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## INSIDE UKRAINE

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The International Center for Policy Studies (ICPS) restores issuing analytic paper «Inside Ukraine», the last issue of which was prepared in September 2010.

The aim of the publication is to provide objective information on current political events in Ukraine and thorough analysis of major tendencies in domestic politics. Such analysis will assist in setting priorities in the process of implementing reforms in Ukraine and in evaluating quality of state decisions from the viewpoint of their impact and sustainability. Special attention is paid to evaluation of political competition in Ukraine and ability of key political players to address challenges.

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## 1. The Government Policy

ATO forces encircle major separatist centers in Donetsk, Luhansk and Horlivka. Deterioration of humanitarian situation in these cities due to long-lasting hostilities will speed up actions of the Ukrainian army. At the same time Russian informational war against Ukraine gains new features. In different regions rumors are circulated to spread panic among the population and undermine trust to political leadership of the country. Lack of systemic government information on ATO losses and conscription becomes a fertile ground for officials being accused of censorship and hiding the truth.

Key political players have agreed to hold consultations on changes in electoral law and introduction of proportional representation system with open lists. Parliamentary parties are interested in preservation of the current system, yet under social pressure they can make certain concessions as regards organization of electoral process. The most feasible options include mixed system or proportional representation system with closed lists, but minimal electoral threshold.

A major drawback of PR system with open lists is complexity of election process and vote count. However, Finland uses a type of the system which is rather easy from technological viewpoint and representative – from the political one. It totally fits Ukrainian realities. Voters vote for MPs in districts. The party result is a total result of its candidates, while order in the party list is defined by a number of voters who supported the candidate.

### *1.1. ATO in cities and new forms of informational war*

A circle of ATO forces around Donbas cities such as Donetsk, Luhansk and Horlivka gets tighter. A major task for the government troops is to make plans on liberation of these cities as soon as possible.

For the last weeks Ukrainian soldiers squeezed separatists from many towns in the region. Meanwhile, the hostilities took place around strategic, yet rather small towns of Luhansk and Donetsk regions. Understanding the danger to be surrounded, terrorists retreated to larger centers, thus concentrating their forces. In their turn, ATO forces managed to divide territory controlled by separatists and thus split them in several groups.

The need to elaborate plans how to liberate large cities within next weeks is defined by deterioration of humanitarian situation there. Due to long-lasting hostilities, transport infrastructure is destroyed, drug stores and shops are closed, there is deficit of fuel and potable water. Municipal utilities do not function properly: they do not disinfect water, do not repair damaged electric networks or collect garbage. In summertime these factors may lead to deterioration of epidemiological situation in these cities. Besides, separatists shelling residential area destroyed a significant share of blocks and killed a lot of civilians.

Government creates “green” corridors for the residents of the above mentioned cities, but few people have used them. Those who were able to leave ATO zone left the cities several weeks ago. According to different estimates, 300 000 people have left 400-thousand Luhansk. The rest are unable to do it due to destroyed transport infrastructure, fear to be killed on the way as well as due to terrorists forbidding men to leave.

According to the National Security and Defense Council, for four hours of August 4, 2014, 350 people used humanitarian corridor from Luhansk to Shchastya. The problem is that many people are unaware that these corridors exist.

Russian informational war against Ukraine gets new features. Earlier it was waged through the Kremlin-controlled media. Nowadays Russian TV-channels are cut off in Ukraine and media resources which present Russian view on events in Ukraine are discredited with numerous cases of disinformation and blatant lie. Therefore, the focus was shifted to circulation of rumors. In various regions of Ukraine there appear similar simple messages which are easily caught by the

***ATO forces  
approached  
Donbas cities of  
Donetsk, Horlivka  
and Luhansk***

***Government  
creates  
humanitarian  
corridors for the  
residents of the  
above mentioned  
cities***

population. They may be categorized as informational campaign aimed to deepen division between people in Western Ukraine and IDPs from ATO zone, which will create conditions for more protracted civil conflict in the country.

Russian mass media draw a lot of attention to Ukrainian protests against partial mobilization. Security Service of Ukraine even committed Alina Eprimian, journalist of Russia Today TV channel, to leave Ukraine due to attempts to destabilize situation in Zakarpatya region through inciting protests against mobilization. Representatives of ethnic minorities, namely Hungarians in Zakarpatya region and Romanians in Chernivtsi region, play significant role in these protests.

Ukrainian government will be able to minimize the protests if the mobilization process is transparent and law enforcement agencies do utmost to punish office abuse and corruption of enlistment officers. It is important to ensure public control over conscription. There are many reports that mobilization in some regions is more intensive than in the others. Besides, more people are talking about set bribe rates to avoid conscription. Transparency and public control over mobilization will provide for decrease in number of such reports and social tension.

Military and political leadership of the country is suspected of underestimating official losses of the Ukrainian army and attempts to influence information policy of some TV channels as regards ATO progress. It is superimposed by more frequent cases when in the web terrorists post photos and videos of captured Ukrainian soldiers being interrogated or Ukrainian mass casualties near destroyed army vehicles. This tactics is to undermine morale of Ukrainian soldiers and incite panic among civilians.

The only way to oppose informational and psychological war against Ukraine is to provide systemic and objective information on ATO, mobilization and Russian behavior. This information will provide Ukrainians with a more complete picture of situation in Ukraine.

## ***1.2. Opportunities to change electoral system***

The coalition collapse of July 24 drastically decreased chances to adopt amendments to electoral legislation. However, when on July 31 Verkhovna Rada did a confidence vote to Arseniy Yatsenyuk's government, President, Speaker, Prime-Minister and faction heads started consultations on changes in electoral process.

In particular, it was agreed to cut the campaign length from 60 to 45 days. The official reason is to decrease expenditure on the campaign in view of large budget deficit. However, shorter campaign does not influence its cost for the state. Thus, such statements are full of populism. Informally, shorter campaign may be explained with the fact that political parties are interested in new political parties having fewer opportunities to conduct full-scale campaign. Deterioration of economic situation in October 2014, aggravated by the start of heating season, is another argument to hold election as soon as possible.

In legal terms, such idea is difficult to implement. Cut of the electoral campaign goes against current Constitution. It clearly says that elections are held within 60 days after the decision on the parliament dismissal is published. Parliament is unable to adopt constitutional amendments in such short run.

As the electoral system type is not mentioned in the Constitution, Verkhovna Rada has more levers to change the system, but not the campaign length. However, almost all the political players are interested in preservation of mixed system, which will allow many politicians to win in FPTP districts. These MPs will make Petro Poroshenko less dependent on political parties while creating a majority. Meanwhile, on July 31, in Verkhovna Rada it was agreed to hold consultations on introduction of proportional representation system with open lists and on opportunity for electoral blocks to participate in the elections.

PR system with open lists is demand of the society politicians will have to adjust to. Declaration on consultations may be interpreted as a desire to "flirt" with

***Rumors as means of informational war***

***It is important to ensure public control over conscription***

***Politicians started consultations on amendments in electoral process***

***Almost all the political players are interested in preservation of mixed system***

a voter, but these ideas will not get necessary number of votes in the parliament.

The proportional system with open lists has several advantages. A voter gets an opportunity to influence the list of candidates nominated by the party. The role of a party leader and the opportunity to sell places in the party list is diminished. The chances for new political parties to be in Parliament increase, and the composition of the Verkhovna Rada reflects the political mood of the population more correctly.

The main arguments of the proportional system critics are the need to form coalition governments and a significant fragmentation of the party system. However, under the circumstances of current political situation in Ukraine, these disadvantages could become benefits. Moreover, it would allow involving the representatives of different regions in the political process, as well as encouraging renewal of politicians' corps.

At the same time, the process of elections' organization under the proportional system with open lists is quite complicated and takes longer than two months, as stipulated by the Constitution. According to Andriy Mahera, the Deputy Head of the Central Election Commission, the software development alone will take one month. Many resources should be spent for training of the DEC members.

Moreover, with a view to the number of people and parties in Ukraine, it is impossible to organize elections in a single multicandidate constituency, as a voter receives one ballot from each party with 450 names in it. The only solution is to compile regional lists, which will include 5-10 candidates from each party who will compete for 3-5 parliamentary seats from a region. However, counting process will also be very time-consuming and require a corresponding competence of election commissioners.

In this regard, Mr. Mahera believes that in the present context the two most probable options are holding elections under the current mixed system or proportional system with closed lists, but with a minimum electoral threshold. It will create opportunities for new parties. Using a proportional system will allow not to legitimize the annexation of Crimea. It will be inevitable during the elections under majoritarian system, because it is impossible to form constituencies on the peninsula.

The technological problems in the organization of elections can be solved by the use of the Finnish model of the proportional election system with open lists. According to it, the number of seats won by a party depends on the total number of votes received by all its candidates (one candidate - one constituency). The order of candidates in the list is determined by the absolute number of voters mobilized by a candidate. Such an approach creates internal party competition and simplifies counting process, as a voter receives only one ballot. On the other hand, the CEC receives more power, as function of defining final results is transferred to the central level. At the same time, the electoral system used in Finland allows binding a deputy to a particular constituency and makes him accountable to the community. Lack of this relation is the main argument of the proportional electoral system critics.

***While being rather complex, the proportional system with open lists has several advantages***

***Finnish electoral system makes party candidates accountable to the community***

## 2. Economic Situation

State Committee of Statistics published macroeconomic indicators for January-June 2014. They continue showing negative trend. A major reason is hostilities in the East and trade war with Russia.

Together with budget changes, Verkhovna Rada adopted amendments to Tax Code, which foresee changes in tax rates, tax benefits and mechanism of tax administration. In particular, military tax is introduced for individual income, excise for a number of goods gets higher and rent on mineral wealth increases.

### 2.1. State Committee of Statistics declares further recession

GDP drop in 2Q 2014 year over year accelerated to 4.7%. Comparing to the previous quarter, GDP drop in 2Q 2014 also sped up – to 2.3%.

As a matter of comparison, GDP drop in 1Q 2014 yoy made up 1.1%, comparing to 4Q 2013 – 2%.

IMF forecasts GDP decrease in 2014 by 6.5%, World Bank – by 5%, EBRD – by 7%.

Index of consumer inflation grew by 11.6%, of industrial one – by 18%. Taking into account significant increase of prices on industrial products, prices on consumer goods will also grow next quarter.

2014 budget foresees GDP drop by 3% with inflation rate of 12-14%.

Comparing to the respective period of 2013, export fell by 5.1%, import – by 18%. Positive balance made up USD 524.5 mln. (in January-May 2013 it was negative – USD 3372.4 mln.). A major reason for considerable import decrease and positive balance is drastic depreciation of hryvnia.

In mining industry product volumes did not decrease much – by 2.2%, while in processing industry decrease was more significant – 7%. The largest drop was in machine production – 18%, chemical industry – 14.1%, in metallurgy – 8.7%.

War in the East, trade war with Russia and related problems with gas are major negative factors which influence dynamics of macroeconomic trends and real economic sector. Donetsk and Luhansk region provided 16% of overall production in Ukraine. Hostilities there make business impossible and negatively influence industrial production in neighboring regions of Kharkiv and Dnipropetrovsk as well.

Negative economic effect, caused by business problems in the East, will be tangible in 3-4Q. Traditionally, at the end of the year agriculture and food production will mitigate GDP drop. Export oriented industries which do not work on the Russian market may also show positive trend.

### 2.2. Verkhovna Rada adopted amendments to Tax Code

A major innovation in tax changes is the introduction of a military duty. It is proposed at the level of 1.5% of individual income.

The law specifies that the tax will be paid similarly to individual income tax. Administration of the tax is worrisome. According to tax officers, instructions for filing reports and accounts for the tax payments has not yet been identified, although charging starts since August 1, 2014.

In the context of easier administration and control procedures for VAT, the introduction of electronic VAT administration system is definitely a good thing. Other change is the increased threshold for obligatory registration of an enterprise as a VAT taxpayer – from UAH 300 thousand to 1 million. Such increase corresponds to the position of IMF technical experts, who state that such threshold should be around USD 100 000.

The government made concessions to exporters of cereals and industrial crops - they will be exempt from VAT by December 31, 2014. It shows that the

***GDP drop in 2Q  
2014 yoy  
accelerated to  
4.7%***

***War in the East is  
a major factor of  
negative  
dynamics***

***Introduction of  
electronic VAT  
administration is  
a positive  
development***



agricultural complex is a priority as a result of active lobbying by relevant businesses.

Another good thing is that products which are now classified as diet products and contain over 8.5% of ethanol, has been categorized as alcoholic beverages. It concerns “diet” distilled beverages which were sold at pharmacies as medicine with the approval of the Ministry of Health of Ukraine. In addition, such beverages were sold without excise labels as well as no taxes were paid.

The most controversial amendments turned out to be those regarding increasing rent rate for subsoil use for private gas production companies. It is envisaged that by January 1, 2015 the rent for extraction of iron ore will increase from 5% to 8%, extraction of oil – from 39% to 45%, gas deposits within 5 km depth – from 28% to 55%, gas deposits over 5 km depth – from 15% to 28%. The initial version of the draft law provided for higher rates, but, as a result of pressure from interested business associations, the government lowered them. Taking into account a high margin for extraction of minerals, especially ore minerals, the proposed rate rise is justified.

The cancellation of tax benefits for individual income in hotel industry should also be upheld, as these tax benefits were needed primarily during the organization of Euro 2012.

Amendments to the Tax Code will concern excise tax. The excise tax on tobacco again increased by 5%. It is the second time that the excise tax rate has been changed since the beginning of the year. If the excise rate on tobacco continues to increase without valid reasons as well as without taking into consideration the paying capacity of people, the “black market” (smuggling and counterfeit) within this industry will flourish. According to the Chief Scientific and Expert Department of Verkhovna Rada of Ukraine, risk assessment of the excise rise is not properly justified, in terms of possible changes in relevant markets, including their “shadow” sector as well as the financial standing of market players. It may negatively influence budget revenues.

The proposed tax amendments will ensure additional budget revenues, but they are unlikely to improve business. In addition, they offer no solution for major problems with public finances. They will also affect the financial well-being of poor people, especially those for whom official salary is the only source of income. Instead of fighting corruption, removing black market from economy, implementation of effective economic reforms, and deregulation, the government keeps increasing tax pressure on people.

### **2.3. Ukrainian government increases rent rates**

Ukrainian parliament endorsed the government’s initiative on the change in rent rate for subsoil use. In the improved draft law No. 4309a “On amendments to the Tax Code of Ukraine and other legal acts of Ukraine”, the government agreed with private gas production companies on lowering the proposed rates. Rent for subsoil use of iron ore has been increased for the second time within 2014: the first time – from 1.5 to 5%, the second time – to 8%. By January 1, 2015 the rent for oil and condensate will be temporarily increased from 39% to 45% (if the extraction is done within 5 km depth) and from 18% to 21% (if the extraction is done at the depth over 5 km) and the rent for gas that is not sold to households will increase from 28% to 55% (for gas with deposits within 5 km) and from 15% to 28% (for gas deposits more than 5 km deep). It is proposed to keep the rent at the present level from 2015 onwards.

Earlier the government proposed to increase rent rates of gas that is not consumed by households to 70% irrespective of the depth at which the extraction is done (instead of 28% for gas with deposits up to 5 km and 15% - beyond 5 km). However, fixing such a high rate lowered the profitability of exploration and development of gas deposits. Alongside the introduction of taxes, the government stimulates domestic gas and oil extraction and enhances energy independence of Ukraine. The government introduced two-year tax exemption period for every new

***Tax changes in mineral rent caused a lot of argument***

***Permanent increase of tobacco excise leads to increase in smuggling and counterfeit***

***High rent rate regardless of drilling depth has decreased profitability of oil and gas fields exploration***

well (tax exemption totals 50% of the standard rent rate).

However, the increase in rate for subsoil use by industrial companies as well as the increase in taxes on oil extraction may push away potential investors, seeking to operate in Ukrainian domestic market. The increase in tax pressure may lead to general stagnation in the relevant sector, suspension of adopted gas exploration programs and impossibility to develop new projects. By pursuing the goal to replenish state coffers, the government takes steps which undermine prospects for the long-term development of energy sector and eliminate stimuli for attracting investment.

Some provisions of the draft law undermine prospects of alternative energy market in Ukraine. The draft law cancels tax benefits for the companies which generate energy from renewable sources. In the past, in June 2014, according to the Cabinet of Ministers resolution No. 589-p “On improvement of settlement system for electricity from alternative energy sources”, the government proposed to decrease green tariff rate by 40%. The government guaranteed that the rate would not be changed till 2030. Such guarantees provided additional stimuli for investment attraction as payback period for such projects is more than 5 years.

Such government initiatives contradict declared intentions to promote alternative energy sources, energy efficiency, and reduction of gas consumption. Taking into account instability with gas supply to Ukraine, changes in tax legislation, caused by the need to cover budget deficit, go against stimulation of domestic extraction and development of alternative energy declared by the government. Instability and unclear justification of tax changes for energy producers decreases investment attractiveness of the whole sector.

***Some government  
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### 3. Political Competition

A close start of snap parliamentary elections make party leadership round off qualitative and quantitative audit of their members. At the same time, leaders of political parties do not announce publicly their vision of the country development as well as the implementation of much-needed reforms. It is not the competition between political parties as to the technological capabilities of political agitation, but the competition between ideas that should lie in the basis of any elections.

The ultimate reboot of political power will depend on electoral law. The change of electoral system is one of the biggest problems that MPs, civil society and expert community are eager to resolve. The ruling elite may either adopt a law on proportional electoral system with open lists, or improve the current Law of Ukraine “On election of People’s Deputies of Ukraine” dated 2011. In any case, electoral law will be changed to serve the interests of the most powerful stakeholders.

#### 3.1. Political parties are getting ready for electoral campaign

This electoral campaign will be conducted in a short period of time. That is why parties with a wide network of local offices and the most prepared members of commissions as well as political agitators are more likely to succeed. The main task for all central party campaign offices is to build a network of activists in every constituency.

However, analytical work in political parties is not oriented towards elaboration, discussion and implementation of reforms. That is why neither speakers, nor official party’s documents and programmes focus on the importance of systemic state reforms.

Following her defeat at May presidential elections, Yulia Tymoshenko announced reorganization of “Batkivshchyna”, which comprises 600 thousand party members. The results of the reorganization process were presented by Ivan Kyrylenko. Lustration commission expelled 1519 members from the party within 3 months, 726 of which were deputies of local councils. The main reasons for such purge were non-payment of membership fee, no relation between the party member and the party, or collaboration with other parties.

The Party of Regions also found itself in a difficult situation. Being one of the biggest political parties, the Party of Regions had more than 1.5 million members as of spring 2013 (more than 1 million of them were residents of Eastern Ukraine). After the Euromaidan, hundreds of thousands of its members submitted their resignation, their factions collapsed in the Parliament and local councils, local offices of the Party of Regions declared self-dissolution. It is also planned to conduct qualitative and quantitative audit of party members to be overseen by the Head of Central Control Commission and Head of Budget Committee Yevhen Heller.

In order to see the real state of affairs in the party, the leadership of the Party of Regions is planning to hold the party convocation to make rotation in party’s leadership and consider organizational issues. There were organizational meetings with party activists in Kharkiv region, Dnipropetrovsk region as well as Mykolaiv region. The Party of Regions is seeking to secure its influence in main regions in Ukraine’s South-East, where its main competitors may become “Strong Ukraine” of Serhiy Tihipko and “Party of Development of Ukraine”.

“Party of Development of Ukraine”, “Civic position” and “Radical Party of Ukraine” will be busy finding new party members in regions. The aforementioned parties are looking for opinion makers, “new faces” among student activists and students.

Yuriy Miroshnychenko and Serhiy Larin from “Party of Development of Ukraine” regularly visit Sloviansk and other towns liberated from terrorists. They provide humanitarian assistance to people, give money and household appliances to orphanages, hospitals and social centers. The leaders of “Party of Development of

*Technological approach to the organization of elections does not provide for competition of ideas between parties*

*Once the biggest political party in Ukraine, the Party of Regions now has lost many of its members*

Ukraine” use social networks and TV channels, such as “Inter”, to communicate with their voters. Anatoliy Hrytsenko and Oleh Lyashko spend much of their time on working visits to different regions of Ukraine.

Right Sector, Democratic Alliance, “Power of People”, “Democrats”, “Freedom” “New life” do not have enough time to build a network of party offices across Ukraine. The lack of time, limited media and financial resources slow down the process of development of new political forces.

Political parties, which should represent interests of social groups at state level, are instead serving interests of party oligarchs. That is why political parties are far from the implementation of reforms, strategic vision and understanding of state policies. Political associations do not have strategic plans as to their development for the next 5-10 years, as it is the case with political parties in the US and Great Britain.

***New parties do not have enough time to build a network of party offices across Ukraine***

### ***3.2. Electoral system as an object of political trade***

Petro Poroshenko repeatedly stated that electoral system should be changed to proportional system with open lists. Such statement clearly shows that the President seeks to protect himself from civil society’s criticism and accusations of preserving the existing system as open lists can ensure fair and open elections.

The incumbent parliament consists of FPTP MPs by 50%. It is not only FPTP MPs, but also the Party of Regions that favors mixed proportional system. The major task for the Party of Regions is to postpone elections and conduct them when the armed conflict in the East is resolved. Another task for the Party of Regions is to preserve the existing electoral system. The Communist Party of Ukraine tries to postpone elections, while it is proportional representation system that fits their interests better.

***Major political parties favour preservation of mixed electoral system***

On the other hand, presidential administration would also like to keep old game rules. Pro-presidential party or bloc “Solidarity” with the support of UDAR or Yuriy Lutsenko’s TUR can easily form the majority in the new Parliament with the help of FPTP MPs.

As for Yulia Tymoshenko’s party, its political conduct is quite strange. If earlier “Batkivshchyna” was standing for proportional electoral system with closed lists, after the resignation of Yatseniuk’s government the party started to promote open lists. “Batkivshchyna”, which has the biggest faction in the parliament, position of the parliamentary speaker and the biggest party quota in the government oppose early elections.

The same situation is on the right wing. “Svoboda” with electoral support of 3-4% is not interested in snap elections.

An important issue is electoral threshold. According to the current electoral law, the electoral threshold is 5% and blocs cannot participate in the election. “Svoboda” may support the President’s variant of electoral law provided that the electoral threshold is reduced from 5% to 3%. Theoretically, if political blocs are restored, the electoral threshold should not exceed 7%. Poroshenko’s bloc, as well as Tymoshenko’s bloc, may be interested in establishing such electoral threshold as both political parties can easily overcome that electoral threshold. The presence of big factions in the new parliament will facilitate the formation of a new coalition.

***Svoboda will insist on the reduction of electoral threshold***

Under such circumstances, parties with the ratings of 2-3% may not make it to the parliament. In order to change the political class in Ukraine, it is expedient to eliminate electoral threshold or reduce it to 1%. Usually, on the day of elections the voter turnout in Ukraine does not exceed 20 million people. MP number is 450. If the electoral threshold is eliminated, the party will need to get 50-60 thousand votes to get at least one seat in the parliament. The maximum reduction of electoral threshold will give an impetus for the development of political parties in Ukraine and will help “new faces” start their political career.

The next step towards ensuring transparent and fair political competition should be changes in electoral law.