate how Estonia survived the transition process and prospered into the 21st century with no gas crises. I will analyze Estonia's privatization decisions, anti-corruption measures and unified national identity, and further posit how all three of those contributed to the success of the natural gas sector.

By choosing Estonia as one of my case studies, I have elected to illustrate an extremely successful post-Soviet transition. In comparison to its former occupier, Estonia has excelled in social, economic and political sectors. Last year, Estonia's GDP was close to 20% higher than Russia's current statistics and it ranked higher in OECD surveys regarding education of students³². The most significant difference between Estonia and many other former Soviet countries is the level of corruption, directly affected by the business environment. In the World Bank index regarding the ease of doing business in 2011, Estonia was ranked at 24 out of 183 while Ukraine came in at 152, even lower than Russia's rank of 120.³³ Due to the strong national

³² Anders Aslund, "Learning Some Big Lessons from Little Estonia," *The Moscow Times*, 22 March 2011.

³³ World Bank Indicators, "Ease of doing business index," *World Bank*, 2011, <http://data.worldbank.org/indicator>, (accessed 24 Mar 2012).

identity, Estonians saw independence from Russia in all sectors and economic industries as their first priority. The disapproval of oligarchs combined with the continuous cultural resistance to Soviet occupation reoriented the Baltic towards the West.

In regards to energy security, Estonia has avoided any major gas conflicts with Russia. There is only one abruption in gas supplies in the country's history, which occurred in 1993 amidst talks of laws against ethnic Russians in Estonia. President Yeltsin announced the stoppage as Estonian parliament was enforcing a new law that would require non-Estonians to pass a language test and apply for Estonian citizenship, or they could be forced to leave the country. The Russian government claimed that the situation arose due to Estonia's \$8 million energy bill, but specific dollar amounts were highly contested due to the constant changing of economic markets.³⁴ Even though Estonia ceded to Russia and changed the legislation about aliens, the crisis could be considered a success. The president at the time quickly established the Nationalities Roundtable for future discussions about minority affairs, and the United States was one the first countries to send financial support to cover costs.³⁵ With this one gas crisis, Estonia was able to appease Russia in a way that did not damage its identity, but also showcased the perseverance that Estonia would find a way to succeed as a former Soviet republic. The following chapter will further analyze this way of business and politics that worked together to form a successful dependent relationship lacking major crises; complete privatization, lack of oligarchs, and national identity.

Complete Privatization

³⁴ Sonni Efron, "Angry Russia Cuts Off Gas to Estonia," *LA Times*, 26 June 1993, <http://articles.latimes.com> (accessed 15 Mar 2012).

³⁵ "Estonia," *Country-Data*, <http://www.country-data.com/cgi-bin/query/r-4354.html> (accessed 26 Apr 2012).

After the end of the Soviet occupation, the Estonian privatization agency developed a system to quickly privatize more than 90 percent of its industrial and manufacturing enterprises. With the passing of the Privatization Law of the Republic of Estonia in 1993, rules and principles were defined in the process of transitioning government agencies to individuals. Immediately after, legislation about every aspect of privatization was passed including the Law on Land Reform, the Law on Foreign Investment and the Law on Security Markets.³⁶ The Estonian privatization agency would advertise a batch of businesses for sale and begin the search for owners that were truly capable of running a productive firm in Estonia's new independent state. Offers for firms were judged on the quality of the business plan, especially creation of jobs and expected foreign investment.³⁷ Unlike in many other former Soviet republics, no favors were given to friends and families of the government leaders. While politicians dealt with the country's newfound independence, Estonian economic leaders looked to give away enterprises to the most capable businessmen.

By 1997, the Estonian natural gas company, AS Eesti Gaas, was fully privatized. Foreign investors quickly became the major shareholders as Russia's Gazprom acquired 37% of the business in less than ten years.³⁸ Even though Gazprom does not own a controlling stake, the development of local gas infrastructure is almost impossible without complete state control of the pipelines. Eesti Gaas has a monopoly on natural gas resources and due to the majority of ownership in Russia's hands the consumers' dependence on Russian suppliers is further

³⁶ Mait Miljan and Kuino Turk, "Privatization in Estonia," in *Privatization in Central and Eastern Europe: Perspectives and Approaches*, ed. Demetrius Iatridis and June Hopps (Westport, CT: 1998), 53-59.

³⁷ John Nellis, "Finding Real Owners – Lessons from Estonia's Privatization Program," *Public Policy for the Private Sector* 66 (January 1996).

³⁸ "Estonia Advised to Nationalize Eesti Gaas," *Natural Gas Europe*, 30 November 2011, <http://www.naturalgaseurope.com> (accessed 8 Mar 2012).

decreased. Additionally, the high prices set by Gazprom shareholders are rarely met with objection due to Estonia's lack of gas relationships with other countries.³⁹

When privatization first occurred, the largest industries often went to Western entities causing a “wholesale import of Western management and accounting methods.”⁴⁰ While Gazprom is now the major stakeholder in Eesti Gaas, Ruhrgas of Germany held the majority during the first wave of privatization in the middle of the 1990's. At the time, Gazprom took the role of minor shareholder and Ruhrgas became the “international Western company, providing know-how, financial resources for restructuring and access to already existing or future networks.”⁴¹ Russia was going through her own economic trials and the state-controlled stake in Gazprom's ownership was only 38%, resulting in a much more business-oriented board. LUKOIL acted as the major gas and oil company in immediate post-Communism Russia, expanding ownership into countries such as Kazakhstan, Bulgaria and Romania. Gazprom was left to manage for itself due to a weak Russian government that lacked any coherent energy strategy.⁴² Even though Russian national stake in Gazprom jumped to 51% majority in 2005, the foundations of fair business that Eesti Gaas and Gazprom established after Estonian independence kept politics out of the gas business more so than in Ukraine, who kept pipeline rights in the hands of wealthy oligarchs.

In the beginning of 2012, Estonia passed a law to implement the European Union Third Energy Package (TEP), which is a legislative package aimed to further open up the gas and electricity markets in the EU. In the case of Estonia, the law was passed in order to conduct the

³⁹ Joanna Hyndle-Hussein, “Estonia liberalizes its gas market,” *Centre for Eastern Studies Weekly*, 11 January 2012.

⁴⁰ Mel Huang, “Wannabe Oligarchs: Tycoons and Influence in the Baltic States,” in *52nd Annual Political Studies Association Convention*, Aberdeen, 5 April 2002 (Aberdeen: Political Studies Association, 2002).

⁴¹ Kaarel Kilvits, Alari Purju and Sirje Padam, “Russia's Foreign Direct Investment in New EU Member States: The Case of the Baltic States,” in *Expansion Or Exodus: Why Do Russian Corporations Invest Abroad?* ed. Kari Liuhto (Binghamton, NY: 2005), 71.

⁴² Nina Poussenkova. “The Global Expansion of Russia's Energy Giants,” *Journal of International Affairs* 63 (2010): 103-124.

separation of ownership and transmission of natural gas sales.⁴³ Under the Independent Transmission Operator option, the package calls for energy companies gaining ownership of their transmission networks, but the transmission subsidiaries would be legally independent joint stock companies under their own name. The parent company and the regulatory authority would be making decisions of investment together. Discussion began in 2010 but the idea of real implementation just recently became powerful. The main goals of the TEP in regards to natural gas are regulation of conditions for access to the gas transmission networks, as well as establishing common rules for the internal gas market. By “unbundling” transmission activities and production/supply actions, the European Union hopes to encourage the independence of national energy regulators.⁴⁴ If grid ownership was placed in the state’s hands, Estonia could begin to locally develop supplies and have access to the pipelines that are within its borders. Additionally, alongside TEP guidelines Estonia would hope to battle the high prices that its citizens are paying. Government representatives have stated that they can “resist an uncontrolled rise of gas prices only by fighting the Gazprom monopoly.”⁴⁵

Within weeks of Estonia’s official announcement to begin unbundling, the CEO of Ruhrgas, now formally called E.ON Ruhrgas International, along with another minor owner Fortum sent an angry letter to Estonia’s Prime Minister demanding a meeting. Both board members from the Estonian investors claimed that the intention of the Prime Minister Ansip violates the ownership rights of shareholders as well as investment protection agreements. However, representatives of Gazprom refused to sign the complaint, stating they “wished to stay

⁴³ John Daly, “Gazprom’s Mixed Outlook for 2012.” *OilPrice.com*, 12 January 2012, <http://oilprice.com> (accessed 8 Mar 2012).

⁴⁴ “The entry into force of the EU third energy package,” *European Commission*, (Brussels, Belgium: 2011).

⁴⁵ “Estonia takes Steps to Reduce Dependence on Gazprom,” *Natural Gas Europe*, 22 October 2010, <http://www.naturalgaseurope.com> (accessed 8 Mar 2012).

out to avoid potential feedback.”⁴⁶ The Kremlin knows that Gazprom would lose some of its control in Estonia if the pipeline grid was sold, but it seems as if the Russian company does not want to stir up relations with a well-behaved customer.

In addition to the privatization process, a lack of hydrocarbons kept Estonians safe from the resource curse. Due to Gazprom’s ownership of both sales and transmission of Estonia’s natural gas, there were no possibilities to re-sell the gas that entered the Baltic. Local Estonian industries were not even allowed to use the pipelines that Gazprom owned. In order for an individual to profit off of re-selling the gas in Estonia, they would have to first strike a deal with Gazprom. Right after the Soviet collapse, businesses were sold to mostly foreign owners, which resulted in a small number of wealthy people in Estonia. In more recent times, the economic crisis and introduction of the euro has kept the number of billionaires low.⁴⁷ An industry that inevitably attracts the most oligarchs due to the high risk-high profit situation was almost non-existent and provided no opportunities for business elites.

From this evidence of privatization, we can test the numerous theories about the importance of ownership and the benefits of privatization. Sachs, Schleifer and Luong and Weinthal all argue that the concentration of wealth in state hands deters transition, while the dispersion of wealth enriches the state and its capability to implement reforms.⁴⁸ When gas companies are privatized and split up into foreign shares, the financial burden of capital investment is shifted away from the state. It also places decision-making authority in the hands of non-state actors, who determine development plans solely based on economic considerations

⁴⁶ Juhan Tere, “Shareholders of Eesti Gaas sent an angry letter to Ansip,” *The Baltic Course*, 8 February 2012 <http://www.baltic-course.com> (accessed 7 Mar 2012).

⁴⁷ Juhan Tere, “Estonian billionaires to disappear in 2011,” *The Baltic Course*, 2 August 2010 <http://www.baltic-course.com> (accessed 7 Mar 2012).

⁴⁸ Luong and Weinthal, *Oil is Not a Curse*.

and not political factors. As I mentioned before, domestic private ownership in Estonia fostered effective institutions that were better able to deal with the variances of a market economy.

In Estonia's case, it may first come as a surprise that a country so determined to shake the Russian grip of control sold the largest stake of its gas company to Gazprom. However, Estonian leaders were aware of their situation after independence and they established realistic goals. Plans of diversification would have to be put on hold until Estonia first completed political and economic transitions. More than ten years later, Estonia has established itself as a strong European nation, boasting low debt levels and high predicted GDP growth rates, and it can now refocus on gaining back some power from Gazprom in Eesti Gaas.⁴⁹ The Russian company's hold on the natural gas monopoly is weakening, as Gazprom's exports to Europe dropped by 9.7% since January 2012.⁵⁰ In addition, Eesti Gaas will be forced to sell their transmission units and pipelines, resulting in the opportunity for Estonia to build up local reserves of natural gas in the case of emergencies. In 2010, Gazprom officials warned the EU and Estonia that any changes in ownership could lead to a drop in supply, but the history of Estonia illustrates the power of national unity on independence issues.⁵¹ Furthermore, Estonia and Finland agreed to set up a gas exchange earlier this year. With a long-term goal of a single natural gas market in the Baltic, Estonians are hoping to exclude Gazprom and reduce gas prices.⁵² While there is the simple truth that Estonia has no individual supplies of natural gas, the initiative to loosen Gazprom's grip on

⁴⁹ Anna Molin and Liis Kangsepp, "Estonia Central Bank: Euro-Zone Debt Crisis Main Risk To Financial Stability," *The Wall Street Journal*, 25 April 2012, <http://online.wsj.com/article/BT-CO-20120425-703392.html> (accessed 25 Apr 2012).

⁵⁰ "Gazprom's export falls," *Baltic Transport Journal*, 2 April 2012, <http://baltictransportjournal.com> (accessed 26 Apr 2012).

⁵¹ "Estonia takes Steps to Reduce Dependence on Gazprom," *Natural Gas Europe*, 22 October 2010, <http://www.naturalgaseurope.com/estonia-takes-steps-to-reduce-gazprom-dependence> (accessed 8 Mar 2012).

⁵² Ott Ummelas, "Finland's Gasum, Estonia's Eesti Gaas plan natural gas exchange," *Bloomberg*, 3 January 2012, <http://www.bloomberg.com> (accessed 10 Mar 2012).

its gas industry is a greater step than most other former Soviet countries have taken. By deciding to privatize, Estonia avoided the major pitfalls of state ownership that would plague Ukraine.

Lack of an Oligarchic System

In addition to Estonia's specific path of privatization and its economic relations with Gazprom, the issue of successful energy dependence is connected with the lack of an oligarch system. With no wealthy businessmen looking to become rich from gas imports, the Estonian government backed by citizens can cooperate with Russia. They are always working towards obtaining more independence, even if that means complying with biased policies to keep the situation peaceful. Corrupt business elites never had a chance to rise in Estonian industry and were never accepted into society because of the attitudes of individual residents. The quick privatization of the gas industry to foreign investors meant that no Estonian could become a millionaire overnight, as many Ukrainians and Russians did. Cited as the "misuse of public office for private gain," corruption in Estonia was met with resistance from the people because of the low level of perceived pervasiveness of corruption.⁵³ According to the social learning theory, if someone thinks that corrupt activities are common in societal norms, they are much more likely to participate.⁵⁴ Because of Estonia's strong anti-corruption attitude, citizens were made aware of the consequences of participation in fraudulent situations and began to shy away from all shady business. In a 1993 public opinion poll, Estonians were asked if they had ever used a connection to get things they couldn't receive in an ordinary way and 67% answered no.⁵⁵ Even

⁵³ Daniel Treisman, "The causes of corruption: a cross-national study," *Journal of Public Economics* 76 (2000): 399.

⁵⁴ Margit Tovits, "Why Do People Engage in Corruption?" *Social Forces* 88 (2010): 1257-1279.

⁵⁵ Richard Rose and William Maley, "Nationalism in the Baltic Studies: A Survey Study," *Centre for the Study of Public Policy* 222 (1993).

though the word “bribe” wasn’t used and there was no heavy negative connotation in the question, the majority of citizens simply did not want to be involved.

Starting in 1988 with the reopening of the esteemed Estonian Student Association (EUS), corruption was not tolerated in national attitudes. By promoting the values of honesty, non-corruption and loyalty, the EUS connected civil society with the political fight against fraud and bribery.⁵⁶ In a country where unity and national pride were extremely strong even before the collapse of Communism, being considered detrimental to the state was an intense insult. Even in the business world where profits can be attained much quicker through bribes, fewer than 20% of Estonian firms in 1999 paid bribes frequently.⁵⁷ With statistics showing that 58% of the population thought positively of the government after independence and 55% thought negatively of it before, Estonians were pleased of their accomplishments post-Soviet Union.⁵⁸ These student associations instilled a sense of pride in fighting corruption, which further set the foundations for an active civil society to protest against illegal activities.

In addition to informal rules of conduct, Estonia established governmental anti-corruption committees starting in 1996 with the Committee on the Prevention of Corruption. Throughout its development into the Select Committee on the Application of the Anti-Corruption Act, members reviewed declarations of personal economic interests from high-ranking officials and elected persons. Estonian leaders decided that not only the highest in power had to be watched, but also the administrative circle that participated in law-making and political strategizing. By establishing these Independent Anti-Corruption Agencies (IACAs), the Estonian Ministry of Justice hoped to find “clean hands.” With the hiring a whole new administrative staff and the

⁵⁶ Li Bennich-Bjorkman and Branka Likic-Brboric, “Successful but Different: Deliberative Identity and the Consensus-Driven Transition to Capitalism in Estonia and Slovenia,” *Journal of Baltic Studies* 43 (2012): 47-73.

⁵⁷ Joel Hellman and Mark Schankerman, “Intervention, corruption and capture: the nexus between enterprises and the state,” *Economics of Transition* 8 (2000): 545-576.

⁵⁸ Rose, “Nationalism in the Baltic Studies,” (1993).

writing of a comprehensive corruption reforms, the government strove to break with the Soviet legacy of bribes and fraudulent behavior.⁵⁹

Investigative media in Estonia has helped the battle against corruption. While major advancements have only been made in the past few years, there were some triumphs in the 20th century. In 1997, Prime Minister Tiit Vahi was forced to resign after the media revealed his schemes of buying state apartments cheap for himself and family members.⁶⁰ The media targeted senior officials and mayors alike if they engaged in any illicit activity. A few years later in the beginning of the 21st century, newspapers devoted extensive space to the investigation of Estonian Railways privatization. The search culminated in Estonian papers releasing information from audiotapes regarding corrupt and shady behavior, resulting in charges against the Minister of Economic Affairs.⁶¹ Business paper “Aripaev” has become increasingly involved with researching money laundering and business corruption.⁶² Even though these are individual examples of the battle against corruption, it still illustrates how a unified Estonia promotes attitudes that call for just and fair actions.

Theoretically, scholars posit that the nature of a post-Communist political system allows for informal networks to take control of politics and business. A strong executive power uses formal rules to exercise informal power and then the informal power to give himself more formal power, creating a self-reinforcing cycle. Scholars have agreed that a strong network of informal rules allows corruption to penetrate into all industries.⁶³ If there are no clear formal policies about energy dependence, management will be manipulated through informal networks that only

⁵⁹ Lars Johannsen & Karin Hilmer Pedersen, “The Institutional Roots of Anti-Corruption Policies: Comparing the Three Baltic States,” *Journal of Baltic Studies* 42 (2011): 329-346.

⁶⁰ “Corruption and Anti-Corruption Policy in Estonia,” *Open Society Foundation* (2002): 192-232.

⁶¹ Aleksei Gunter, “Minister charged with shady privatization,” *The Baltic Times*, 29 March 2001, <http://www.baltictimes.com> (accessed 11 Mar 2012).

⁶² Anti-Corruption Network for Transition Economies, *Status Report of the Republic of Estonia under the Baltic anti-corruption initiative*, (Paris, France: 2003).

⁶³ Balmaceda, *Energy Dependency*.

benefit few people. Through Estonian national identity that will be discussed later and the strong anti-corruption attitude of the citizens, these informal rules were not able to form. The example of Estonia disproves the multiple scholarly theories that blame the simple nature of Communism for the cause of corruption. With each new constitution that Estonia passed, the parliament, Riigikogu, legally acquired more power with the majority of state resources at its disposal to control and constrain. As Figure 1 shows, the Estonian government has been built in way so that many branches have veto power over policy change. The existence of political constraints has been relatively high in Estonia, compared to Ukraine's volatility. This stability that has existed in has allowed the government to establish formal norms to block out the rise of power in informal corrupt networks.

Figure

1.

QuickTime™ and a
decompressor
are needed to see this picture.

Source: Witold J Henisz, *Political Constraint Index Dataset*, 2007.

While the president is considered more of a symbolic figure in Estonia, one of the executive's main priorities is to secure the survival of Estonian nationhood and culture. The preservation of state universities, libraries and operas has always been written into the constitution and due to the unified population, no executive has tried to breach those laws.⁶⁴ In checking the executive power, the structure of Estonian government has been successful in distributing political strength and constraints. Often times specific Offices are created to aid Ministries with certain situations or even take over all responsibility in order to ensure fair government. More frequently, government has cooperated with private firms to hand over power in certain social spheres of life. In the country's capital, parking is arranged by a private security firm, rather than by the government. As the people's legislative representative body, the Riigikogu makes sure the executive power is acting in the interests of Estonians. It functions as an intermediary between the prime minister and the public. The Parliament's three main functions are legislation, review of the executive power, and representation. Any member of the Riigikogu has the right to demand explanation of certain actions from the government and its members. If something does not seem to be in accordance with national interest, parliament

⁶⁴ "Institutions of executive power and the public service," *Estonica Encyclopedia about Estonia*, <http://www.estonica.org> (accessed 15 Mar 2012).

members can question the government's sincerity and make public their questioning.⁶⁵

Regarding economic affairs, the State Audit office reviews all monetary actions and since 2000, has the right to also check if the executive power "acts in accordance with the fundamental rights." As mentioned before, the power of the media also plays a role in balancing the executive's power. The Public Information Act of 2000 guaranteed access to all documents in the public domain. Tax information for all businesses is freely published and easily accessible. The press serves to ensure that citizens understand the executive power and its decisions.⁶⁶

All of the situations that I discussed above resulted in lack of corruption in the energy sector. Even when Russia cut off supplies to Estonia in 1993, no economic leaders chose to offer bribes and favors to end the situation. The power of the Estonian people's desire to remain independent prevailed. A remark made by a member of the Parliament encompassed Estonian attitude perfectly when he proclaimed, "They want to cut gas, let them do it. We will suffer but not for long, and in a way that will teach us to be more independent."⁶⁷ Estonia's Baltic neighbors have been noted as successful transitions, but both Latvia and Lithuania have experienced conflicts with Russia during reform periods. The Prime Minister of Lithuania of 1999 was forced to resign months after taking office over possible connections between organized Russian crime and energy sector deals. Both countries have fought corruption involved in the transactions of Mazeikiu Nafta, the biggest oil complex in the Baltic region.⁶⁸ However, Estonia has been able to maintain a relatively stable relationship with its supplier.

⁶⁵ "Work of the Riigikogu," *Riigikogu: The Work of the Parliament*, <http://www.riigikogu.ee/index.php?id=34584> (accessed 8 May 2012).

⁶⁶ "The supervision of executive power," *Estonica Encyclopedia about Estonia*, <http://www.estonica.org> (accessed 15 Mar 2012).

⁶⁷ Efron, "Angry Russia Cuts Off Gas to Estonia."

⁶⁸ Merle Maigre, "Energy Security Concerns of the Baltic States", *International Centre for Defense Studies* (March 2010).

When comparing Estonia to Ukraine in later chapters, I will illustrate how extensive networks of formalities ensure that the head of the nation is not allowed to abuse executive power. Other scholars place the blame for corruption and oligarchy in weak institutions. Due to the enactment of the Public Service, which sets out certain codes of conduct for the public administration, all institutions in Estonia have become heavily monitored. The introduction of internal audit and control contributes to the transparency of state institutions and their financial tendencies. Over 85% of bank assets belong to foreign credit legal institutions, meaning Estonian banks are being held to high international standards. The Estonian Banking Association has been cooperating with the Financial Intelligence Unit, monitoring possible money laundering and fraud cases. With EU membership, the banking institutions gained the ability to work with multiple economic groups in the European Banking Federation. Strong political branches checked by public organizations combined with stability among economic institutions results in the transparent nature of Estonian society.⁶⁹ All of these systems work together in a balance of power to ensure that corruption cases such as the ones in the rest of the Baltic do not occur in Estonia.

Unified National Identity

Starting from the beginning of the 20th century, Estonia's history experienced only a few periods of true independence. Deterred by its close economic ties to Russia, Estonia's prospects for the future were dim following the collapse of the Soviet Union. Privatization reforms allowed businessmen to become rich and powerful over night, yet Estonia was able to overcome the curse

⁶⁹ "Status Report of the Republic of Estonia," 2003.

of the Soviet Union that many blamed for high corruption levels. The country's ability to cultivate a Communist counter elite that emphasized the importance of national heritage brought the public together against Soviet connections.⁷⁰ Turmoil in the 20th century meant that traditional practices of the times could not be passed down through familial connections, and Estonian history and national pride served as the common uniting factor among the public.⁷¹ Through the use of soft resistance, Estonians focused on their national heritage to fight Soviet occupation.

Scholars recognize the power of a unified force in a newly independent state. Abdelal argues that if a country's national identity is continuous through the public and supported by all parties, it can move forward with a clear goal.⁷² The presence of a clear desire for a European identity guided Estonia on the path to successful transition, as well as successful dependence. By looking into Estonia's political parties and the level of opposition, I will conclude why identity kept the energy sector managed properly. Estonia acknowledged the reality of the dependence situation with Russia, but its unified and highly uncontested identity encouraged people to sacrifice for the later benefit of their national goals. With a strong and established pro-European identity, Russian leaders became convinced that they had lost Estonia from their sphere of influence.

This sort of cultural orientation specifically away from Russia began in the 1960's when Estonians organized into cultural networks. Collective groups meeting to discuss nationalism formed much earlier than *perestroika* in 1987, which established a foundation for further soft

⁷⁰ Li Bennich-Bjorkman, "Cultural Roots of Estonia's Successful Transition," *East European Politics and Societies* 21 (2007): 316-347.

⁷¹ Indrek Tart, "Basic Human Values and Identity Research in Estonia, Latvia and Lithuania after 1989," in *Landmark 1989: Central and Eastern European Societies Twenty Years after the System Change*, eds. Heinrich Best and Agnieszka Wenninger (Berlin: 2010), 91-107.

⁷² Abdelal, *National Purpose*.

resistance after Estonia became more open. Perhaps one of the most influential groups of people was the journalism department at Tartu University, led by Communist liberals who advanced into powerful political positions early in the country's transition.⁷³ These professors and students met weekly to discuss how to keep the country united through its transitional period, and brought those same ideas to the capital once elected into political power. At the time, no other Baltic state had the same scope and continuity of informal networks and clubs. Further affecting the democratic state building that would later bolster successful energy management was the Pro Patria's transition from a civil club into the post-1991 governing party. This transformation from club actors to political actors meant that "civil society was directly linked to Estonian party formation and state-building strategies."⁷⁴ The government had to answer to its citizens, in all political and economic sectors.

The foundations of Estonia's focused ideology were formed when Pro Patria nationalist elites took power in the 1992 elections. Besides deeming the Soviet occupation illegal and against the will of Estonia's population, the 1992 Constitution made it clear that Estonian citizens would determine all decisions about the state.⁷⁵ Stated in the first paragraph, "Estonia is an independent and sovereign democratic republic wherein the supreme power of the state is held by the people."⁷⁶ Additionally, the constitution established Estonian as the official state language and limited jobs in the public service to Estonian citizens. National elites wanted to guarantee the development of Estonian national identity, language, and control under the protection of their own nation-state. Rather than proving their gained independence, the constitution was meant to

⁷³ Bennich-Bjorkman, "Cultural Roots."

⁷⁴ Li Bennich-Bjorkman, "Party Formation and Elites in the Baltic States," *Baltic Worlds* 2 (2009): 33.

⁷⁵ Eiki Berg and Saimar Oras, "Writing Post-Soviet Estonia on the World Map," *Political Geography* 19 (2000): 601–625.

⁷⁶ "Estonia – Constitution," translated by Martin Scheinin, *International Constitutional Law*, 1995, <http://www.servat.unibe.ch/icl/en00000_.html (accessed 15 Mar 2012).

restore an independence that was unlawfully taken from Estonia for over 50 years. As soon as the constitution was elected into power, Estonian culture fully supported the changes. Citizens with Russian ancestry were given only resident alien status and not counted in Estonia's overall population.⁷⁷ The Baltic country had completely reconstructed its national identity and all aspects of life depicted the new independent reality. Everything from school lessons, national maps, and foreign policy rhetoric followed the new Estonian ideology.

During transition periods such as the time after Communism, many countries are not willing to endure hardships past a certain breaking point. Citizens agreed to slower transitions when new democratic leaders called for sacrifices in the name of independence, yet in reality leaders were voted out of office if results weren't seen in a short period. Estonians were different in that they agreed to these slower changes and understood that the independence they wanted from Russia came at a price. Public opinion polls conducted in 1995 showed that 50% of ethnic Estonians were not satisfied with their current family economic situation, but 41% were coping and satisfied with the sacrifices.⁷⁸ The national unity that became so solid and established in everyday life after Estonia gained political freedom allowed the people to agree to common sacrifice. This decision to oppose Russian political and economic pressures gave Estonia an opportunity to slowly gain advantage over its oppressor. Due to the simple lack of natural resources, Estonia had to accept dependence on Russian gas right after Communism. However, the relationship was not between a completely subordinate country and a superior power. Estonia has made clear its plans to work on independence as soon as it was the right time for their continued national policies.

⁷⁷ Berg and Oras, 67.

⁷⁸ Richard Rose, "New Baltics Barometer II: A Survey Study," *Centre for the Study of Public Policy* 251 (1995).

Following Estonia's 2004 accession into the European Union, its relationship with Russia became tense with issues of insecurity and historical distrust. Energy security became one of the top priorities for Estonia's government as politicians and businessmen struggled with increasing energy dependence on Russian supplies. For years Estonia pushed for national policies that left Russia and her power politics in the past, yet in the beginning of the 21st century they were still 100% dependent on Russian natural gas.⁷⁹ Upon accession, all of the Baltic States hoped for new opportunities from the European common energy market. Under regional infrastructure projects and the EU's Third Energy Package, new member countries could "start to integrate gradually into the European energy market and reduce their dependence on Russia."⁸⁰ However, the reality of the situation was that Estonia did not have enough alternative energy suppliers. Poland and Lithuania recently agreed to a pipeline that would connect the Baltic States with the EU energy market, yet Estonians saw cause to worry.⁸¹ Politicians believe that Poland's search for cheaper energy translates into narrow national interests and questions the sincerity of Baltic-Polish cooperation. Additionally, before this recent announcement of finalized cooperation between Lithuania and Poland, complications had been forming since 2010 with constant planning delays and little security that the project would eventually commence. Instead of dealing with difficult partnerships, Estonia decided to stay with the dependent situation and wait for another opportunity.

When I look at the multiple parties, I will show how multiple competing leaders all agreed on the Estonian idea of national identity. In one of the first elections centered on the idea of independence, the Estonian Popular Front won 43 seats in the 1990 Estonian Supreme Soviet

⁷⁹ "Energy Mix Fact Sheet: Estonia," *European Commission* (Brussels, Belgium: 2007).

⁸⁰ David Galbreath and Ainius Lasas, "The 'Baltic' Factor in EU-Russian Relations: In Search of Coherence and Cooperation in an Era of Complexity," *Contemporary European Studies* 19 (2011): 268.

⁸¹ "Poland, Lithuania eye EUR 471m gas link," *EUbusiness*, 10 February 2012, <http://www.eubusiness.com> (accessed 7 April 2012).

elections. During the first session, the new parliament re-elected the former Communist Arnold Ruutel as chairman. Even though Ruutel was part of the Communist Party, he fully supported Estonian independence. Before the elections he was a key player in drafting the Estonian declaration of sovereignty.⁸² Moving to the first free parliamentary elections in 1992, the top parties continued to all support complete independence. The Pro Patria Fatherland party, the Secure Home bloc and Estonian Popular Front movement were all major influences during the country's fight for independence. The Popular Front mobilized the citizens and gave opportunity to express dissatisfaction. The Pro Patria union based its idea on nationalism and drafted many political and economic legal reforms during the transition. As leader of the victorious Pro Patria National Coalition, Mart Laar became Prime Minister and transformed Estonia into a 'Baltic Tiger'.⁸³ In his first term, he successfully orchestrated the withdrawal of Soviet troops, introduced the new Estonian currency and implemented a flat tax that has decreased steadily.⁸⁴ Laar was very public with his hopes to lift Estonia out of its economic and political struggles. This tenacity caused the nation to re-elect him as Prime Minister in 1999, when he oversaw the beginning of complete privatization and a steadily growing economy. He has said, "he believes in economic freedom because he believes in the Estonian people."⁸⁵

The desire to leave the legacy of Communism behind overwhelmed Estonian leaders and many politicians rallied around this point. In publications multiple years after independence, Laar stated that the initial secret to Estonia's success was the "sweep the place clean" policy that could raise a new generation untouched by Communist tradition. The Minister of Foreign Affairs

⁸² "Arnold Ruutel," *Office of the President*, <http://www.president.ee/en/republic-of-estonia/heads-of-state/5102-arnold-rueuetel/layout-headofstate.html> (accessed 18 Mar 2012).

⁸³ Manuel Álvarez-Rivera, "Elections to the Estonian Riigikogu 1992," *Election Resources on the Internet*, <http://www.electionresources.org/ee/> (accessed 16 Mar 2012).

⁸⁴ "Mart Laar's Biography," *Cato Institute*, <http://www.cato.org/special/friedman/laar/>.

⁸⁵ "Laar's Biography," *Cato Institute*.

made great claims about Estonia belonging in the EU, stating that EU membership had become so self-evident to the Estonian people. The country has long believed its proper place was in Europe and this yearning to rejoin the Euro-community seemed natural.⁸⁶ Such defined content of nationalist parties was the driving force behind economic policies. If the country were politically geared towards becoming European, the gas sector would have to follow those rules. By selling Gazprom major shares of Eesti Gaas, Estonians proved the strength of their national identity. Privatization of the gas industry to the highest investors ensured that the country could smoothly transition into a democratic and market economy. Being European meant opening the market and allowing foreign business. Estonia could have privatized and kept the wealth within country borders, but their national identity dictated their economic goals. Additionally, national identity pushed Estonia to accept higher prices that Gazprom proposed in order to avoid greater conflicts and continue reforming.

Summary

From looking at the different ownership structures in gas industries, it seems that allowing the supplier to own shares in the gas company reduces the chances for conflict. Gazprom owns the largest portion of Estonia's natural gas firm, yet this hasn't allowed Russian officials to completely manipulate the gas industry in the Baltic state. By choosing the privatization route, Estonia has avoided the troubles of state ownership. Business activity is carefully monitored, with fewer opportunities for rent-seeking activity and employing close

⁸⁶Karin Rannu, "Estonia's Accession Negotiations with the European Union," in *Estonia's Way into the European Union*, ed. Kaja Tael (Tallinn: 2009), 36-43.

contacts. A major depoliticization occurred and decisions about Estonian gas were made on strictly economic considerations.

Because of the country's choice to privatize, Estonia also avoided the rise of a strong oligarchic power. Part of Estonia's overall goal was complete transformation of its country to lose any Communist and Soviet legacy, including the culture of corruption. Establishing anti-corruption committees and instilling the idea of fair nature held businesses to a high standard. A parliamentary government system caused there to be a high number of political constraints, making sure no branch was becoming overly powerful. In addition to a national attitude against corruption, the lack of any gas resource contributed to Estonia's avoidance of powerful oligarchs. There was no gas to exploit, and since the company was immediately fully privatized, people could not benefit from quick schemes to rent-seek.

Lastly, both privatization and corruption successes in Estonia were due to the strong national identity formed early on in the transition process. Every citizen and politician was completely in consensus on the country's goal of becoming a European nation. All parties in the government agreed on the same national identity and were not shy in publicly calling for a turn away from Russia. Due to an overall extremely short period of independence, Estonian citizens wanted to liberate themselves from dependence as much as possible. A clear national policy directed the government's economic policy, and with a unified national identity came the willingness to sacrifice for the greater good.

By mapping out the successful ways Estonia approached and handled its energy dependence, I have set up the foundations for a comparison with my next case study, Ukraine. In the next chapter, I will focus on Ukraine and analyze how differences in all three of the variables led to an overall drastically divergent energy management system.

III. Ukraine

While there were major ideological breaks from the Soviet Union after its collapse, the complex network of economic dependences continued to exist. Geopolitics impacted all of the former Soviet republics, but the struggles became most evident in Russia's immediate neighboring countries, especially Ukraine. This chapter will be focusing on the certain situations and occurrences in Ukraine that contributed to its now conflict-ridden energy management. Clouded by conflicts between politics and business, Ukraine's history illustrates different periods of advancements and backsliding. The country split into regional clans as they it gained independence and these groups have continuously fought between Russian alliances and European support. I will be analyzing how the lack of national identity, combined with the rise of a strong oligarch existence due to partial reforms resulted in Ukraine's severe case of failed energy dependence.

As the transition from post-communism politics continued, it soon became obvious that Ukraine could only be categorized as partially reformed. Presidents attempted to quickly push through economic reforms to better the living standards in Ukraine, yet 68% of the population felt the country was heading in the wrong direction.⁸⁷ Even in recent times, elaborate economic reforms covering a dozens areas in multiple industry sectors have been presented to the Rada, but real laws are rarely implemented and supported strongly enough to make a difference.⁸⁸ I will further provide evidence of division in the country and how it directly affects the ability to

⁸⁷ Polling the Nations, "In general, do you feel things in Ukraine are going in the right or wrong direction?" *Eurobarometer* (1994).

⁸⁸ "Support to the Social Sector Reform in Ukraine," *United Nations Development Programme* (Kyiv, Ukraine: 2011).

manage energy properly. Using theories from my previous case study, this chapter will depict the other end of the dependency spectrum, the failed example with great potential for conflicts.

Presidents stayed away from full nationalization but encouraged the use of national symbols. The new class of oligarchs allowed economic transformations to only go so far so that they alone profited. Living standards decreased for the common Ukrainian and the country lacked any strong democratic and reformist political force. As I illustrate the unsuccessful conditions of the Ukrainian nation, it will become evident that many of the decisions Estonia made during its transitional period directly resulted in a successful, yet dependent gas relation. In contrast to every Estonian element that contributed to a strong energy security position, Ukraine's partial economic reform, strong presence of powerful oligarchs and a divided national identity all led to a problematic and conflict-ridden energy relationship with Russia.

Before expanding on the variables of poor natural gas relationships, I will first provide evidence for Ukraine's categorization as a failed example. As stated earlier, Estonia imports 100% of its natural gas and the country has no proved reserves. The country is completely dependent on Russia and Gazprom's delivery of gas. On the other hand, Ukraine has the 24th largest proved reserve of natural gas in the world with over 1 trillion cubic meters.⁸⁹ With so much reserve, one would think that Ukraine could restrain from turbulent battles with Russia regarding price. However, more than half of the natural gas Ukraine consumes comes from Russia due to the tight gas reserves that outdated infrastructure cannot safely extract.⁹⁰

Next, I will discuss Ukraine's history and the multiple conflicts that have occurred with Russia. Beginning in 1994, Ukraine maintained tumultuous relations with Russia and Gazprom. After acquiring a \$600 million debt, Gazprom cut gas supplies for two months from 114 million

⁸⁹ "List of Countries with the Largest Natural Gas Reserves," *Aneki.com*, <http://www.aneki.com/gas.html> (accessed 26 Mar 2012).

⁹⁰ "Ukraine Economy Profile 2012," *Index Mundi*, <http://www.indexmundi.com/ukraine> (accessed 26 Mar 2012).

cubic meters to 40 million cubic meters. In 2006, the two parties could not agree on a price and supplies were once again stopped. This led to Ukraine consuming gas intended for European consumers. More debt and lack of agreements caused supplies to be cut in 2008 and 2009.⁹¹ When Victor Yanukovich became president again in 2010, he called for a fair and just price in Kiev. He proposed Russian involvement in the management of Ukraine's gas transport system if Gazprom could decrease the price for natural gas. Russian officials have said they would have entertained this proposal many years ago in order to avoid investing billions in creating pipelines. However, now that extensive pipe networks have already been constructed Russia no longer is interested in this gas consortium. Additionally, Yanukovich promised his public that Ukraine would act in a way that would persuade Russia to agree to a decrease. He stated that if the Baltic countries were receiving gas for \$260 for 1000 cubic meters, there was no reason for Ukraine to be paying \$305.⁹² This past March, Ukrainian parliament agreed to split Naftogaz, the national energy company, into production and transportation divisions according to the TEP that Estonia is also following.⁹³ Naftogaz is completely 100% state-owned and is the major player in natural gas business. The company extracts almost 90% of Ukraine's gas: out of the 20.5 billion cubic meters extracted last year, Naftogaz and its subsidiary companies extracted 18.3 billion.⁹⁴ By announcing a preliminary decision to split the company, Ukraine hopes to entertain offers to allow Russia and Europe to manage some of Naftogaz's assets.

Now two years after Yanukovich's promises to improve relations, Ukraine is paying one of the highest prices for Russian gas in Europe. Gazprom is continuously unhappy with

⁹¹ "Gas Conflicts Between Russia and Ukraine." *RIA Novosti-Infographics*, 2012, <http://en.rian.ru/infographics/20120326/172353907.html> (accessed 27 Mar 2012).

⁹² "Natural gas price high on Yanukovich agenda in Moscow," *Ukraine Business Online*, 5 March 2010, <http://www.ukrainebusiness.com.ua> (accessed 27 Mar 2012).

⁹³ "Ukrainian Parliament Approves Naftogaz Split," *RIA Novosti*, 20 March 2012, <http://en.rian.ru/business> (accessed 27 Mar 2012).

⁹⁴ "How Naftogaz will be Privatized," *Kyiv Weekly*, 12 September 2011, <http://kyivweekly.com.ua> (accessed 27 Mar 2012).

“Yanukovych’s pursuit of his own personal and corporate interests” and the Ukrainian president is “frustrated with Russia’s unwillingness to make concessions in the name of Slavonic brotherhood.”⁹⁵ The media has criticized Yanukovych for pursuing a foreign policy that focuses only on keeping himself in complete power. Many proclaim ‘imitation of integration’ is the newest policy in regards to the battle between the EU and Russia. Yanukovych acts as if he will work with both, but in reality no integration with either side has been achieved. The president does not want the influence of either actor to grow and pose a threat to his personal power.⁹⁶

Yanukovych has questioned all elements of the gas deal negotiated in 2009, yet Russia is relentless about their involvement with Naftogaz. Gazprom has promised to consider a decrease in price only if their officials earn powerful positions in the Ukrainian gas industry. In addition to a muddled and unclear price battle between Russia and Ukraine, the former Soviet republic has intertwined its debt with the Kremlin. Russia has been consistently loaning money to Ukraine to pay Gazprom bills, much of the money even coming from Gazprombank. While Ukraine has recently been flexing its newfound muscles and saying that Russia will soon have to agree to new prices due to EU influence, Russia will most likely never let Ukraine completely be out of their control. Gazprom knows that by keeping the EU out of energy affairs, the process can continue to be blurred and full of crooked behavior. After providing a brief synopsis proving Ukraine’s disruptive history, I can move on to analyzing my three variables.

Partial Reform

⁹⁵ Olga Shumylo-Tapiola, “Ukraine and Russia: Another Gas War?” *Carnegie Endowment for International Peace*, 21 February 2012.

⁹⁶ Olena Prystayko, “Two years of Viktor Yanukovych in power: Observations and conclusions of a trip to Ukraine in December 2011 – January 2012,” *Ukraine and Post-Soviet Space Blog*, 20 February 2012.

The process of privatization in Ukraine set the foundations of how political and economic business is now conducted. After the collapse of Communism, the new decade served as a chance for former Soviet republics to break from Russia. Necessary economic reforms could have carried Ukraine into the Western community of successful democracies, but half-hearted attempts at change hindered any advancement. Skewed privatization turned the country into a stadium for elite domination and corruption, causing Ukrainian citizens to retreat into their private lives and shy away from civil society.⁹⁷ With no opposition strong enough to make a difference, oligarchs were able to attain power in the gas industry during privatization and conduct business in a way that benefitted only those who they chose.

As political science theory dating back to Adam Smith has noted, the “invisible hand” of the private sector tends to allocate and utilize resources much more efficiently than the “heavy hand” of central planning. Scholars such as Schleifer, Fischer, and Sachs all conclude that the heavy politicization of state ownership in gas industries causes decisions to be made to meet political goals, not economic ones. As mentioned earlier, countries that did not privatize immediately were often stuck in the middle with no clear, decisive plan. State ownership was established and with no constraints on economic spending and political decisions, weak fiscal regimes emerged. Not only did weak financial institutions inhibit basic democratization in Ukraine, but also corrupt bargaining and massive government spending enveloped the gas industry. Ukraine hoped for quick privatization but as independence was granted, the government still had no articulated privatization plan. In 1992 the government proposed the first privatization program, but by the end of the year only 68 small state enterprises had been transferred to the private sector. In 1993, the first priority was to complete the privatization of

⁹⁷ Scott Radnitz, “The Color of Money: Privatization, Economic Dispersion, and the Post-Soviet ‘Revolutions,’” *Comparative Politics* 42 (January 2010): 127-146.

small retail units and enterprises with foreign capital participation. At the end of the fiscal year, the goal was not achieved and programs in 1994 listed the same priorities. This kind of repetition with no success illustrates the lack of attention paid to privatization by the government.

Additionally, some privatization programs contradicted government laws. While economic authorities offered privatization certificates for no less than 70% of the total value of the assets subject to privatization, the law stated that the total value of state property could not be more than 40% of the value.⁹⁸ Because the authorized privatization programs were not aware of their limits in economic reform, chaos in the form of unrestrained spending ensued.

While small-scale privatization picked up speed and was eventually completed by 1997, medium- and large-scale privatization almost came to a complete stop in 1996. Even though over 90% of small businesses had been transferred to the private sector, these enterprises only accounted for 2% of official industrial output. By mid-1997 only 9,649 out of the 18,000 larger businesses in Ukraine had entered the preprivatization stage and of that number, only 5,087 had transferred more than 70% of shares to private owners. Beginning in 1994, the Rada published a yearly list of companies that would be exempt from privatization.⁹⁹ For years thousands of businesses in the energy sector were kept on the list, likely due to the profitable nature of this industry. In addition to the exemption list, the Rada banned the privatization of transmission and distribution pipelines and related infrastructure. These pipelines formally belonged to the State Property Fund, Ukraine's privatization authority. UkrGazProm was responsible for the maintenance and operation of the transmission and distribution networks, and it was completely owned by the state. In 1997, the Rada began investigating the territorial monopolies in Ukraine's

⁹⁸ Raphael Shen, *Ukraine's Economic Reform: Obstacles, Errors, Lessons*, (Westport, CT: Praeger, 1996).

⁹⁹ Paul D'Anieri, Robert Kravchuk and Taras Kuzio, *Politics and Society in Ukraine*, (Colorado: Westview Press, 1999).

gas market so potential foreign investors could be attracted.¹⁰⁰ In an effort to combine the government's plan and the policy put forward by Western institutions, Ukraine established the national gas company Naftogaz. The company's assets would include everything the state owned in the oil and gas industry.¹⁰¹

Granted permission by a presidential decree in 1998, the government created Naftogaz as a possible attempt to regain the control that the Rada had been gaining with their influence over the privatization process. Ukrainian Parliament appointed and dismissed the heads of the State Property Fund, along with multiple powerful ministers who made decisions regarding privatization goals.¹⁰² To appease those who argued for separation of the previous gas company, the presidential decree announced an unbundling plan that Naftogaz would have to follow. Similar to all other reforms, this goal was never achieved and Naftogaz still controls all production, transmission, and supply functions. Because of the constant infighting between those who "advocate vertically integrated, opaque, monopolistic structures and those who want a transparent, competitive gas market governed by stable rules," Ukraine's privatization was constantly halted in the energy sector.¹⁰³ In current times, Yanukovich has announced that full privatization will be complete in 2014, more than twenty years after the initial plans were proposed. However, the gas industry is still exempt from this plan. Yanukovich quickly added, "the state should own a restricted number of companies that fulfills key functions of the state and guarantee national and economic security."¹⁰⁴ In addition to the president's disapproval, a recent

¹⁰⁰ Axel Siedenberg and Lutz Hoffmann, *Ukraine at the Cross Roads*, (New York: Physica-Verlag Heidelberg, 1999).

¹⁰¹ Lazlo Lovei, "Gas Reform in Ukraine: Monopolies, Markets, and Corruption," *Public Policy for the Private Sector* 169 (December 1998).

¹⁰² "History: State Property Fund," (2006), *State Property Fund of Ukraine*, <http://www.spfu.gov.ua/eng/history.php> (accessed 17 Apr 2012).

¹⁰³ Lazlo Lovei, 1.

¹⁰⁴ "Yanukovich: Companies' privatization in Ukraine should be completed by 2014," *KyivPost*. 9 December 2011, <http://www.kyivpost.com> (accessed 28 Mar 2012).

bill about gas and oil reform ruled privatization of the gas transit system still illegal. Members of the Rada have said that they will try to prove how “the current hasty privatization of the gas transport system is a move against the national interests of Ukraine.”¹⁰⁵ Because people of business power have entered into the political arena, full privatization of the energy sector will always face severe opposition from the winners of partial reform that will be discussed later.

As I turn to look into specific theories, I will illustrate how the gas reform plans became corrupt once oligarchs got hold of them. In Ukraine’s case, the existence of partial reform causes Ukraine’s government to maintain a state ownership that benefits only a few. Luong and Weinthal argue that under state ownership, the boundary between state elites and bureaucrats is blurred. Since both groups have access to profits, both work together to establish the most beneficial scheme. Elites and bureaucrats are more likely to steal because of their positions as de facto government employees, which do not receive compensation for performance. The company does not have to worry about national or international scrutiny over transactions, and the government utilizes its leverage as the dominant owner to fulfill domestic fiscal and spending requirements.¹⁰⁶

Others like Hellman put forth the partial reform theory, where the winners of this system cause greater damage than the dissatisfied losers. Mutual understanding of corrupt action benefits both sides in the gas sector, so neither business nor political leaders will try to push for complete reform. Gas oligarchs are able to obtain high costs in the short-term and in a country with such an uncertain future, collecting money as fast as possible is the preferred plan. Through

¹⁰⁵ “Energy reform bill doesn’t provide for GTS sale,” *Ukrainska Energetika*, 24 February 2012, <http://ua-energy.org/> (accessed 28 Mar 2012).

¹⁰⁶ Luong and Weinthal, “Combating the Resource Curse.”

acquired veto power from political positions, oligarchs capture state institutions to preserve partial reform.¹⁰⁷

In 1993, red directors came to dominate Ukrainian government, especially the gas sector. These business managers typically from Eastern Ukraine joined the political world to maximize personal revenues by slowing reform. By intentionally introducing laws that only generated benefits for their elite groups, real reforms were put on hold.¹⁰⁸ One of these powerful business leaders was Pavlo Lazarenko, the former Prime Minister of Ukraine. Under President Kuchma's protection, Lazarenko stole millions of dollars through different illegal enterprises. After allowing the United Energy Systems of Ukraine to control a monopoly over the distribution in Eastern regions of Ukraine, Lazarenko collected the payments that Ukrainians were paying for the gas. He had previously made negotiations with the natural gas trading company that the Ukrainian government would pay their debts to Gazprom, yet all the funds were being wired to offshore accounts and the Gazprom debt rose higher and higher. Interestingly, Yulia Tymoshenko was head of the UESU during Lazarenko's time. She was a close associate of Lazarenko, even though years later she would passionately campaign for a free and transparent gas industry. Throughout these occurrences, Kuchma acted as if the event was of no importance. He hired lawyers that he knew were corrupt and Lazarenko was fired only when the West began to heavily pressure Ukraine.¹⁰⁹ This kind of mutual understanding demonstrates how a small circle of elites worked together to sustain partial reform, forcing high costs on Ukrainian citizens and even higher benefits for themselves.

¹⁰⁷ Hellman, "Winners Take All."

¹⁰⁸ Anders Aslund, "Problems with Economic Transformation in Ukraine," in *The Fifth Dubrovnik Conference on Transition Economies*, Dubrovnik, 23-25 June 1999 (Dubrovnik: Croatian National Bank, 1999).

¹⁰⁹ Roman Kupchinsky, "The case of Pavlo Lazarenko: a study of high-level corruption," *The Ukrainian Weekly*, 24 February 2002, <http://www.ukrweekly.com/old/archive/2002/080205.shtml> (accessed 18 Apr 2012).

Another powerful Ukrainian figure that demonstrates blurred lines and halted reform is Dmytro Firtash, who co-owns RosUkrEnergo, multiple chemical plants and Ukraine's 11th largest bank. In addition to controlling the Swiss-created gas company, Firtash is known for his connections with energy minister, Yuriy Boiko. It has been discussed among Ukrainian politicians that Firtash was a major force behind the sentencing of former Prime Minister Yulia Tymoshenko. She called for the elimination of the intermediary RosUkrEnergo due to its corrupt and unclear transactions with Gazprom.¹¹⁰ To further illustrate Firtash's growing influence, Yanukovich recently appointed him as head of the National Tripartite Social and Economic Council. Through this leadership position, Firtash will be in charge of labor development in Ukraine and the future of any changes in economic policies.¹¹¹

In discussing the implications of Hellman's theory about partial winners, I mentioned earlier how the Rada passed many bills, exempting any energy enterprises from becoming privatized. In March 2012, the Ukrainian government agreed to allow a restructuring of Naftogaz but not full privatization. The EU said that Ukraine must unbundle their system if they are expecting any investments in their pipeline system from the West. However, since Ukraine is afraid of Russian domination if they lose the rights over pipelines, the Rada agreed to continue banning privatization of energy businesses.¹¹² In addition to parliamentary support, the president held a conference of oligarchs in 2005 to reassure them re-privatization was not a future option. Oligarchs opposed Yushchenko largely because they feared their industries would be forced to privatize, but the president continued to stall reforms in order to benefit political leaders and

¹¹⁰ "A Very Ukrainian Trial," *The Economist*, 11 October 2011, <http://rss.economist.com> (accessed 29 Mar 2012).

¹¹¹ "Yanukovich appoints Firtash to council," *KyivPost*, 18 February 2012, <http://www.kyivpost.com> (accessed 29 Mar 2012).

¹¹² Europe News, "Ukrainian government to ban Naftogaz privatization," *Global Gas Transport*, <http://www.globalgastransport.info/archive.php?id=7327> (accessed 28 Mar 2012).

business counterparts.¹¹³ All of these events illustrate the mutual agreement between company and government to keep reforms only partially completed.

In addition to the fundamental claims that private ownership is better than state ownership, scholars have discussed the influence of opposition in ownership structures. Luong and Weinthal argue that if there no strong protesting actors then state ownership will continue to disallow foreign investment and make decisions that economically benefit only close government contacts.¹¹⁴ Ukraine is burdened with an inactive civil society. The first true opposition groups emerged as Ukraine battled for independence. Formally known as the Ukrainian People's Movement for Perestroika, the Rukh movement began their fight for nationalism as a powerful force. However, as they realized that independence was in fact approaching, the group suffered from the lack of a stable identity. It questioned alliances with former Communists who vowed to reform and it soon began an assertive nationalistic campaign that appealed to only small parts of the nation. While Rukh successfully rallied Ukrainians to call for independence, the movement was not successful in translating their power into a tangible political party.¹¹⁵ The Orange Revolution in 2004 demonstrated a burst of strong and active Ukrainian civil society, but soon after the population retreated back into silence. Civic nationalism called for a return to Europe and people of all ages camped at Independence Square until the Rada declared the presidential results invalid.¹¹⁶ With the door closed on Kuchma's reign in Ukraine, the path to democracy and market economy opened. At the time of the revolution, analysts suggested that Ukraine's executive branch was transforming into a bipolar

¹¹³ Taras Kuzio, "Yekhananov Refers To Oligarchs as "National Bourgeoisie," *Eurasia Daily Monitor* 2. 2005.

¹¹⁴ Luong and Weinthal, "Prelude to the Resource Curse."

¹¹⁵ Ilya Prizel, "Ukraine between proto-democracy and "soft" authoritarianism," in *Democratic changes and authoritarian reactions in Russia, Ukraine, Belarus, and Moldova*, eds. Karen Dawisha and Bruce Parrott (Cambridge 1997), 330-370.

¹¹⁶ Paul Quinn-Judge and Yuri Zarakhovich, "The Orange Revolution," *TIME Magazine*, 28 November 2004.

system. Collaboration between two actors would be the new focus of government, rather than just one ultimate ruler. However, Yushchenko saw civil support decline as he had trouble gaining Rada support for reforms.¹¹⁷ By appointing Yanukovych, his presidential rival, as Prime Minister, Yushchenko essentially told Orange Revolution protesters that their stand against government did nothing. This end to civil society is further encouragement for the government to take advantage of its state ownership.

Through the lenses of several privatization theories, we can see that Ukraine has chosen to keep the gas sector in close proximity with state ownership. Foreign investors are often pushed away with opaque and corrupt business ways, resulting in full reign of power for Ukrainian oligarchs. Due to the inefficiency of obtaining resources, Ukrainians have had to resort to corrupt measures by paying out rents to stay in power. With no other industry that can produce such high benefits for oligarchs, the government keeps Naftogaz under its control to secure the wealth. If an indifferent population is mixed into the equation, the government will chose to keep gas companies under state control so rules can be manipulated. Due to a lack of a clear privatization reform after independence, Ukraine has been battling with multiple economic ideas that are always halted by one side or the other. Discussing oligarchs next, I will prove how this community of elite businessmen involved in economic and politics hindered any positive reforms that could have put Ukraine on the path to joining the West.

Powerful Oligarchic System

¹¹⁷ Paul D'Anieri, *Understanding Ukrainian Politics: Power, Politics, and Institutional Design*, (New York: M.E. Sharpe, 2007).

Perhaps the most noticeable difference between Ukraine and Estonia is the presence of an oligarchic system. Estonia's organized privatization and privately-owned gas company resulted in no corrupt ruling elite that hindered the country's transitional process. In Ukraine, many businessmen pushed for unrealistic reforms that benefited only a few and stopped others that would demand more transparent actions. It became apparent that the quickest way to become rich was through bribes and stealing. A low level of transparency clouded the Ukrainian economy and with each new president the oligarchs gained more formal power. In the beginning, oligarchs first had to establish their power in politics. By providing financial support to presidents and joining the parliament, they built up their power structures. With each new government elected, the oligarchs became more of a permanent unit that the president was forced to cooperate with.¹¹⁸ Intense corruption became the focal point of politics, causing Ukraine to score 152nd out of 182 countries on the Transparency International Corruption Index.¹¹⁹ Russia's 50 wealthiest oligarchs in 2008 only accounted for 35% of the country's GDP, while in Ukraine the number jumped to 85%.¹²⁰ The former Soviet Republic battles with a major oligarch problem that continues to corrupt all industries and sectors.

The foundation of corruption began right after independence, during the initial presidency when Leonid Kravchuk was elected as a national communist. With the implementation of the Declaration of Sovereignty, the supremacy of Ukrainian law popularized Kravchuk due to the nationalist twist but he did not actually support the democratic movement. While both candidates in the 1991 election stood for independence, Kravchuk portrayed himself more successfully as a "levelheaded centrist and a seasoned statesman." Once independence became legitimate, the democratic opposition known as Rukh expected the country to undergo the transition from

¹¹⁸ Balmaceda, *Energy Dependency*.

¹¹⁹ "Corruption Perceptions Index 2011," *Transparency International*, 2011.

¹²⁰ Taras Kuzio, "Oligarchs Wield Power in Ukrainian Politics," *Eurasia Daily Monitor* 5 (2008).

Soviet socialism to political democracy and market economy. However, Kravchuk disappointed the country and simply “adopted a new political language while preserving the old state machinery.” He wanted to distance Ukraine from Russia but overnight millionaires began to gain power.¹²¹ Soon the president was more concerned with balancing the various oligarchs and the demands, rather than democratic control and institutional means of policy-making.¹²²

When the 1994 presidential election occurred, Leonid Kuchma exploited the economic catastrophe and called for the rebuilding of Russian ties. His tendency of reciting promises of Russian alliance restoration but maintaining an independent foreign policy gave the new Ukraine ruling elite legitimacy. Business Administration Groups (BAGs) began to form through patron-client relations. Political support in exchange for economic favors became a common practice. BAGs built their own parties based on important oligarchs and not a shared ideology. Kuchma favored these wealthy men as long as they continued to financially boost the executive power. Since oligarchs were divided into many different factions, there was no opposition majority and Kuchma was always able to garner support when necessary.¹²³ In March 1994, business directors were the 3rd largest individual group in the Ukrainian parliament, the Rada. The energy sector was the most successful in gaining representation of wealthy actors, electing 15 deputies.¹²⁴ Directors of small and medium-sized businesses were frustrated by the legal inactivity regarding privatization and hoped they could start more business-oriented legislation in the Rada. Large business actors were simply looking to protect themselves from the state and keep as much of their profit as possible. In 1995, the Rada passed the Power Bill, which put the parliament in charge of approving the list of enterprises to privatize and controlling the State Property Fund.

¹²¹ Serhy Yekelchuk, *Ukraine: Birth of a Modern Nation*, (Oxford: Oxford University Press, 2007).

¹²² Balmaceda, *Energy Dependency*, 85.

¹²³ Balmaceda, *Energy Dependency*.

¹²⁴ Puglisi, “Ukrainian Oligarchs.”

Perhaps the most powerful motivation behind mixing in politics was the guarantee of immunity any Rada member receives from charges on almost any crime.

Scholars have discussed this kind of political economy of corruption and agreed that consequences include bureaucratic delays, slowed growth, decreased legitimacy of government, and inefficient privatization.¹²⁵ Because of the informal networks formed between the elite circles, oligarchs refuse to deal with those they do not know in fear of being exposed. They rather keep inefficient methods that are benefiting a few instead of risking the upheaval of the whole system. With nine out of ten Ukrainians believing corruption is common in the country and 73% saying that corruption is considered a fact of life, change does not seem to be in the future.¹²⁶ If people believe that corruption has become a norm, they will see no incentive to fight against the crisis and it will continue to penetrate all industries. In addition to the normalcy of corruption, I will use Balmaceda's mechanisms to look at how corruption affects the gas sectors. She closely examines the system of interest articulation, the role of the president and the role of the parliament.¹²⁷ As seen in Figure 2, weak government institutions had consistently low capabilities to control the corruption, mainly because they were the chief culprits. I will analyze this inability to restrain corrupt activity and how the president often perpetuated the problem further.

Figure 2. Control of Corruption

¹²⁵ Susan Rose Ackerman, "The Political Economy of Corruption," in *Corruption and the Global Economy*, ed. Kimberly Ann Elliott (Washington: DC: 1997), 31-60.

¹²⁶ International Foundation for Electoral Systems, "Key Findings: Public Opinion in Ukraine," *USAID* (July 2011).

¹²⁷ Balmaceda, *Energy Dependency*.

QuickTime™ and a
decompressor
are needed to see this picture.

Source: Daniel Kaufmann and Aart Kraay and Massimo Mastruzzi, “The Worldwide Governance Indicators: Methodology and Analytical Issues,” *World Bank Policy Research Working Paper* 5430 (2010).

As I prove how corrupt practices and influential oligarch elites result in poor management practices, I will address Ukraine’s inability to realize the issues of dependency. The country’s energy policy is simply another example of the government’s tendency to ignore lasting reform. Massive natural gas reserves have been treated as political trophies. The need for predictability, transparency, and dependability in gas supply has rarely been the main influence in energy policy. People have accepted corruption in their lives and do not feel the need to fight against a fraudulent way of life. Figure 3 shows that over the past five years, the percentage of the population that has been involved in some sort of corruption has been stable around 60%. This astronomical number signifies how deeply entrenched corrupt attitude has become in Ukraine, allowing members of the gas industry to continue rent seeking with no opposition. Each

succeeding president has succumbed to pricing battles with Russia and corrupt intermediary companies, resulting in ineffective gas consumption that leads to major debts.¹²⁸

Figure 3. Involvement in Corruption

QuickTime™ and a
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are needed to see this picture.

Source: Data from European Research Association, *Corruption in Ukraine. Comparative Analysis of National Surveys: 2007–2009, 2011*, (Kyiv: 2011).

I will discuss the economic downfalls of corruption first, looking at Ukraine's ineffective ability to consume gas. Luong and Weinthal claim that corrupt business practices lead to great inefficiency in the gas industry.¹²⁹ With almost a trillion cubic meters of natural gas in reserves, Ukraine has the potential to be much less dependent on Russia for its gas imports. Before the collapse of the Soviet Union domestic gas production reached a high of 69 billion cubic meters (bcm). It has decreased to below 20 bcm and Ukraine is dependent on Russia for almost 60% of its imports. Scholars have argued that if privatization conditions did not pave the way for corruption to form, Ukraine could be more than 50% self-sufficient in gas. It is the third largest

¹²⁸ Jonathan Elkind and Edward Chow, "Don't Act Surprised," *New York Times*, 7 January 2009.

¹²⁹ Luong and Weinthal, *Oil is Not a Curse*.

gas consumer in continental Europe and even though it consumes two-thirds as much gas as Germany, Ukraine's GDP is less than 5% of Germany's.¹³⁰

In addition to ineffective use of its reserves, Ukraine has wasted its advantage as the major gas transit country between Russia and Europe. Almost 80% of Russian gas shipments to the EU go through Ukraine.¹³¹ Kravchuk inherited Soviet pipelines with a capacity of 175 bcm per year, but today Russian gas shipments tend to be less than 100 bcm. The Kremlin is also planning pipelines that bypass Ukraine, and if both the Nord Stream and South Stream are completed, Ukraine will be of no value in the gas transit market by 2016. Because of flawed economic reforms at the beginning of independence, Ukraine established itself as an unreliable partner for both the East and West. The country has tried to use its leverage as the connection to Europe, but as the previously mentioned pipelines are being constructed, Ukraine is rapidly losing any control over the gas situation. Energy efficiency has been advertised as the surest way to increase Ukrainian security for over 20 years, yet the gas sector is still completely overrun by businessmen.¹³² Even with large reserves, the inefficiency causes Ukraine to have very little access to its own resources.

As corruption leaked into the gas sector after independence, the criminal activity soared in Ukraine. To analyze Balmaceda's claim that informal financial systems arose from corrupt systems, I will briefly look at the creation of RosUkrEnergo as a clear example of Ukrainian reform meant to illegally harbor financial interest in the hands of few. In 2004, the intermediary company was established as a way to transport gas between Russia and Ukraine, and hopefully

¹³⁰ Edward Chow, "US Analyst: Ukraine can be more than 50% self-sufficient in gas if eliminates corruption," *ForUm*, 1 February 2012., <http://en.for-ua.com/analytics/2012/02/01/162456.html> (accessed 8 Apr 2012).

¹³¹ "Russia halves Ukraine gas shipments," *The Business Recorder*, 30 March 2012, <http://www.brecorder.com> (accessed 28 Mar 2012).

¹³² "Ukraine's huge energy efficiency potential is key to improving its energy security" (2006), *International Energy Agency*, http://www.iea.org/press/pressdetail.asp?PRESS_REL_ID=186 (accessed 8 Apr 2012).

reduce prices. Gazprom owns half of the company and Swiss-registered CentraGas Holding AG controls the other half. Since the Ukrainian oligarchs that were the driving force behind this Swiss company wished to remain unknown in the process, RosUkrEnergo slid into deeper corruption. While many thought that the Ukrainian half would be put into the hands of the state, the oligarchs managed to use their power in politics to secure this position in the gas industry. It soon leaked that one single businessman, Dmytro Firtash, owned 90% of Centragas and effectively was in charge of Ukraine's gas consumption, production and purchase.¹³³ It is not surprising that a billionaire would prioritize his own needs before the needs of poor citizens, but it is shocking that a nation's government would allow this kind of ownership.

Politically, Ukraine's high level of corruption stems from the presence of a very strong executive branch. In theory, a powerful president with "wide-ranging powers can quickly implement a comprehensive reform program" and transition Ukraine into a successful postcommunist country.¹³⁴ However, presidents like Kravchuk and Kuchma harbored their executive power and only reformed what benefitted the upper circles of society. Today, President Viktor Yanukovich continues to deny pressure from the International Monetary Fund to implement long-term reforms and surround himself with family clans. The culture of patronage networks began when more than 200 members of Kuchma's clan of Dnipropetrovsk moved to Kiev to take key positions in the government and control resource allocation. Immediately, matters concerning the presidency were conducted behind closed doors with no public influence. Likewise in 2010 when Yanukovich became president, his Donetsk clan swarmed the capital and gained both wealth and power. With the restoration of the 1996 constitution, he gained much

¹³³ Hans Stege, "RosUkrEnergo background and thoughts on its future," *Kremlin Inc.*, 26 October 2007, <http://kremlininc.wordpress.com> (accessed 9 Apr 2012).

¹³⁴ Robert Orrton, "What Hinders Reform in Ukraine?" *PONARS Eurasia Policy Memos* 166 (September 2011)

greater presidential power.¹³⁵ Since the beginning of Ukrainian independence, many have acknowledged that “business in Ukraine if it is not entirely criminal is semi criminal.”¹³⁶

The semi-presidential system in Ukraine has greatly influenced the outcome of economic policies, especially due to the fact that it often behaves in the way of superpresidentialism. With power concentrated mostly in the hands of the president and personality politics prevailing, it is difficult for any strong opposing parties to form. In Ukraine’s government system, formal and informal power is completely in the hands of the president. It is the highest position and the most desired one for ambitious politicians. The problem occurs when the prime minister position is used as a stepping-stone to the presidency. As an office of high national recognition in a country where personality and wealth is more important than actually ideology, prime ministers have the ability to organize formal electoral supporters. Using the high national power, serving as a prime minister often has the potential to place the politician in the presidential race.

In addition to a powerful executive, Ukrainian government is governed by the Rada, which determines the basic principles of domestic and foreign policy. As I discussed earlier, parliament was in complete control of the privatization process after independence. They have the power to introduce changes to the highly contested Constitution, as well as approving the state budget. Proving to be detrimental to the sincerity of government, voting patterns were often based on clientelistic and not ideological preferences. Deputies are swayed by any kind of bribe and will vote the ways that financially benefit them in the short-term. The President often uses tactics such as buying votes and intimidating opponents to pass certain laws. However, this kind of bribery also instills an anger in the deputies that causes major infighting. Because of the Parliament’s power to dismiss cabinets, semi-presidential systems experience very quick

¹³⁵ Anders Aslund, “All Power to ‘The Family’,” *KyivPost*, 27 March 2012, <http://www.kyivpost.com/> (accessed 8 Apr 2012).

¹³⁶ Puglisi, “Ukrainian Oligarchs.”

turnovers in governments. As soon as the executive branch acts in a way that the Parliament disproves, it is possible for them to change cabinets.¹³⁷ This kind of constant change does not prove conducive to forming a comprehensive energy policy. Instability in the government means policy goals are continuously being transformed.

After understanding the way both the executive and legislative branches work, it is important to analyze how the constant infighting leads to troubled gas policies. As early as 1994, President Kuchma fought with the elected Rada and pushed the limits of presidential powers. This created a tradition of distrusting the capabilities of the government.¹³⁸ Ten years later when Ukraine's civil society surprised the world with the Orange Revolution, citizens believed corrupt practices would be over in every industry. President Yushchenko and Prime Minister Tymoshenko joined their blocs together to pursue a new Ukrainian government, particularly emphasizing the need for clean, fair, and long-term energy policy.¹³⁹ Tymoshenko began to conduct intensive investigations into Naftogaz's debts and RosUkrEnergo's profits. Yushchenko was soon pressured by oligarchs to stop Tymoshenko's risky behavior into cleaning up the energy industry, and Tymoshenko was dismissed.¹⁴⁰ Within one year, the calls and fervor of the Orange Revolution were dismissed due to the power of corrupt money. Tymoshenko took the chair of Prime Minister again in 2007 but within years was charged with misusing her public office in gas affairs. By signing a 2009 agreement to seize 11 billion cubic meters of gas from RosUkrEnergo, Tymoshenko made major enemies in oligarch circles. She hoped to completely shut down these intermediary companies, but Firtash and other wealthy men eventually found a

¹³⁷ Oleh Protsyk, "Troubled semi-presidentialism: stability of the constitutional system and cabinet in Ukraine," *Europe-Asia Studies* 55 (2003): 1077-1095.

¹³⁸ Yekelchuk, *Birth of a Modern Nation*.

¹³⁹ Balmaceda, *Energy Dependency*.

¹⁴⁰ "Profile: Yulia Tymoshenko," *BBC News*, 13 December 2011, <http://www.bbc.co.uk/news/world-europe-15249184> (accessed 9 Apr 2012).

way to put Tymoshenko in jail.¹⁴¹ The government quickly called it a case of high treason because the former PM pushed Ukraine further in debt. RosUkrEnergo would not be shut down and now all of the seized gas would have to return, a difficult task when the country was known for its inefficient energy consumption.

It has been almost ten years after the Orange Revolution when the leadership promised to clean up the gas industry but Ukraine is now back in the hands of Yanukovich. Russia and Ukraine continue to wage price wars against each other, with oligarchs gaining more and more individual powers in major gas companies. With Naftogaz continuously loaning money from Russia with no means of repaying, the future of Ukrainian energy management looks bleak.¹⁴² Oligarchs like Firtash are gaining both political power and economic wealth, and there are very few opposition individuals with any legitimacy. Last year, Yanukovich proposed anti-corruption bills and boldly stated that the country's corruption posed an "immediate threat to constitutional rights and freedoms of citizens." While the bills allow monitoring the incomes of elected officials and seizure of assets tied to money laundering and terrorism financing, there is little hope that these will change the social culture in Ukraine. Yanukovich has been adamantly saying he wants to clean up the country, but it is hard to believe a president who appointed family members to every high ministry position.¹⁴³ According to polls done by the Razumkov Center, 54.6% of Ukrainians do not support Yanukovich. In a survey asking what profession citizens trusted most, politicians were only ranked higher than prostitutes. Since the people of Ukraine hold the government in such low rankings, they will not be interested in any supposed

¹⁴¹ Pavel Korduban, "Ukraine Shows no Hurry to Return Gas to RosUkrEnergo," *Eurasia Daily Monitor* 7 (July 2010).

¹⁴² "Ukraine's Naftogaz seeks \$2 billion Gazprombank loan," *KyivPost*, 30 March 2012, <http://www.kyivpost.com> (accessed 10 Apr 2012).

¹⁴³ Samuel Rubinfeld, "Ukrainian Parliament Passes Several Anti-Corruption Bills," *The Wall Street Journal*, 8 April 2011.

reforms the president encourages. The gas crises between Ukraine and Russia is one the most discussed issues in the energy security, yet the majority of Ukrainian citizens only claim to “know something” on the matter.¹⁴⁴ With each passing year full of presidential scandals and oligarch control, Ukrainian government is distancing itself from the citizens. Presidents and prime ministers fight with each other rather than presenting comprehensive plans. With no desire to risk safety for the benefit of the country Ukraine will remain stuck in this mixed business-political realm.

Divided National Identity

As a unified national identity kept Estonia focused on their reorientation towards the West, Ukraine’s divided population has continuously toggled its identity between East and West. During the times of the USSR, Ukraine’s identity was completely defined by the Soviet politics and actions against Europe. When the Soviet Union collapsed, the basis for Ukraine’s identity for the past 70 years crumbled alongside. The immediate task was to decide what the new source of inspiration for identity would be: OSCE, EU and NATO or CIS and the Common Economic Space. During Kravchuk’s regime, European protection was more important than European values. The president used the West as security against anyone trying to take away Ukraine’s newfound independence.¹⁴⁵ With Kuchma’s election began the tumultuous history of mixed opinions within one country. While the president advocated for a pro-Ukrainian security policy, he believed in the positive outcomes of a Russian alliance. Kuchma became increasingly more

¹⁴⁴ “Do you trust the representatives of the following profession?” *The Razumkov Centre*, 2006, http://www.uceps.org/eng/poll.php?poll_id=254.

¹⁴⁵ Oliver Schmidtke and Serhy Yekelchuk, *Europe’s Last Frontier: Belarus, Moldova, and Ukraine between Russia and the European Union*, (Palgrave Macmillan, 2007).

dependent on small group of oligarchs and domestic policy centered on appeasing to a few elite members. The EU and NATO offered to work on potential membership, but constant fluctuation in intensity and commitment brought about “Ukrainian fatigue.” International actors could only do so much as long as Kuchma continued to advocate for stronger Russian ties.¹⁴⁶

However, once western Ukrainians got a small helping of EU integration they realized how beneficial Western aid could be to improving their lives. Thus began the regional division of a country. In a country with almost 45 million people, 17.3% of Ukraine’s population is Russian. The former Soviet country is home to the largest single Russian diaspora in the world, and many eastern parts of Ukraine can be compared to Moscow neighborhoods.¹⁴⁷ In the 1994 parliamentary elections, people elected the Communist Party into the majority with 86 out of 338 newly defined offices, signifying the country wanted to maintain the old regime with minor changes.¹⁴⁸ Kuchma’s regime saw more division among citizens as the question of who would be Ukraine’s main ally was asked over and over again. West Ukraine never fully embraced communism as its own, choosing to be more influenced by European neighbors whose architecture and culture flowed over the borders. The East, on the other hand, almost immediately called for a return to Soviet-style economy. These warring sides caused one of the main problems in Ukraine’s inability to manage their energy relationships well; lack of a unified population that could pursue economic reforms in accordance to national identity.

After Kuchma’s period of international isolation due to corruption charges and murder investigations, Yushchenko emerged as a clear Western candidate. On the eve of the Orange

¹⁴⁶ Taras Kuzio, “Neither East nor West: Ukraine’s Security Policy Under Kuchma,” *Problems of Post-Communism* 52 (Sept/Oct 2005): 59-68.

¹⁴⁷ The World Factbook, “Ukraine,” *Central Intelligence Agency Publications*, <https://www.cia.gov/library/publications/the-world-factbook>

¹⁴⁸ Stephen Velychenko, *Ukraine, The EU and Russia: History, Culture and International Relations*, (Palgrave Macmillan, 2007).

Revolution, the nation finally seemed united and alive about their fight for democracy. Ukrainians found a legitimate leader to rally behind who understood that integration with the West could be the next phase of Ukraine's transition.¹⁴⁹ Corruption and oligarchy were supposed to be transformed into transparency and democracy. The standard of living for the average citizen would increase and Ukraine would begin their journey into the European neighborhood. Russian officials attempted to intervene in the presidential elections to help Yanukovich win, but citizens surprised the world and elected the seemingly more democratic president. With dozens of political analysts from the Kremlin producing fake pamphlets about Yushchenko in Kiev, Russian political commentator Andrei Piontkovsky admitted that "the basic strategy [of the outside political image makers] is aimed mostly at the Russian population of Ukraine, to portray Yushchenko as a Russophobe and Ukrainian nationalist and to provoke an ethnic split in Ukrainian society."¹⁵⁰ Due to this Russian involvement, many regions in the geographic center of Ukraine as well as the political center were drawn to Yushchenko and away from Russian bribes. As seen on Map 3, Yanukovich won regions around the Crimea and right on the eastern borders, areas that have historically always been pro-Russia. Contributing to this small victory for Yanukovich was the Russian offering of special travel cards and passports for Ukrainians who pledged allegiance to Russian culture. Ukrainian citizens could enter Russia without visas and they would hold the same rights as Russian citizens. While in many Eastern provinces this was an ideal offer, opposition parties saw it as Russia's complete misunderstanding of Ukrainian domestic policies and its attempts at nation-building.¹⁵¹

Map 3. Results of 2004 Presidential Election

¹⁴⁹ Schmidtke and Yekelchik, *Europe's Last Frontier*.

¹⁵⁰ Taras Kuzio, "Russian Policy during Ukraine towards Elections," *Demokratizatsiya* (Fall 2005): 491-518.

¹⁵¹ Taras Kuzio, "Russian-Ukrainian Gas Crisis Fuelled by National Identity," *Eurasia Daily Monitor* 6 (2009).



Source: “2004 Presidential Election,” *GlobalSecurity.org*, <http://www.globalsecurity.org/military/world/ukraine/election-2004.htm>.

The Orange Revolution intended to make dreams of European democracy come true, yet a mere few months passed and the content of the national identity began unraveling. As soon as street protests were over, opposition leaders could not agree on any reforms. Tymoshenko accused Yushchenko’s cabinet of large-scale corruption, and he accused her of siphoning additional profit from gas revenues.¹⁵² Criticism from the Rada meant the President had to succumb and appoint Yanukovich, his rival, as new Prime Minister. Yushchenko still spoke adamantly about EU relations but in 2006, Russia cut off all gas supplies due to unpaid bills. Occurring right before the March parliamentary elections, Yushchenko’s government argued that the Kremlin acted politically to stimulate support for Yanukovich and his Party of Regions. After the incident of Russian gas bullying, Yushchenko began to mute his avowed European dream. Ukrainians were disheartened with his lack of action and once again, national identity became divided. The Orange Revolution led many Ukrainians to believe that true national identity was as a European country and Yushchenko would lead them there. Once the gas crisis

¹⁵² Stephen Mulvey, “Ukraine’s Future Looks Less Orange,” *BBC News*, 26 July 2006, <http://news.bbc.co.uk/2/hi/europe/5215210.stm> (accessed 10 Apr 2012).

occurred and Ukraine was made out to be an unreliable partner and consumer, Yushchenko's government lost complete legitimacy.¹⁵³ Kuchma had been accused of ordering the assassination of journalist during his term, yet after Yushchenko and his gas involvement the country felt that Kuchma had been more apt in the presidency.¹⁵⁴

As I turn to examining the importance of national identity through Abdelal's methodology, I will look more closely at candidates' platforms through Ukraine's independent history and uncover how diverse the country's policies have been. Abdelal argues that difference in the content of national identities led to varying government preferences for disintegration and reintegration with Russia. The goals of each country depended on who they thought they were on the international stage. Abdelal chooses to look intensively into the platforms of nationalist political parties, as well as opposing parties to see if they are in consensus. If the national identity of a country is contested, he looks into how strongly parties fight against each other and if there is an ill feeling about the debate.¹⁵⁵ Additionally, it will be important to look at how actively citizens support this national identity presented in terms of civil society.

Before the protests of the Orange Revolution, Kuchma criticized the Western calls for free elections in Ukraine. He had declared that he wanted Ukraine to join the EU but without adopting a Western political-economic system, and also alongside Russia's approval. Kuchma gave speeches claiming that "Ukraine would never be without Kuchma," opposing Yushchenko's forces and their new planned direction for country policy. Regarding energy security, Kuchma's problems began in 1994 when heavily subsidized Russian imports ended. Regional companies began to conduct business by different sets of rules and Ukraine became

¹⁵³ Jim Nichol, Steven Woehrel and Bernard Gelb, "Russia's Cutoff of Natural Gas to Ukraine: Context and Implications," *CRS Report for Congress*, 15 February 2006.

¹⁵⁴ "Who performed better the duties of the president of Ukraine, Viktor Yushchenko or Leonid Kuchma?" *The Razumkov Centre*, 2008, http://www.uceps.org/eng/poll.php?poll_id=148.

¹⁵⁵ Abdelal, *National Purpose*.

economically divided. In opposition, the president created Naftogaz Ukrainy, which effectively put him in charge of the whole gas market in Ukraine. Wielding this new power, Kuchma began to implement policies that prioritized private interest as apposed to national interest. His tendency to conduct business by low levels of transparency caused Western isolation of the country, which in turn split Ukraine's national identity.¹⁵⁶ Half of the country was devastated that Europe had gotten tired of helping Ukraine, while the other half was waiting for Russia to re-open its borders. A divided Ukraine led to a lack of a coherent economic policy, and so Kuchma decided to only please oligarchs who could help re-elect him in the next election.

With Yushchenko as president, Ukraine's national identity had an opportunity to unify and combat the country's energy dependency. As head of the Our Ukraine party, he campaigned on a platform that "advocated more ties to Europe and the West, greater openness in governmental affairs, and a re-examination of some of the business deals that the Kuchma government had entered into that gave away the formerly state-run enterprises to the powerful Ukrainian or Russian oligarchs."¹⁵⁷ He believed in the power of allowing foreign investment in order to introduce transparent methods into the business system. Yanukovich in 2004 was seen as the possible continuation of Kuchma's regime marked by "unpopular administration accused of corruption and economic mismanagement."¹⁵⁸ He had the open support of Putin and the Kremlin, and many groups of oligarchs who feared Yushchenko's anti-corruption plans. Both leaders had different ideas of what Ukrainian identity should be, but in the end Ukrainians agreed that EU integration was an idea that they should rally behind. When Yushchenko won, he stated, "this is a victory of the Ukrainian people, the Ukrainian nation. We were independent for 14

¹⁵⁶ George Mossessian, "Ukraine's Energy Policy Under Kuchma and Dependence on Russia." *UC-Davis Paper*.

¹⁵⁷ "Viktor Yushchenko," *Encyclopedia of World Biography*, <http://www.notablebiographies.com/news/Sh-Z/Yushchenko-Viktor.html>.

¹⁵⁸ "Profile: Viktor Yanukovich," *BBC News*, 2 March 2010, <http://news.bbc.co.uk/2/hi/europe/4038803.stm>, (accessed 15 Apr 2012).

years, today we became free.”¹⁵⁹ If Yushchenko could have firmly held on to his pro-European ideals, there is a chance that Ukraine could have created a national identity and begun its path to joining Europe.

The ideas of the Orange Revolution began to slowly dissolve a few months after Yushchenko took office. Infighting and corruption charges caused the nationalist bloc to disintegrate and once again allowed Russian-backed leaders to take charge.¹⁶⁰ The problem rests in the fact that Yushchenko and his coalition all held differing views about Ukraine’s national identity. While he wanted to reform the markets of Ukraine in order to form closer relations with the EU, the president also demanded on using intermediary companies for natural gas negotiations with Russia. There was not a specific goal, even amongst a seemingly pro-Western platform. Political leaders called for an overall more independent Ukraine, but the country needed a much more specific national identity to repair such deep divisions. Now with Yanukovich as president, the conflicts between Ukrainians and Russian ethnicity do not seem to be dissipating. A continued lack of unified national interest will allow people to see positive benefits from involvement in corrupt gas deals. If there is no established sense of responsibility to the nation, businessmen do not see the harm of halting reform and illegally receiving rents.

Any sort of comparison of East and West ignites a sense of deep competition. In a recent poll regarding ideology, three cities represented East, West, and Central Ukraine. Results showed that Lvov supported the national-democratic parties, Donetsk the Communist ideals, and over two-thirds of Kirovograd’s citizens were “hesitant to decide the most acceptable ideology.”¹⁶¹

¹⁵⁹ “Yushchenko wins Ukraine election,” *BBC News*, 27 December 2004, <http://news.bbc.co.uk/> (accessed 15 Apr 2012).

¹⁶⁰ Mark Medish, “Ukraine’s Presidential Election – The End of the Orange Revolution,” *Carnegie Endowment for International Peace*, 8 February 2010.

¹⁶¹ “Ukraine: West-Center-East – Unity in Diversity,” *Research and Branding Group*, 2 April 2012, <http://www.rb.com.ua/eng/projects/omnibus/8393/> (accessed 15 Apr 2012).

Kirovograd is located directly in the center of Ukraine. In addition to ideology, the question of European or Russian alliances is also separated down the middle of the country. Public opinion polls show that in the West, 77% of the population supports an international economic union with the EU, while in the East more than 50% support a customs union with Russia, Belarus, and Kazakhstan.¹⁶²

Following Abdelal's model of content and contestation, Ukraine's national identity cannot be described as weak. Nationalists fervently called for their ideas, but citizens did not agree on the meaning of a Ukrainian identity. The country was too regionally fragmented for the government to make a decisive break from Russia, but the nationalism was also too developed to allow unions with the CIS. Ukraine attempted to have partial membership with both non-state actors and just as partial economic reform failed, partial national identity did not succeed. Even elites in Ukraine were not unified under one identity. In comparison to a Russian elite that pursued national interest through energy coercion, the Ukraine elites were rather pursuing private economic interests through energy policy.¹⁶³ During the Orange Revolution, oligarchs were divided. Three groups provided funds, while other clans sat idly on the side to wait out the revolution. After Yushchenko's election into office, the Dnipropetrovsk clan notably left politics and other smaller oligarchs decided to begin their careers in government positions. As I mentioned before, the lack of a national identity meant that even elites had nothing to unify around. The massive rents available in the energy sector caused the most powerful people in Ukraine to scramble with no plan.

¹⁶² "Public Opinion Survey – Residents of Ukraine" (2011), *International Republican Institute*.

¹⁶³ Juliet Johnson, "Comments on: Fatal Attraction: Rents of Dependency, Energy Dependency, and the Yushchenko Presidency," in *The Second Annual Danyliw Research Seminar in Contemporary Ukrainian Studies* Ottawa, 12-14 October 2006 (Ottawa: University of Ottawa, 2006).

Summary

Evidence from Ukraine's history depicts a completely different story than Estonia's path after independence. As a former Soviet republic with strong Soviet identity, the situation proved not ideal for quick privatization. Ukraine has fought to keep its gas business under state control, while partially reforming other sectors in order to seem progressive. This partial reform has allowed a small circle of elites to benefit quickly and greatly. A lack of foreign investment in Ukrainian gas business means firms are held to no higher standard, which almost always results in corrupt officials. The choice to leave natural gas companies in state ownership control has completely mixed the economic and political spheres in Ukraine. Gas enterprises perform poorly with no consequences and managerial rent seeking has become the business norm.

As a result of state ownership implementation, certain informal networks formed in the gas industry. Ukraine suffered from a complete collapse into corruption. A majority of the population believed bribery and fraud were just another part of everyday life, letting the dangerous cycle of informal and formal power continue to govern gas problems. Even leaders who were supposed to uphold Western business standards later fell victim to the attraction of quick rents. Problems arose from semi-presidentialism, leaving all of the power to individuals who prioritize personal interests over benefits for the greater good. The feuding system of policy-making, as well as the president's priority of balancing oligarchs, contributed to constant corruption. Lack of transparency allowed this system of reinforcing power to function and deterred any foreign investment.

National identity, when unified and agreed upon, kept business and political leaders from slipping into the rent-seeking world. Ukraine experienced the exact opposite of a unified country.

The nation was split regionally, with Westerners calling for pro-EU reforms and Easterners waiting for an invitation to a reformed Russian union. There was disagreement in every cabinet that passed through power about what direction Ukraine and its gas industry should take. Because of the underdeveloped sense of national identity and interest, Ukrainian leaders weren't able to resist the temptation of easy rent seeking through energy contacts. The country has periodically tried to decrease dependence on exports from Russia, but citizens are not ready to sacrifice in the short-term in order to benefit in the future. Additionally, business leaders saw that complete reform was never as lucrative and corporate interests always conquered national interests. Some have pointed out that Ukraine is much larger than Estonia, therefore making it harder for people to unite under certain causes. However even if the country were cut down in size, the Ukrainian national identity would still be a high divided issue.

Conclusion

With the collapse of the Soviet Union came division of energy resources. Countries that were accustomed to easily obtaining cheap natural gas from Russia were now forced to depend on one country for imports. As much as energy management is determined by political and economic policy, ideology proved to play a major role in the former republics. Countries in the Baltic immediately established themselves as former European nations returning to the neighborhood. Eastern European countries faced a larger problem due to Russia's pull into its sphere of influence. Combined with a completely divided population, nations failed to establish not only a comprehensive energy policy, but also a clear and complete transition reform. Energy dependence became the top priority as countries reorganized after the collapse.

By looking at the past and present of energy history in Estonia and Ukraine, I was able to illustrate the drastic differences between two countries in the post-Soviet Union era of energy politics. My case studies depicted two sides of the energy management spectrum and the research enabled me to conclude that three specific variables work together to either enhance or hinder the implementation of a successful energy policy. The level of privatization, presence of corrupt oligarchs, and unified national identity influenced the diverging paths that energy management took in Estonian and Ukrainian history.

Looking towards the future, Estonia will continue to work on decreasing their dependence level. There is not as much worry for Estonian progress, due to its strong institutes and cooperative government. They should be looking towards options of diversification, such as consortiums with the Nordic countries and heavier involvement in EU gas markets. The chance of conflict is now low because of Estonia's full integration in the European Union. If Russia were to shut off gas to the Baltic country, there is a large chance the EU would have to

economically or politically intervene. Estonia's focus should be looking for the most economic diversification path and continuing their diplomatic approach to Russian high gas prices.

The next question that one would posit is whether or not there is potential change in the future for Ukraine. Estonia's example of energy management can serve as a goal for Ukraine, but are the realities of entrenched corruption in the gas sector too dark for improvement? First, Ukraine needs to realize that both the US and the EU will not provide much assistance in the near future if Ukraine doesn't show minor improvement. In the Western sphere, countries are facing internal economic issues that are not improving. News in US is now centered on the upcoming presidential elections, causing foreign policy to shift towards countries in the Middle East. Additionally, the US will not be quick to forget the multiple years of corrupt attitude at the beginning of Yanukovich's term. With increased democratic backsliding in Ukraine came decreased American support. In terms of the EU, the euro economic crisis has controlled the political conversation. European leaders will not discuss the expansion of a community that is economically failing to include countries like Ukraine, which experience trouble taking care of their own populations. At the time of his election, Yanukovich vowed to improve relations with both of Ukraine's neighbors. However, his idea of a suppressed democracy has slowly been pushing Ukraine further into the Russian sphere of power. Before discussing gas politics, Yanukovich will have to decide if he wants to pursue a strong relationship with Western power or create an authoritarian government system.

The country has passed multiple reform plans for the natural gas industry, but the problem lies with insufficient implementation power. Reforms are slow and never fully completed, mainly due to the financial hardship they would cause in the short-term. The first step is to conduct institutional reforms in order wipe out the Soviet legacy. If the security apparatus is

not purged of its corruption inheritance and lack of professionalism, the business and political ways of the past will continue to resonate in policy actions. With Yanukovich slowly pushing the country towards authoritarianism tendencies, the Rada needs to have enough power to veto his laws. The key to successful reform rests in state institutions that are strong enough to implement the rule of law, but not to interrupt the political freedoms of its citizens. With institutional reforms, anti-corruption committees and organizations can be formed and enforced with real political power.

In discussing the Parliament, Ukraine needs to conduct a new ruling on the presidential reform that was overturned in 2010. The law that was passed in 2004 gave the Rada the right to appoint the prime minister and most of the cabinet members.¹⁶⁴ Two years ago in 2010, the constitutional court reversed the law, stating it was unconstitutional. This recent ruling cemented Yanukovich's super-presidential power, and essentially ended hope for any new reforms. Now the president can place his close economic contacts into powerful political positions, reinforcing the cycle of informal networks. Ukraine needs to purge itself of such a strong presidential figure. If the country hopes to attract European or American financial aid for reforming economic and political sectors, it needs to show that there have been at least minor attempts at loosening the executive grip on the country.

The question of oligarchs is one that is hard to solve. How does a country that has been influenced by oligarchs since its independence all of a sudden decrease their power? In addition to the gas industry, which I will address next, Ukraine needs to begin full privatization of its larger enterprises. Furthermore, foreign investment is the solution in this case. With foreign companies buying shares in Ukrainian companies, economic considerations are typically the first

¹⁶⁴ "Ukraine court boosts powers of President Yanukovich," *BBC News*, 1 October 2010, <http://www.bbc.co.uk> (accessed 25 Apr 2012).

priority, not domestic political concerns. In addition, Ukraine needs to open up its market to the global economy to set standards for performance. State ownership companies are not responsible to anyone and losses on an annual basis do not result in any drastic consequences. The government sets a state budget, but it carries no value and allows poor performance in the public sector. It is time for Ukraine to start establishing realistic goals, ones that can be met with small successes at first.

When specifically addressing the natural gas industry, Ukraine has opportunities due to its abundance of reserves. If domestic abilities are not quite capable of tapping into their own reserves, than Ukraine should be selling those rights to major global companies. In addition to acquiring foreign bidders for their reserves, Ukraine needs to begin discussing diversification seriously. By promoting unrealistic goals in terms of dependence, the government gives a faulty sense of security to its people and even to its own leaders. In recent news, Ukraine has been constantly discussing its plans for decreasing dependence. The European Union has declared a modernization initiative with Ukraine, giving objectives to the country for upgrading their gas transportation system (GTS). The country has discussed reversing the GTS so it could import gas from the European Union. Naftogaz is considering planning short-term contracts with a German company through Slovakian pipelines. Ukraine has even officially declared its intentions to invest almost 800 million Euros in the trans-Caspian pipeline, resulting in the transport of liquefied natural gas from Georgia to Ukraine and bypassing Russia.¹⁶⁵

However, the continual problem is that all of these plans are contingent on Ukraine following through. The country may have announced grand plans and intentions of energy improvement, but for now they are just ideas with no formal structure. Unfortunately for

¹⁶⁵ “Ukraine Heads Towards Gas Supply Diversification,” *LNG World News*, 26 April 2012, <http://www.lngworldnews.com> (accessed 26 Apr 2012).

Ukrainian prospects, the country has a history of falling through in terms of reform. The question now is how much more conflict can Ukraine take? Have prices and tensions reached an all-time high point that will prompt the country to undertake serious reform? If Ukraine does not begin to reform any of the numerous problems in its society, the world will begin to lose all interest in helping. Without any foreign influence, Ukraine may slip back into the overwhelming Russian power sphere and the gas problem will expand to involve European countries.

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