Revision of Privatisation in Ukraine: A Cost-Benefit Analysis

Executive Summary
Since the beginning of 2005, a controversial discussion on revaluation or even revision of recent privatisation deals has created substantial uncertainty of property rights in Ukraine’s economy. As an immediate result, the growth of investment activities went down significantly. In this way, and independently of whether or not revaluation or repatriization is justified, the form of this discussion has already had a significantly negative impact on Ukraine’s macroeconomic performance. This is even more dramatic since a lower increase of investment activities at present also means lower growth of income in the future.

Against this background, our paper discusses how policy makers should continue with this process. We start by looking at two cases of international experiences where privatisation has been reviewed in the 1990s, the restitution in Poland and the revaluation of privatised utilities in the United Kingdom. The comparison demonstrates that privatisation revision causes neglectable costs only if it is conducted in a transparent and predictable way under stable political conditions and if it is limited to a revaluation without that effective changes in property rights are envisaged. As this cannot be guaranteed in the Ukrainian situation, we argue that costs of a revision of privatisation will be significant and must be compared to expected benefits of this measure.

Moving on to a cost-benefit analysis, we estimate that further measures aiming at a revision of privatisation such as discussing lists of critical assets or formulas for revaluation will create costs of a 2.5% lower growth rate in real GDP, which equals half of the already observed reduction in GDP growth in the first quarter of 2005. As for benefits, we find that even if revision of privatisation of “Kryvorizhstal” and “Ukrrudprom”, the two most critical cases in 2004, as well as all privatisation cases in 2003 and 2002 will result in double prices, net benefits will hardly amount to 2.5% of Ukraine’s GDP in 2004.

Hence, we recommend policy makers to not implement any further measure for revising previous privatization deals. Instead, we recommend focusing attention on reassuring property rights without any exemption. While this does not mean that specific cases cannot be re-examined in courts based on the existing legal framework, it is essential for regaining investment growth and a necessary precondition for long awaited FDI. Finally, we lay out how the privatisation law itself needs to be changed so that the repetition of similarly controversial cases as e.g. “Kryvorizhstal” or “Ukrrudprom” can be ruled out in the future.
1. Introduction: What happened?

In February 2005 the Verkhovna Rada has adopted a program of the new Government “Towards People”, which declares that the “government will guarantee the revision of conditions and results of privatisation competition for separate objects in case of non-fulfilment or inadequate fulfilment of given obligations by the new owner, or violation of privatisation procedures, in particular with respect to the participation of other potential customers and the determination of the price, and other violations of legislation”¹

Shortly after taking over its activity, the new Cabinet of Ministers has recalled from the Parliament the privatisation program for 2005 and initiated the revision of privatisation competition results of “Kryvorizhstal” due to non-competitive privatisation conditions, which, as they claim, resulted in substantial price underestimation. As a result an Economic Appeals Court acknowledged the deal on “Kryvorizhstal” as illegitimate in June and ordered the shares of the company to be transferred back to the State Property Fund. While a new round of privatisation of the 93,02% of the company’s shares is intended, the concrete procedure remains unclear as of now.

Besides “Kryvorizhstal” there exist other potential cases for privatisation reviews. In February various government officials initiated talks about a list of enterprises for further revision due to ‘possible violations during the privatisation of these objects’. The list was promised to be prepared by the government but has been kept secret. Initially, there were rumours about 3000 of stakes for further revision. Than, the list was confined to 29 enterprises, later reduced to 20, while some sources also said 22. Along with the intentions to prepare the list, the Minister of Economy was charged with working out a “Mechanism” for revaluation. However, just like the list this mechanism has never been presented. Instead, discussion went out of control with various speculations that were fuelled by statements of many politicians, even at regional level, about possible changes in ownership. In addition, several draft laws on nationalization, of examination the accuracy of privatisation, and property guarantees to the owners were registered in Ukrainian Parliament.²

In order to stir up the investment activity, the Prime minister and the Speaker of Parliament signed in June 2005 a memorandum in the presence of Ukraine’s President, in which the government confirmed its intention to not deny legally established property rights. Instead, the memorandum established that all possible revision of privatisation shall be done based on court rulings. However, statements of government officials, according to which a law that lists all strategic objects subject to revaluation could accelerate the revision process, which – if left to court procedures – could take too long, again questioned the memorandum.

The intention of this paper is to assess the economic costs and benefits that a revision of privatisation in Ukraine might have, and to give policy recommendations based on this assessment. We will start with assessing the consequences of the developments described above on Ukraine’s economy. Next, we will look at two cases of relevant international experience and derive some lessons for the Ukrainian case. Finally, we will move on to a preliminary analysis of economic costs and benefits of a possible revision of previous privatisation in Ukraine. Based on these findings we will conclude with policy recommendations.

¹ Adopted by the Resolution of CMU #115 (115-2005-п) from 04.02.05, approved by the Resolution of Verkhovna Rada # 2426-IV (2624-15) from 04.02.05
The Draft Law of Ukraine “On the nationalization of strategically important enterprises of mining complex of Ukraine” #7079 registered 16.02.2005
The Draft Law of Ukraine “On the guarantees to the owners of privatized property” #7238 registered 23.03.2005
2. A first Assessment: What are the consequences?

Ultimately, the described discussion on revaluing privatisation in Ukraine has caused substantially higher uncertainty of property rights, mainly for the following reasons:

- The government’s intention to prepare a list of privatised assets subject to re-evaluation, together with its failure to really do so, has had a significant impact on a much larger number of firms who feared to be included in the list. The situation further worsened as the discussion went out of control and many politicians, even at regional level, made statements about possible changes in ownership of small-scale assets.

- Revisions of past privatisation deals are also likely to be caused by increasing budget pressure. In March, the Ukrainian Parliament increased the level of expected revenues from sales of state assets in the 2005 budget by 39% to UAH 6.99 bn, which is almost at the level of the total budget deficit (UAH 7 bn). However, until May the State Property Fund has managed to collect only 10% of the expected amount. Although the Ukrainian President recently announced the intention of selling five high-value enterprises (“Turboatom”, “Kryvorizhstal”, “Odessa Portside Plant”, “Severodonetskiy Azot”, and “Ukrtelecom”) it is unlikely that they all can be fully privatised within the second half of the year. In the meantime, revenues from possible revaluation or reprivatization are repeatedly mentioned as option for closing the budget deficit.

- The initiated disputes on the revision of privatisation deals in the beginning of 2005 without exact criteria of ‘illegitimacy’ were differently interpreted by some parties and have given rise to even violent fights for property, as it was for example the case for several regional power-disturbing companies (Oblenergos). Such incidences have also contributed to increasing uncertainty of property rights regulation in Ukraine.

- Finally, the possibility of a change in government after parliamentary elections in March 2006 creates ever more room for speculation.

The consequence of higher uncertainty of property rights is significantly lower investment growth. As Table 1 shows, the tendency of increasing investment levels during recent years has come to an end. In the first quarter of 2005, fixed capital investment increased by only 4.5% in real terms, which is dramatically less than the 52.1% during the same period of 2004 (Table 1). On a regional level, investment levels increased in only 13 Oblasts so far, compared to 24 regions at the same period in 2004.

Table 1  Fixed capital investments in Ukraine (1st Quarter 2001 - 1st Quarter 2005)

<table>
<thead>
<tr>
<th></th>
<th>Q1-2001</th>
<th>Q1-2002</th>
<th>Q1-2003</th>
<th>Q1-2004</th>
<th>Q1-2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed capital investments (actual prices, UAH m)</td>
<td>3954.4</td>
<td>4804.8</td>
<td>6124.2</td>
<td>10235.8</td>
<td>12638.1</td>
</tr>
<tr>
<td>Year-on-Year growth rate*</td>
<td>23.7</td>
<td>9.6</td>
<td>23.1</td>
<td>52.1</td>
<td>4.5</td>
</tr>
</tbody>
</table>

* In% of volume index of corresponding period in previous year, calculated in comparable prices (see Statistical Yearbook of Ukraine).

Source: State Statistics Committee

The impact of this decline in investment growth – together with the also reduced growth of exports – on Ukraine’s economic performance is significant. In each of the first four months of 2005, real GDP growth has fallen to around half its level of the same month in 2004. On average, GDP grew in the first quarter of 2005 by only 5.4%, down from 12.3% in the first quarter of 2004 (Table 2).

3 This is in particular true for the national fixed-line telecommunication operator “Ukrtelecom”, which has been prepared for privatization for several years already without that official intentions have been clarified as of now.

4 In the first quarter of 2004, exports grew by 16.5% year-on-year, as compared to around 40% in same period of 2004 (IER: Monthly Economic Monitor Ukraine No.7-2005).
Table 2  Real GDP growth (January to April 2003-2005)

<table>
<thead>
<tr>
<th>Cumulative real GDP growth (% yoy*)</th>
<th>Jan</th>
<th>Feb</th>
<th>Mar</th>
<th>Apr</th>
<th>Q1</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>7.7</td>
<td>7.2</td>
<td>7.0</td>
<td>7.1</td>
<td>7.0</td>
</tr>
<tr>
<td>2004</td>
<td>9.0</td>
<td>10.2</td>
<td>10.8</td>
<td>11.5</td>
<td>12.3</td>
</tr>
<tr>
<td>2005</td>
<td>6.5</td>
<td>5.5</td>
<td>5.4</td>
<td>5.0</td>
<td>5.4</td>
</tr>
</tbody>
</table>

*yoy  year-on-year change
Sources: State Statistics Committee, Ministry of Finance, NBU, IFS, IER calculations

Accordingly, results from the IER business survey\(^5\) for the first quarter of 2005 also confirm that managers of small, medium, and large-scale enterprises have rather pessimistic expectations about the impact of revision of privatisation deals on their activities.

Finally, the discussion on revision of privatisation might also have a negative impact on Foreign Direct Investments (FDI) because it increases the uncertainty for foreign investors as well. In fact, expectations about a FDI boom have not been fulfilled despite an enthusiastic assessment and positive media coverage of the ‘Orange Revolution’ in Western countries. Instead, FDI inflows have grown by only 2.7% in the first quarter of 2005, which falls even short of the level for the same period in 2004 (3.2%, see Table 3)

Table 3  FDI in Ukraine in the 1st Quarter 2004 and 2005 (in USD m)

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>CIS countries</th>
<th>Other countries</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q1-</td>
<td>Q1-</td>
<td>Q1-</td>
</tr>
<tr>
<td>2004</td>
<td>6730.2</td>
<td>434.3</td>
<td>6295.8</td>
</tr>
<tr>
<td>2005</td>
<td>8562.5</td>
<td>554.4</td>
<td>8008.0</td>
</tr>
<tr>
<td>Capital of non-residents:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Beginning of accounting period</td>
<td>6946.5</td>
<td>442.6</td>
<td>6503.9</td>
</tr>
<tr>
<td>- End of accounting period</td>
<td>8797.4</td>
<td>574.5</td>
<td>8222.9</td>
</tr>
<tr>
<td>Capital growth</td>
<td>3.2%</td>
<td>1.9%</td>
<td>3.3%</td>
</tr>
</tbody>
</table>

Source: State Statistic Committee

3. International experiences: What can we learn?

In the past, privatisation deals have been ex-post revised in several other countries. The intention of such measures can generally be distinguished into two different objectives, or a respective mix of both. On the one hand, revision might be motivated by the intention to redo unlawful violation of property rights. On the other hand, it might simply seek to correct for undervaluation. Depending on the specific intentions, privatisation revision has led to very different results. This can be demonstrated by the intuitive cases of Poland and the United Kingdom.

Poland  In the early 1990’s Poland commenced with the process of identifying government-confiscated property and returning it to rightful owners and their heirs. The motivation was purely based on justice reasons. Descendants of Poles and displaced Polish Jews were allowed to claim properties and assets that were first seized by the Nazis during World War II and later nationalized by Polish communists.\(^6\)

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However ‘good’ the intentions, the process has turned out to be rather sporadic. Several draft laws expected to define the mechanisms of reprivatization were vetoed in Polish Parliament, so that no exact systematic selection criteria have so far been adopted. Instead, courts have to find a balance between protecting the right of private property as stated in the Polish constitution on the one hand, and considering the provision that the restitution must not violate the interests of third persons on the other hand. The total value of open claims is extremely large. According to the Ministry of Public Finance, the vindication of only 30% of the more than 150,000 unresolved cases would require a sum that equals 33 times the budget of Poland in 1998. As a result of this clearly unrealistic intentions and implementation, the outcome of restitution claims is highly uncertain. In turn, this uncertainty has reduced investment activities in real estate, and the restitution has successively lost the support of the population.

**United Kingdom (UK)** During the first years after utility companies in the UK were privatised in the early 1980s, private investors have received much higher profits than they expected due to low initial share prices and lax regulation, which enabled them to misuse their market power. As a result, stock market based values of privatised utilities significantly exceeded their initial selling prices, in some cases by as much as 124%. In order to revalue the privatised assets and to claw back some of these high profits the British Government introduced an additional, one-off Tax payment. This so-called *Windfall Tax* as envisaged in the Budget of 1997 was imposed in addition to the general corporate income tax. Windfall Tax revenues were intended to be used to finance a Welfare-to-Work program worth GBP 5.2 bn, which aimed at reducing unemployment levels in the economy.

In contrast to the Polish case, conditions and terms of the revaluation were clearly defined. It was intended to correct for systematic undervaluation of initial sales prices and targeted on electricity generating, transmitting, and supplying companies; water and sewerage companies; the nuclear-power generating companies; the British Airways Authority (BAA); British Gas; British Telecom (BT); and Railtrack. The valuation mechanism that established the additional payments was given by a simple and transparent formula according to which the privatised enterprises paid 23% of the difference between the value on initial flotation and the value based on after-tax profits for up to the first four years after privatisation.

Since the procedure did not intend to change private property rights, and since payment obligations were all determined by past profits, this one-off 'lump-sum' tax did not lead to changes in the companies’ behaviour and no efficiency losses were observed. Moreover, no evidence could be found that the cost of investment capital did increase or that planned investment was curtailed.

Comparing the Polish and the UK case demonstrates that the costs of privatisation revision through reduced investments and firm-level efficiency tend to be lower if the measure intends to only correct for undervaluation rather than for changes in property rights. In contrast to the Polish restitution, costs in the UK case were also minimized by specific terms and conditions of the measure that were set as transparent and accountable as possible (e.g. firms were valued according to historic stock market information), based on a well-

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7 THE HREI WEBSITE: ELECTRONIC GATEWAY TO EDUCATIONAL REFORM by Janet Helin, Director, HREI (New York, USA), source: http://www.human-rights.net/HREI/journal/vol2_no1.html
9 Companies where privatized by flotation, meaning that its shares were sold to private investors.
11 COORDINATED ISSUE UTILITY INDUSTRY UNITED KINGDOM WINDFALL TAX UIL 901.12-00, source: www.irs.gov
12 *Financial Statement and Budget Report 1997*, Modernizing the welfare state, Welfare to Work, paragraph 2.07
14 Microeconomically, it can be argued that the prospect of simple revaluation of privatised assets is much less detrimental to investments than that of a full change in ownership, since revaluation only deters investment projects with marginal profitability while a possible change in ownership will deter investments altogether.
defined legal basis. Moreover, the measure was introduced by a government, which itself was backed by a sufficient majority of the Labour party in the British parliament.

4. Analysis: What are the Costs and Benefits for Ukraine?

For the present case of Ukraine, the intention behind a revision of privatisation is very unclear. As described in sections 1 and 2, the discussion is motivated by rather mixed objectives varying from justice and revaluation concerns to fiscal objectives and even strategic considerations of financial industrial groups and their allies. Against this background, and given the generally uncertain political situation with a multi-faction coalition government and upcoming parliamentary elections next year, as well as the significant difficulties in independent valuation of firms, an application of a transparent revision scheme that simply intends to revalue previous privatization deals, as it was done in the UK, appears impossible for the case of Ukraine. Rather, any scheme that might possibly be implemented by policy makers will follow a mix of different intentions and – more close to the Polish case – will also create significant costs.

How large could the economic costs and benefits of such a revision of privatization be? The drop in growth of investment and GDP, as discussed in section 2, indicates that the costs of the current unclear situation have become already significantly high and – since this uncertainty reduces investments in all sectors – affect the economy as a whole. A further continuation of the current debate, with ongoing speculations on a systematic revision of previous privatization deals and all the uncertainty about concrete proposals that such a step will bring with it, will increase these costs even further as investment growth will remain to be bounded until the revision is fully closed. Since present investments are the basis for future income, these costs will affect the economy even after revision is completed. To name a price, we assume that the effect of increased uncertainty and hence lower investments causes a reduction of real GDP growth by 2.5%, which accounts for about half of the expected reduction of real GDP growth in 2005.16

Given that expected costs will be rather high, a revision of privatization makes sense only if expected benefits are substantially above costs. This however is rather unlikely, as the calculations in Table 4 demonstrate. In column b we show the results of privatization of the four largest enterprises in 2004 (in prices for each enterprise), which together accounted for UAH 8.6 b or 89% of total receipts from privatization in 2004 (UAH 9.6 b). In column e we roughly estimate the value of each enterprise, as given by the Net Present Value of its annual profits (average from 2002 to 2004 upon data availability, see Table 5), assuming an interest rate (discount factor) of 15% per annum. In Column f we compare this estimated value of each firm with the price for which it was sold (column b). A value below 100% indicates that the privatization price is below our estimated value. As can be seen – and also considering that our estimates of firm value are admittedly rough – only for Kryvorizhstal and Ukrrudprom, the two most-controversial privatization cases in 2004, there appears to be substantial undervaluation. Accordingly, while we cannot rule out undervaluation in specific cases, our calculation does not suggest that the privatization process in Ukraine has undervalued state-owned assets systematically. Hence, benefits from a general revision of privatization might be rather limited.

15 With still infant stock markets and insufficient accounting standards, firm valuation depends highly on subjective criteria, which can clearly induce corrupt practices.
16 For 2005, the IER forecasts 7% of real GDP growth (www.ier.kiev.ua/Ukraine/mfu_ukr/cgi), as compared to 12.1% in 2004. This expectation is supported by the already observed reduction of year-on-year GDP growth in the first quarter from 12.3% in 2004 to 5.4% in 2005 (Table 2). Of course, this drop of GDP growth has also been caused by other reasons. For example, the revaluation of Ukraine’s currency has reduced export earnings and world market prices for steel, Ukraine’s number one export commodity, have declined. However, all those effects cannot convincingly explain the full reduction of GDP growth, since the revalued Hryvnia also reduces the costs of installing imported equipment, and world market prices for steel have lost by only 10% and the Asian steel prices by only 2% on a year-on-year basis (www.cruspi.com). Moreover, the full costs of privatization revision will not be limited to a drop of GDP growth in the present year. Rather, reduced present investments will be also followed by reduced GDP growth in the future.
Table 4  Privatization in Ukraine in 2004

<table>
<thead>
<tr>
<th>Enterprises privatized in 2004:</th>
<th>Privatization:</th>
<th>Share in total</th>
<th>Annual profits*</th>
<th>Estimated value**</th>
<th>Valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Shares sold</td>
<td>Price</td>
<td>privatization revenue</td>
<td>(UAH m)</td>
<td>(UAH m)</td>
</tr>
<tr>
<td>- a -</td>
<td>- b -</td>
<td>- c -</td>
<td>- d -</td>
<td>- e -</td>
<td>- f -</td>
</tr>
<tr>
<td>Kryvorizhstal</td>
<td>93%</td>
<td>4260</td>
<td>44%</td>
<td>1138</td>
<td>7055</td>
</tr>
<tr>
<td>Ukrrudprom (total over 9 enterprises)</td>
<td>1440</td>
<td>15%</td>
<td>370</td>
<td>2458</td>
<td>59%</td>
</tr>
<tr>
<td>Pavlogradvuhillya</td>
<td>92%</td>
<td>1400</td>
<td>15%</td>
<td>109</td>
<td>645</td>
</tr>
<tr>
<td>Dniepropertovsk Dzerzhinskogo steel plant</td>
<td>99%</td>
<td>712</td>
<td>7%</td>
<td>96</td>
<td>630</td>
</tr>
<tr>
<td>Krasnodonvuhillya</td>
<td>60%</td>
<td>770</td>
<td>8%</td>
<td>15</td>
<td>59</td>
</tr>
<tr>
<td>Total of five enterprises</td>
<td></td>
<td>8582</td>
<td>89%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total revenue from privatization in 2004</td>
<td></td>
<td>9600</td>
<td>100%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Average over profits for three years upon availability of data; see Table 4  
** Net Present Value of average profits at discount rate of 15%  
Source: State Property Fund, own calculations.

Table 5  Annual Profits (UAH m) of selected state-owned enterprises

<table>
<thead>
<tr>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kryvorizhstal</td>
<td>530</td>
<td>870</td>
</tr>
<tr>
<td>Ukrrudprom (total over 9 enterprises)</td>
<td>85</td>
<td>71</td>
</tr>
<tr>
<td>Pavlogradvuhillya</td>
<td>na</td>
<td>-137</td>
</tr>
<tr>
<td>Dniepropertovsk Dzerzhinskogo steel plant</td>
<td>200</td>
<td>24</td>
</tr>
<tr>
<td>Krasnodonvuhillya</td>
<td>na</td>
<td>na</td>
</tr>
</tbody>
</table>

Source: InvestGazeta Top 100 Rating; Prometal
Comparing expected costs and benefits of a revision of privatization demonstrates that net gains of such a step cannot be expected. This conclusion is based on the following, stylized calculation: assuming the optimistic case that a systematic revision yields additional revenues of UAH 5.7 b from privatization in 2004 (double prices of Kryvorizhstal and Ukrrudprom) and UAH 2.76 from privatization in 2003 and 2002 (double prices for all assets privatized in those years17) the total additional revenue of UAH 8.4 b accounts for 2.4% of Ukraine’s GDP in 2004. This is still below the reduction of real GDP growth by 2.5% that we identify as costs above. Still, it must be stressed that this calculation is even overoptimistic: the costs of 2.5% reduction of real GDP growth have already materialized and more is sure to come if the controversial discussion of privatization revision with its corresponding uncertainty of property rights is continued. On the other hand, it is unlikely that a second round of privatization will lead to double prices of all assets under revision, precisely because of the affect that the revision as such has on security of property rights (it would also require that all privatization deals of 2003 and 2002 have been undervalued by 50%).

5. Policy Recommendations: What should Policy Makers do?

What should Ukrainian policy makers do? Should they continue efforts towards a general revision of privatisation, or should the issue of legality of privatisation be completely left to Ukrainian courts?

The issue of whether or not previous privatisation deals have violated Ukrainian law is a question, which is to be answered only by Ukrainian courts. This is possible and has already happened (e.g. for the most controversial case of “Kryvorizhstal”), as existing legislation foresees several reasons for individuals to appeal to court in case the privatisation is believed to have violated existing laws. Legislation also allows for voluntary settlements between the different parties for a faster dispute settlement. Hence, the main requirements for finding sufficient solutions to legal complaints against privatisation are in place and no further legislative changes are necessary to be taken by government and/or parliament.

From an economic perspective, revision of privatisation makes sense only if the expected benefits from revaluation of privatised assets exceed the costs that such a step is expected to cause. As our previous analysis demonstrates, this is not the case! Hence, we strongly recommend Ukrainian policy makers to not implement any further measure for revising previous privatization deals, such as defining a list of objects subject to investigation or possible formulas for revaluation. Instead, we strongly recommend policy makers to focus their attention on reducing the costs that the controversial discussion has already caused. This foremost requires to re-assure property rights without any exemption! While this does not mean that specific cases cannot be re-examined in courts based on the existing legal framework, Ukraine’s economy as a whole stands to gain significantly more from reassured property rights, as this is essential for stronger investment growth and a necessary precondition for long awaited FDI.

While we recommend no further steps to be taken to revise previous privatisation deals, Ukraine’s privatisation policy itself needs to be revised. Otherwise, future privatisation deals will stay on the same weak foundation than those that are currently subject to revision, and the repetition of similar events – and similar costs – in the future cannot be prevented.

17 According to the State Property Fund, privatization revenues in 2003 and 2002 accounted for UAH 2160 m and UAH 603 m.
Revising privatisation policy requires preparing and ratifying in parliament a **new program for privatisation** that specifies the general principles of how privatisation procedures are supposed to be conducted and includes a list of all enterprises that are put for sale. Such a program is necessary to have a commonly accepted legal basis for all future privatisation. For this purpose, the existing draft programme for 2003 to 2008, which has been discussed in parliament since 2002 and recalled earlier this year, can be used as a starting point. However, it needs to be sharpened in its intentions and improved in the proceedings it implements according to the following principles:  

- Privatisation of state-owned assets should not be seen as a mean to fill short-term fiscal deficits. Instead, the guiding principle for privatisation should be to **maximize social welfare** by selling to the most efficient private owner, that is the one who is best suited to sell its output at the lowest costs, produce goods of the highest-possible quality, use most-innovative technologies etc.  

- Finding the most efficient owner requires fair and open competition during the privatisation process. In the past, violation of this principle, often possible due to various loopholes in the existing privatisation laws, has prevented fair competition in many cases. Typically, the State Property Fund of Ukraine (SPFU) has in the past set qualification requirements for potential buyers of so-called strategic enterprises. In theory, the intention has been to avoid speculative deals by limiting the number of possible buyers to 'industrial investors' who are interested in continuing operations of the enterprise and are most capable to increase its efficiency. In practice, however, selection criteria have often formed barriers for competition, which lacked an obvious economic justification. Instead, conditions tailor-made for specific financial industrial groups have prevented other, mostly international buyers from participating in tenders. Accordingly, we propose to **abandon** the practice of setting selection criteria for 'industrial investors' and to **replace it with sufficient obligations** for the new owner. For example, sales of newly privatized enterprises or parts of enterprises by the new owner can – for a given period – be ruled out by appropriate regulation. Furthermore, an investor's ability to increase firm-level efficiency can also be judged upon the basis of his investment commitments, which should be included into the selection rule.  

- The process of pre-privatization restructuring of enterprises and assets should be clearly defined. In general, a **pre-privatization audit** should be conducted in order to a) separate potentially profitable units from those that should undergo a bankruptcy procedure; b) structure and settle arrears; c) separate social and cultural infrastructure units from businesses and transfer them to local governments and municipalities. To ensure transparency, results of the audits and the proposed restructuring plan should be made public.  

- The SPF should **refrain** from drafting business and investment plans for individual enterprises. This task should be left to the interested investors, and can up front be announced as selection criteria in the tender.

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18 The following discussion is build upon arguments made in earlier advisory papers on Ukraine’s privatisation law, in particular S24 (Does Ukraine Need a Special Law on Re-privatisation? – January 2003) and A10-2002 (Comments on the Draft of State Privatization Program 2003-2008).

19 This is also reflected by the good fiscal practice to not use one-time privatisation revenues for financing continuous expenditures such as payments to pension funds etc.

20 In general, strategic enterprises are considered to be either monopolistic enterprises, enterprises that ensure a competitive advantage and economic independence of the country, or ‘unique’ enterprises (that utilize rear tangible, intangible or human resources).

21 For example, potential buyers for “Kryvorizhstal” were obliged to have a proven record of usage of Ukrainian coke for at least 3 years, from which 2 years should have been profitable. No foreign investor and only three Ukrainian financial-industrial groups qualified for this criterion, and the two largest Ukrainian groups even announced a joint bid before the tender was hold.
• As a general principle, the state should **not maintain control stakes** (such as 50%+1 or a ‘golden’ share) in privatized assets, as this is a clear contradiction to the intention of selling an enterprise, while it reduces the possibilities of private investors to improve efficiency of operations. If, however, the state is not ready (for whatever reasons) to sell the control stake of an enterprise (e.g. a pipeline), other options than privatization such as Public Private Partnerships, should be considered.

• The privatization process should be used to create fair and equal competition between the newly privatized enterprise and its (state- or private-owned) competitors. This means on the one hand that subsidies and tax privileges, which have been given at the firm level to state-owned enterprises, should not be extended to private owners. On the other hand, it also requires that all measures of state support such as subsidies, tax privileges etc at the sector level should be reduced to the absolute minimum or – better – be eliminated altogether. For enterprises belonging to network industries (so-called **Natural Monopolies**) such as the energy sector, pre-privatization measures must also include the specification of clear regulatory principles for sector operations.22

FP, KO

Lector: LH

Kiev, 8.7.05

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22 The German Advisory Group and the Institute for Economic Research and Policy Consulting have produced several guidelines of how such policies should be set up, such as "Development of Domestic Markets in Ukraine. Welfare through Competition" or "Towards Higher Standards for Living An Economic Agenda for Ukraine", all available online at [http://www.ier.kiev.ua/Ukraine/books_ukr.cgi](http://www.ier.kiev.ua/Ukraine/books_ukr.cgi).