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The Prospects for Privatization in Ukraine

by

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Abstract

Ukraine is a late-starter in privatization with the definite advantage of being able to learn from recent experience in Poland and the Czech and Slovak Federated Republic. Unfortunately, it now appears Ukraine will make two mistakes avoided elsewhere in Eastern Europe. First, the way in which Ukraine proposes to use multiple means of payment for privatized assets will likely prove very confusing and cause delays in privatization. Slower privatization will mean greater opportunity for "insiders" -- managers and workers in firms to be privatized -- to obtain property rights without paying for them. Second, while Ukraine is trying to empower insiders and involve them in privatization, the legal basis for this is currently very confused. It seems likely that insiders will obtain only partial property rights -- they will be able to prevent control from passing to outsiders, but they will not become the de jure owners of the firm. The most probable outcome of the current Ukrainian privatization plans is therefore the disintegration of state enterprises. This should be regarded as a warning to other late-starters in privatization.

A translation, by Santiago Eder, of the Ukrainian "State Program for the Privatization of the Property of State-Owned Enterprises," in the version which was passed by the Ukrainian parliament on July 7, 1992, is available from the National Council for Soviet and East European Research upon request.
1. Introduction

In Ukraine, as in most post-communist countries, privatization is at least nominally at
the top of the political agenda. The Ukrainian Privatization Program, adopted by parliament
in July 1992, lays out an ambitious timetable for achieving an impressive set of goals (State
Program 1992). If the government could achieve only a small part of these goals, this would
have a major impact on the Ukrainian economy. But the prospects for success remain
uncertain.

We have elsewhere analyzed at length the current situation in Ukrainian state
to
terprises and how this is likely to be affected by privatization (Johnson, Kroll and Eder
1992). In fact, however, very little government-sponsored privatization has yet taken place
in industry, and crucial details -- such as the role of investment funds -- remain unclear.

How then can we judge the prospects for privatizing large state firms?

A substantial amount can be learned from studying the immediate prospects for
Ukrainian "small-scale" privatization -- mostly shops, restaurants, and other relatively small
businesses. This form of privatization has proved relatively straightforward in Poland and
the Czech and Slovak Federated Republic (CSFR), and Ukraine has the significant advantage
of being able to learn from their experiences. In addition, compared with Eastern Europe,
there are fewer conflicting claims to real estate, the restitution of property to previous
owners is not a major issue, and small-scale privatization is a policy goal which appears to
have widespread social and political support in Ukraine.

Unfortunately, with regard to both small- and large-scale privatization, it appears
Ukraine may encounter two problems which were avoided in Eastern Europe. First, the use
of multiple means of payment for privatized assets will likely prove very confusing and cause
delays in privatization. Slower privatization will mean more time for conflicts to emerge
over substantive issues. The second problem is that, according to the Privatization Program,
the rights of insiders -- workers and managers in firms to be privatized -- are both extensive
and ill-defined. The most likely outcome is that insiders will obtain partial property rights
which enable them to block the transfer of control to outsiders, but which do not allow them
to become proper de jure owners. In effect, this will continue a process of spontaneous
privatization which has been underway in Ukraine for at least a year (Johnson and Kroll

The next section describes the background privatization legislation in Ukraine.
Section 3 explains the multiple means of payment which will be used to purchase state assets
and Section 4 analyzes the rights allowed to workers by the Privatization Program. Section 5
evaluates the Ukrainian program using six criteria and concludes that privatization in Ukraine
is unlikely to be successful.

2. Background

After prolonged debate, the Ukrainian parliament passed three key privatization laws
in the first week of March 1992. The "Law on the Privatization of Assets of State
Enterprises" regulates the sale of all enterprises and organizations with an undepreciated
book value ("balance value") greater than 20 million rubles. The "Law on the Privatization
of Small Enterprises (Small Privatization)" covers the sale of all assets with an undepreciated
book value of less than 20 million rubles. The "Law on Privatization Securities" governs all
issues concerning the "privatization vouchers" which will be given to the population. (These three laws will be referred to collectively as the Privatization Laws.)

There currently exist two main forms of state property in Ukraine: that belonging to local governments (known as "communal property") and that belonging to the republic. While local governments are responsible for the privatization of communal property -- which includes most of the assets eligible for "small privatization" -- they must follow guidelines established by the State Property Fund. Under the Privatization Laws, the Ukrainian State Property Fund formally received all ownership rights over republican property and became responsible for the preparation and execution of privatization of all republican property.

The State Property Fund is directly responsible to the parliament, and although it must agree and consult on all issues with the Cabinet of Ministers, it is theoretically independent from the executive branch of government. At least on paper, the Ukrainian executive does not have strong operational control over privatization.

On July 7, 1992, the Ukrainian parliament approved the "State Privatization Program" for 1992 (hereafter "the Program") which had been submitted for approval by the State Property Fund in the last week of May 1992. The Program establishes the mechanisms and targets for the sale of all republican property during 1992 and it also outlines the mechanisms which should be used by local governments when drawing up their own privatization programs (State Program 1992). Although the parliament left the broad outline of the original Program unchanged, it introduced two important amendments which have the potential of turning the entire privatization program into a leasing program, where the state will remain as de jure owner of property and the insiders -- legally known as "workers'
collectives" -- will become the de facto holders of property rights (see section 4 below).

Below we focus primarily on the implications for small-scale privatization, because here the effects already seem clear.

The basic rules set by the Program for small-scale privatization are as follows. Any Ukrainian or foreign juridical or physical person can participate in the small privatization process. The starting price for each enterprise will be the "reconstruction cost" -- the historic cost book value (ostatochnaya stoimost) of the enterprise, with some adjustment to take account of inflation. It is assumed that in the majority of cases the reconstruction cost will be less than the market price. Enterprises will be sold as going concerns, so a buyer must also take on the existing level of debt. Small privatization is supposed to begin in September 1992, and it is officially expected that most of the enterprises in this category will be sold within a three year period. However, the design of the actual program suggests the actual process will proceed much slower due to confusion over the acceptable means of payment and the precise rights granted to workers.

3. Multiple Means of Payment

An important assumption of the Program is that the Ukrainian population does not have enough resources at its disposal to purchase the majority of the available state assets. In order to overcome this problem, the Program allows Ukrainian citizens to purchase privatized assets with rubles, hard currency, and two special means of payment -- privatization vouchers and Privatization Savings Accounts. There will also be the so-called Privatization Deposit Accounts, which are a "piggy bank" account where a citizen will
deposit all the money that he or she wants to use for privatization, including vouchers, money from the privatization savings account, and rubles. When citizen buys a privatized asset, he or she will make the payment using "money" from this account.

Privatization vouchers will be given to all Ukrainian citizens, regardless of age. These vouchers will be non-tradeable and will have a total value denominated in rubles. It is currently expected that each citizen will "receive" a voucher with a face value of 30,000 rubles, although this will probably rise in line with the continuing inflation. In an attempt to overcome the technical and logistical problem of issuing the vouchers, the State Property Fund has decided that the vouchers will not have paper form. Instead, each citizen will go to the Savings Bank and open a special account, (the Privatization Deposit Account), where the value of the vouchers will be credited. When a citizen wants to utilize the vouchers in a purchase, these will be transferred electronically to the appropriate bank account of the seller.

The Ukrainian State Property Fund was influenced by the voucher scheme now being implemented in the CSFR, but there are three major differences between the versions devised in Kiev and Prague. First, in Ukraine citizens will get vouchers denominated in rubles, whereas in the CSFR the vouchers are measured in special privatization "points". In this respect, the Ukrainian scheme is more similar to the current Russian privatization plans (see the discussion in Johnson, Kroll and Eder 1992).

Second, in the CSFR the privatization vouchers are negotiable -- in the sense they can be sold to an intermediary fund in return for immediate cash or the promise of future payment. In Ukraine at this time, vouchers can be used only by the person to whom they
were issued. However, a law on intermediary funds is supposed to be drafted soon.

The third and most important difference is that in CSFR small-scale "privatization" actually meant the auctioning of leases, with only money being an acceptable means of payment. In contrast, in Ukrainian small-scale privatization, vouchers are intended to be used interchangeably with money and with a third means of payment, the privatization savings account (PSA). In order to be used to purchase privatized assets, these three means of payment need to be deposited in a privatization deposit account.

In many ways the currently proposed use of vouchers in Ukraine resembles the scheme now being implemented in Russia. However, the Ukrainian state appears unable to organize a rapid and widespread voucher privatization process, particularly as this is supposed to include all small-scale assets. These technical problems can probably be resolved within a year, but by that time it will be much harder to privatize any state enterprises -- because of the rights now being obtained by insiders.

4. Insiders' Rights

Ukrainian government officials have declared repeatedly that in the interests of social fairness, workers should not be allowed to gain control of the enterprise in which they work. This is a major reason for the complicated voucher scheme which is supposed to distribute state property equally among all Ukrainian citizens regardless of age or occupation. In fact, however, under the current Program it appears that insiders -- usually referred to as "workers' collectives -- will receive some substantial advantages in terms of acquiring their firms. However, the nature of these advantages has not yet been specified precisely, and this
is likely to be a major source of political conflict when the privatization process begins to get underway.

The most significant result of the parliamentary debate over the Privatization Program was a seemingly small change in the wording of one clause. Clause 2.4 of the first part of the Program defines the process by which an interested party can buy an enterprise through leasing. In the version originally submitted to parliament, this clause read as follows:

Buyout of state-owned assets leased with a "buyout option": a method of privatization where the leasee, who on a competitive basis acquired the right to rent the assets with a buyout option, becomes the owner ... in accordance with the lease agreement.

In the final version approved by parliament, the same clause now reads:

Buyout of state-owned assets leased with a "buyout option": a method of privatization where the leasee becomes the owner, in accordance with the lease agreement.

This amendment threatens to move the entire privatization process outside the framework created by the Privatization Laws and the Program. In April 1992, the Ukrainian parliament passed a Law on "Leasing the Property of State Enterprises and Organizations." This law makes it extremely difficult for the state to refuse to lease an enterprise if the workers' collective approves of the lease. The original Privatization Program tried to limit the power of the workers' collectives by allowing them to lease an enterprise only in cases where they emerged as the winners of a competitive bidding process. However, in the Program as passed by parliament all restrictions on obtaining a lease were removed, so it is now quite possible that the Ukrainian state will be unable to prevent workers' collectives bypassing the privatization legislation and leasing out their enterprises directly.

But does it matter if state property is transformed into leased property? After all, a significant amount of small-scale property in Eastern Europe, particularly shops and
restaurants in Poland and CSFR, was initially leased. In addition, there have been favorable initial results under the Polish so-called "privatization by liquidation," which amounts to a leveraged buyout with the financing provided by the state -- i.e., this arrangement is very close to being a lease.

There are four main reasons why the scope for leasing under the Ukrainian Privatization Program gives cause for concern. First, in Ukraine -- unlike in Poland or CSFR -- the state will not be allowed to turn down lease applications by insiders. Even if this legal situation is somewhat modified when parliament reconvenes in September, insiders will likely have a great deal of control over the terms of leases. Second, in Ukraine it is unclear that leasing will actually lead to full privatization -- in the sense that individuals eventually receive full de jure ownership rights over the firm. According to the Law on Leasing, workers have three years from the moment the lease contract is signed to decide whether they want to buy the enterprise. During that time assets could easily be transferred at below market prices out of the state enterprise, leaving behind just an empty shell.

Third, in Ukraine leases on enterprises are not transferable and the enterprise cannot be subleased. This is a significant difference from recent practice in both Poland and CSFR. Leases with only partial property rights probably reduce the incentives for insiders to maintain the firm as a going concern. Fourth, parts of an enterprise can be subleased in Ukraine. Unfortunately, given the context of other laws, this is also not a good feature. Most likely it will help create a confusing tangle of claims about who owns precisely what in the firm. By the time the state wants to sell -- for vouchers or cash -- a formerly leased enterprise, there may be nothing left to sell.
Many western privatization specialists are now in favor of privatization "from below," because they argue that significant privatization in post-communist countries is only possible if managers and workers are actively involved. This is a plausible view, particularly considering the problems privatization has encountered so far in post-communist countries, especially Poland. However, this does not imply that the extreme "bottom-up" approach in Ukraine should be viewed favorably. Current Ukrainian proposals fail to guarantee the transfer of full de jure ownership rights to private individuals. As a result, they seem likely to cause only partial privatization through the disintegration of state enterprises.

It remains to be seen how this situation will develop. Several strong protest voices have been raised against the apparent free rein given to the workers, and it is possible that when parliament reconvenes in September either the Law on Leasing or the Privatization Program itself will be amended. But in the meantime parliament has strengthened the hand of insiders immeasurably.

5. Conclusions

Six criteria are commonly used to evaluate privatization proposals in post-communist countries and to define what it means for these programs to be successful. The first four criteria are concerned with the process of privatization, while the fifth and sixth focus on the nature of firms which privatization creates.

First, will privatization be rapid? In particular, will sufficient privatization take place while there is still a clear political consensus in favor of privatization? Second, will privatization be complete, in the sense that it results in the transfer of all de jure property
rights to private persons? If the privatization is initially incomplete, for example by only allowing leases, is there a clear procedure and timetable for private persons to acquire all de jure rights? Third, will privatization be clean, in the sense that it does not involve too much corruption? Fourth, will the privatization process allow sufficient opportunities for all interested citizens to participate? Fifth, will privatization create firms which have effective corporate governance, so stockholders are able to effectively supervise managers and to prevent them from taking actions which are not in the best interests of the stockholders? Sixth, will privatized firms be structured in a way which allows them to bring in outside capital, either in the form of debt or equity?

Judged in terms of these six criteria, the Ukrainian privatization program seems unlikely to be successful. Problems with organizing the voucher scheme seem sure to prevent rapid privatization. But even more serious are the issues raised by the rights allowed to "insiders" -- workers and managers in firms which are to be privatized. It appears likely insiders will get some property rights at very low prices. However, they will not be able to acquire the entire firm, so privatization will remain incomplete, and -- even worse -- there does not currently exist a clear set of rules for converting partially privatized assets into fully privatized assets. Nevertheless, insiders will get sufficiently strong claims to be able to minimize the property rights obtained by outsiders, so there will be only limited participation by the population as a whole.

The net result is likely to be firms in which managers and workers have considerable de facto property rights, but never full de jure ownership. They will have control over the property, but it will not be their property. The most probable outcome is a lack of
investment and the clandestine transfer of assets to the private sector. These firms will not acquire a proper system of corporate governance and they will find it very difficult to bring in outside capital.

The mistakes made in Ukraine so far offer two important lessons to other late starters with privatization. First, overly complicated voucher schemes significantly slow down privatization, particularly if also used for small-scale assets. Second, if insiders are given substantial rights in privatization, great care must be taken to ensure the final result is complete privatization -- in which fully transferable property rights are created and outside investors are willing to participate. It is unlikely that the formation of closed, partially privatized companies is in anyone’s long-term interest.
References

State Program on Privatization in Ukraine, July 1991, translated by Santiago Eder. (This translation is available from the National Council for Soviet and East European Research.)


Endnotes

1. These three laws do not cover the sale of the state-owned housing stock or the sale of land. These issues will be dealt with by separate legislation which is still being written.

2. Until March 1992, the Ukrainian Ministry of De-Statization and De-Monopolization of Production was in charge of the sale of state-owned assets, but it is no longer an active participant of the process, and will now only fulfill tasks delegated by the State Property Fund. Similarly, the Ukrainian Ministry of Privatization was important in the development of the Privatization "Conception" in 1991, but now appears unlikely to play an important role in the actual implementation.

3. Vouchers intended for use in small-scale privatization cannot be directly used for the privatization of land or housing, because special housing and land vouchers will be issued once the sale of these assets begins. However, there is a commitment to make different types of vouchers convertible among themselves at rates which are to be announced later.

4. It remains unclear whether this "electronic" or "non-paper" voucher is simply a temporary measure designed to speed up the start the privatization process or whether it will be a permanent measure.

5. Due to the technical problems of the banking system, at least during 1992 there will be a limit on the number of people that can actually open their voucher accounts. Only those people that have actually bought a privatized asset and who need to use their vouchers for payment will be able to open their accounts.

6. In March 1992, a Presidential decree was issued that doubled the amount of savings every citizen had in his or her savings account on January 1, 1992. The extra money -- known as "privatization savings accounts" -- can only be used to purchase privatized assets (including land and housing).

7. Note that the law was not published, and did not take effect, until June 1992.

8. It is not clear whether this will result in more or less property passing into private hands. The Law on Leasing gives leaseholders a buy-out option which should be exercised within three years of signing the lease. But this is only an option -- at the end of the three years the leaseholders can decline to buy.