Large privatisation receipts in Ukraine: Recommendations on how to use the money wisely

Executive Summary
As shown by recent international experience, privatisation receipts can be rather large both in absolute terms and as a proportion of the state budget. This has been the case for Ukraine in 2005 when Kryvorizhstal was sold, and is likely to happen again in the near future. When privatisations are implemented, it is crucial that its proceeds are spent wisely. In particular, privatisation receipts should not be used to increase recurrent expenditures, since this can cause a precarious fiscal mismatch. Also, the consumptive use of the funds should be avoided. A proper spending strategy requires some time to prepare and implement. Therefore, we think that it is very important to discuss the spending options for Ukraine now, i.e. before large privatisation receipts flow into the state coffers again.

In this paper we discuss three international best-practice options for spending large privatisation receipts: debt repayment, financing of infrastructure projects, and reform of the state pension system. We argue that the repayment of state debt should be given no priority, since the state debt has an important benchmarking function and its level is not particularly high in Ukraine. The financing of infrastructure projects makes sense, but only if the state provides just a minor share of the needed finance, while investors from the private sector and multilateral financial institutions should contribute the main bulk. The main use of privatisation proceeds should be in our view the implementation of the second pillar of the pension system. Large privatisation receipts should flow into a privatisation fund, whose only function is to support the initiation of the second pillar.

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1. Introduction

There is widespread agreement among economists that well-done privatisations of state owned enterprises can considerably increase the economic well being of a country. In the last three decades, most privatisation programs both in the developed and developing world have shown quite a successful record in terms of economic efficiency, welfare and growth. There are a number of reasons for this. First of all, the sale of state assets helps strengthening the role of the private sector and may considerably increase competition, thereby fostering the market economy as a whole. Second, private ownership can lead to higher efficiency and profitability at the firm level. This is particularly the case, when the privatised firms are properly restructured and recapitalized and when firm-outsiders take over its management. Third, privatisation can help to attract foreign capital, along with foreign technological know-how. Fourth, privatisations can free resources for the public sector, which might be better allocated. Likewise, the fiscal burden of loss-making state enterprises will be reduced.

However, large-scale privatisations may also entail some dangers, which can be avoided if they are properly surveyed and managed. Besides a series of microeconomic issues, privatisations have important macroeconomic consequences, which have to be dealt with. Here, we will focus mainly on the fiscal implications of privatisations. In most cases a systematic sale of state property implies that the government receives vast amounts of cash. As a consequence, the crucial question arises: How should the money be spent? As shown by international experience, this question can provoke a heated public debate in which countless "innovative" ideas are put forth. In many cases the danger prevails that the money is spent unwisely, putting at risk fiscal sustainability and "eating away" funds that could have been better invested in the country's long-run development.

The question on how to spend large privatisation receipts has been of special importance for Ukraine since the end of 2005, when the (second) privatisation of Kryvorizhstal took place. As other large state enterprises are likely to be sold in the near future, this question will remain of high importance for the country. The goal of this paper is to discuss and evaluate main options for spending large privatisation receipts in Ukraine. Part 2 discusses the prospects for large privatisation receipts in Ukraine in the near future. Part 3 describes some general principles for wise and sustainable spending of large privatisation receipts. The advantages and disadvantages of three main policy options for Ukraine are then discussed in Part 4. Lastly, in Part 5 we conclude.

2. The prospects for large privatisation proceeds in Ukraine

In several recent statements, the new government of Ukraine declared the selling of state property as an important policy goal. In particular, the Draft State Budget for 2007 foresees UAH 10.0 bn (approximately USD 2 bn) from privatisation receipts, which is much higher than the UAH 2.1 bn target for 2006. Also, according to a Decree by the Cabinet of Ministers on major budget parameters for 2008-2010, the privatisation plan for 2008 is UAH 10.1 bn, for 2009 UAH 9.2 bn, and for 2010 UAH 7.9 bn. Consequently, for the period 2007-2010 a total of UAH 37.2 bn or approximately USD 7.3 bn are planned. The yearly average amounts to USD 1.8 bn.

This cumulative amount of USD 7.3 bn could be earned under a moderate privatisation policy, e.g. by selling Ukrtelecom and a number of electricity generating companies. If the government will pursue a more aggressive privatisation agenda, i.e. in case many of the likely

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1 As an example, the government should put many efforts in minimizing the social costs of privatisations, such as a decrease in the quality and accessibility of public services or environmental exploitation. On the firm level, appropriate management and restructuring processes have to be set in place and it should be secured that social standards are fulfilled.

2 To avoid confusion, this paper leaves out other macroeconomic aspects of privatisations; in particular the potential monetary consequences are not discussed here, which can however be crucial for a small open economy such as Ukraine. For a proper discussion, we are currently preparing a second, closely connected paper dealing with the monetary impact of foreign direct investment and large privatisation receipts.


4 For example, the market capitalization of 6 state-owned electricity-generating companies is estimated at USD 1.5 bn, while Ukrtelecom has an estimated value of almost USD 3.5 bn.
candidates are sold within the next 4 years, the privatisation receipts could well reach USD 12 bn or even more in the period 2007 to 2010.

These amounts are large in relation to Ukraine’s GDP and consolidated budget. The (implicit) government figure of USD 1.8 bn corresponds to 1.0-1.6% of the predicted GDP and to 3.5-5.3% of the consolidated budget in the relevant years. The higher but still realistic figure of USD 3.0 bn per year corresponds to 1.6-2.6% of GDP and to 5.7-8.7% of the consolidated budget. Needless to say, only fair tenders and careful sale processes will provide these estimated amounts of cash. If state assets are sold off below their real value for political or other reasons, the proceeds and their social benefits will obviously be much lower.

To summarize, the government is likely to receive considerable privatisation receipts until 2010. For this reason, it is essential to discuss the possible uses of these potentially large inflows as early as possible. In our view, the debate should start now, i.e. quite some time before any proceeds are ultimately transferred to the budget. Otherwise, the speed and pressures in political decision-making might hamper the development and implementation of a cautious long-term strategy. In the following we will discuss some general principles on how large privatisation proceeds should be spent in a way that allows maximizing the social benefits of privatisations and minimize its dangers. Thereafter, we turn to a more specific discussion of concrete spending options.

3. Criteria for an appropriate use of large privatisation receipts

From a public economics point of view, two basic principles should be respected in order for privatisations to be truly beneficial in the long run.

Principle 1: Avoid a precarious fiscal mismatch between temporary privatisation receipts and recurrent expenditures

There is an eminent danger that politicians regard privatisation proceeds as a source of long-term revenues and use them to increase recurrent expenditure items, such as public salaries or pensions. Given the limited number of large state enterprises, privatisation receipts are, however, implicitly finite. The proceeds will dry out sooner or later, while recurrent liabilities and costs remain. Unsustainable fiscal decisions after privatisations can thus create a precarious fiscal mismatch between extraordinary privatisation revenues and regular, recurrent liabilities. Such mismatch can put the financial stability of a country at risk, leading to an increase in the structural deficit and higher levels of debt. As a general principle, privatisation proceeds should therefore be used to finance extraordinary, transitory disbursements only.

Principle 2: Invest the proceeds in the future of the country instead of consuming them

Similar to government debt, proceeds from privatisation are no regular type of “revenue”. Instead, privatisation should be seen as an exchange of assets. By selling a state-owned enterprise, the government exchanges a productive facility with potential future profit flows against cash. Hence, if the state-enterprise is sold at a fair price - which is obviously a crucial prerequisite - privatisation will neither reduce nor increase public sector wealth. However, the proceeds from selling the public asset might not be used in a way that benefits a country’s long run perspective. For example, the extraordinary cash proceeds might be channelled into consumption, which was partly the case after the second Kryvorishchal sale (see Box 1). Privatisation proceeds should be used to finance projects that provide a positive long-term yield to the economy, just as the original state-owned asset did. Generally speaking, the money should be invested in the country and the people with a clear long-term perspective. This is what we regard as the second principle of wise spending.

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**Box 1**
The use of the Kryvorizhstal proceeds

In October 2005 Kryvorizhstal was sold for UAH 24.2 bn (USD 4.8 bn) to Mittal Steel Germany GmbH. This was the biggest privatisation deal in Ukraine and corresponded to around 25% of the yearly central budget. After repaying UAH 4.26 bn to the previous owners, the remaining privatisation proceeds were transferred to the Treasury accounts.

To understand how the privatisation proceeds were used, we compared the planned central budget before the Kryvorizhstal privatisation and the final execution of the central budget (general fund) afterwards. As the privatisation proceeds were beyond the planned receipts, these extra funds can be treated as a windfall profit. That allowed us to presume that the final execution figures were to a large extent driven by the ability to use the privatisation receipts. In 2006 the funds were readily available, which makes the tracking of ‘wisdom of privatisation money use’ much more complicated. Here, we just paid attention to the major directions of spending.

In 2005, the government revised the budget after receiving high privatisation receipts. The revision included approximately an UAH 4.7 bn increase in spending, 75% of which were directed to current consumption such as wages and pensions. The comparison between projected and final figures of the central budget (general fund) in 2005 shows that privatisation receipts allowed government to repay debts at UAH 1.1 bn, not initially planned, and accumulate funds at Treasury accounts. At the same time, current expenditures increased by 5% (UAH 4.4 bn), and capital expenditures remained at the same level despite the recapitalization of state banks by UAH 0.7 bn. Thus, in 2005 privatisation receipts definitely allowed maintaining high current spending, although some money were spent for debt reduction.

In 2006, the previous year’s privatisation receipts accumulated at the Treasury accounts allowed to repay state debt as net borrowing reduced by UAH 3.8 bn. Also, these receipts allowed financing central the fiscal deficit in January-July, out of which the most was directed to current expenditures. The execution of current expenditures is 55% of annual plan, while capital expenditures are heavily underfinanced (20% execution of annual plan). Moreover, at the beginning of 2006 re-current expenditures were increased, e.g. via the introduction of social privileges to children of war.

Summing up, despite a considerable debt repayment in 2005-2006, the surge in current consumption was the most prominent change in fiscal policy that happened after large privatisation receipts were obtained.

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**4. Evaluating the policy options for Ukraine**

With a view to the above, what are the concrete policy options in Ukraine? Obviously, an amount of USD 7 to 12 bn can be spent for a wide array of things. For example, the 2007 budget for Ukraine foresees to employ the expected privatisation proceeds for diverse purposes in agriculture, construction, the manufacturing industry and the energy sector. However, the experiences in many other countries and the economic literature in general helps to identify three basic spending options that have shown to be sustainable and wise: (i) the repayment of state debt, (ii) the co-financing of large public investments such as infrastructure projects and (iii) the reform of social security systems, in particular pension reform and the introduction of a second, capital based pillar.

In the following, we will discuss each of these spending options for Ukraine. The two key principles outlined above will guide us in the evaluation. For one, we will ask if the spending choice entails the danger of a fiscal mismatch, i.e. if it puts at risk fiscal sustainability on the medium and long run. Second, we will scrutinize, whether the option is good for the country’s development in the long run.

**4.1 Repayment of state debt**

Repaying debt is a clear-cut and widespread spending option for privatisation proceeds. Debt repayment clearly fulfils the first of the above principles. In fact, such decision avoids any risk of a fiscal mismatch and of an unsustainable budgetary policy. Repaying or swapping debt may instead help to improve the overall fiscal situation and debtor confidence is likely to increase. For highly indebted countries, the servicing of debt may also entail the additional benefit of improved access to financial markets and cheaper borrowing.
used for consumption nor for unproductive investments. Instead, assets owned by the
government are simply exchanged against government liabilities, in a very straightforward and
"clean" operation.\(^7\) Although debt repayment is a good standard policy recommendation for
employing privatisation receipts and although this practice was largely used in a series of
countries including Italy, Greece, Hungary, Israel, Peru, Mexico and Turkey, we believe that it
is not the best option for Ukraine at the moment.

Currently, Ukraine's debt burden and its debt servicing cost are relatively low and declining.\(^8\)
The country has favourable credit market conditions and growth prospects are good. Hence,
there is no immediate need to reduce debt. Additionally, the repayment of debt might further
dry out the sovereign debt market in Ukraine, which has become more and more illiquid in the
last years.\(^9\) Generally, illiquid debt markets cause a series of problems, which should be
avoided. First of all, a liquid state debt market is important since sovereign debt pricing fulfils
an important benchmarking function for credits to private enterprises and for corporate bond
issuances. In fact, sovereign risk is often regarded as the best available proxy to set country
risk premium. Additionally, it should be kept in mind that a country needs a proper credit
history to be a credible borrower. Without regular repayments in past years, investors may be
suspicious about the sovereign's willingness to pay and typically demand high disproportional
risk premium. Lastly, domestic sovereign bonds are needed as an important asset for local
insurance companies or pension funds to invest in. A country with healthy financial markets
needs a liquid domestic bond market. Taken together, we do not see debt repayment as the
number one choice for using potential future privatisation receipts in Ukraine.

4.2 Co-financing of investment projects

This is the option that seems to be chosen by the new government. The co-financing of
investments such as large infrastructure or housing projects is a common use of privatisation
receipts for example in the Czech Republic, Romania or Jordan. For this spending option, the
first principle is complied with by and large. Most costs for infrastructure and housing arise in
the construction process itself. Consequently, the bulk of necessary expenses are temporary
which matches with the transitory nature of privatisation proceeds. However, large investment
projects also trigger a certain degree of recurrent expenditures such as the costs for
operations, maintenance, salaries, or capital servicing (depreciation). But if this fraction is
small, or if it has not to be paid by the state, budgetary sustainability is not endangered.

As regards the second principle, it is fulfilled under only certain strict conditions. Although
most projects are officially aimed at improving economic welfare, they ultimately might not do
so. Only if the investment projects are truly beneficial, i.e. with a high socioeconomic yield
then the public money from privatisations will not be wasted. Unfortunately, the past record of
public investment in Ukraine is not favourable. Many projects have turned out to be highly
inefficient and a large proportion is not even concluded at all.\(^10\) As in many emerging markets
large infrastructure projects have also been a breeding ground for corruption.\(^11\) One prominent
example for the inappropriate management of public investments is the immensely expensive
highway constructed between Kiev and Odessa, which was nicknamed the "golden road" due to
its exorbitant costs.

The key question when choosing this spending option for privatisation proceeds is therefore:
How to ensure that the public investments are truly efficient? As a general answer, we suggest
that large investment projects should not be paid entirely by the state. To avoid a
misallocation of funds, the private sector or even multilateral financial institutions should

\(^7\) Nevertheless, it should be kept in mind that debt repayments typically ease external pressure for fiscal adjustment
and reform. Therefore, it should always be safeguarded that debt repayments are not taken as an encouragement to
relax fiscal policy and to increase spending and borrowing.

\(^8\) At the end of 2005, the total debt to GDP ratio was 18.4%. This ratio is expected to decrease further in 2006.

\(^9\) Besides a highly illiquid corporate bond market, there has been no sovereign bond issue for more than a year until
September 2006, which is a very long pause compared to most other emerging economies.

\(^10\) Each year the state capital investments funds are distributed to all uncompleted investment objects that have been
started at some point in time. Unfortunately, each year a large number of new projects are initiated, regardless of
whether older projects are completed or not. In 2002 and 2003, for example, over half of the central budget funds for
capital investments were channelled into projects with completion rates below 50%.

\(^11\) A 2004 report by Ukraine’s Central Auditing Administration states that only 70% of allocated funding for state
capital investments was subject to inspections and audits. Around 10% of the funds are even attributed to non-
targeted and outright illegal spending.
instead come up with large parts of the financing. The state should only pay for a minor share of the investment project, i.e. 10-20%. Such a constellation has clear advantages in terms of transparency, accountability and management. Moreover, such an arrangement makes sense in that more projects could be realized with the same amount of public privatisation proceeds.

To summarize, we regard the use of privatisation for infrastructure projects as a generally favourable solution. However, the solution will be only long-term beneficial for the country, if highly efficient projects in priority areas are chosen. Given the current record of investment projects that are entirely financed by the government, there is some reason to be sceptical whether this will be the case. We therefore regard a large degree of financing by the private sector and/or international organizations and proper auditing as a key requirement when choosing this spending option. In the medium-term, public efforts in Ukraine should definitely be directed to improving the procedures for selecting, financially planning and implementing state investment projects.

4.3 Supporting pension reform: the launch of the second pillar

Around the world, privatisation receipts have been an important source of revenues to reform pension systems. Large extraordinary proceeds can be a crucial element in establishing the so-called second pillar, a capital-based accumulation fund implemented by the state and featuring personalized pension accounts. Privatisations provided an important financial basis to introduce this key element of a modern three pillar pension systems in several South American countries, but also in transition countries such as Poland or, more recently, Slovakia. We believe that spending privatisation receipts to reform the pension system makes much sense for Ukraine, too.

In Ukraine, the second pillar was officially introduced on paper in 2003 and has originally been foreseen for implementation in 2007. According to a draft law on the introduction of the second pillar, the contribution to the second pillar will total 7% of the wage bill. This amount will be directly paid by employees, initially only by those below the age of 40. The new pension law also states that the second pillar should only be introduced if the budget in the first pillar is balanced, which is not the case at the moment. The huge increase in pension benefits in the pay-as-you-go (PAYG) system in 2004-2005 has considerably widened the overall pension deficit, which is now likely to persist for some time to come. In this situation, privatisation proceeds can provide crucial funds to kick-start the second pillar and allow this essential reform to take place. Concretely, large sums from privatisations may help to finance the transitory financial gap in the pension system, which will inherently arise after launching the second pillar.

In the first years of the reform, the percentage of pension contributions flowing into the accumulation fund will in fact be missing in the first pillar. In a recent report, the World Bank has provided some estimates of the size of this pension gap in Ukraine under the basic assumption of a 7% employee contribution to the second pillar and assuming an implementation in 2008. Under favourable conditions, i.e. with 4 to 5% yearly GDP growth and, more essentially, a successful reform of the first pillar, the transitory gap is estimated to sum up to USD 7 bn and will approach to zero in 2016. Realistically, the gap is likely to turn out double as big. However, in general, the potential privatisation receipts of up to USD 7-12 bn in the near future seem large enough to cover a substantial part of this transitory gap, which provides an important quantitative backing for our discussion.

Given the above, we propose to use privatisation receipts for launching the second pillar. Privatisation receipts should be allocated for filling the transitory gap in the first pillar, which will be caused by the introduction of the second pillar. But the receipts should not cover the structural deficit in the first pillar, which has no link to the implementation of the second pillar.

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12 The utility and economic yield of the project will be usually scrutinized more thoroughly ex ante if private investors invest their money. Also management and transparency has been shown to increase in such public-private-partnerships. Generally, the governmental support might increase the probability that project are ultimately realized.

13 For example, potential investment projects should be checked by reputed international auditing firms.

14 Currently employees pay only 2% of the wage bill as pension contributions, while employers pay the rest (31.8% of the wage bill).

15 In a pessimistic scenario with no reforms in the first pillar and a mere 2 to 3% of GDP growth, the gap will be much wider summing up to USD 31 bn in the first 9 years. Then, also the transition period will be much longer.
In the main, the suggested scheme complies with our first spending principle. Both privatisation receipts and the financial gap arising due to the introduction of the second pillar are transitory, i.e. limited to a period of 10-15 years. Additionally, this strategy may help to considerably improve the country’s financial position in the long run. In fact, when implemented properly, the reform will considerably reduce future expenditures on pensions.

However, in its basic form, the scheme lacks flexibility. As outlined above, privatisation proceeds are highly unpredictable and volatile. There is a general uncertainty whether large receipts will ultimately materialize and how large they will be. At the same time, it is necessary to carefully plan the fiscal implementation of the second pillar well in advance. Without a buffering mechanism, the scheme would therefore entail fiscal risks.

A suitable solution to this problem is the establishment of a privatisation fund with the only purpose to launch the second pillar. Like in Bolivia in the 90ies, such transitory privatisation fund should underlie the same regulatory requirements as the state pension fund itself, i.e. with clear investment rules and a high degree of transparency. Once enough money has been accumulated in the privatisation fund, and safeguarding that the capital has not been spent for other purposes, the second pillar can be launched. A careful threshold for such launch could e.g. be an accumulated volume of USD 3 bn, which, depending of course on the ultimate figures could provide a financial basis for several years of transitory gap financing. Altogether, such privatisation fund will reduce fiscal uncertainty and provide a tool to handle either very large or more limited privatisations.

Regarding the second principle of wise spending, it is fulfilled for this spending option if we consider the overall changes. While the privatisation proceeds are channelled to the transitory gap, exactly the same amount of funds is brought to the Accumulation Fund, i.e. enter the capital market. It is sustainable and wise long-term strategy for socioeconomic development.

First of all, the pension system itself will improve, with the second pillar being an important long-term complement to the pure day-to-day PAYG system. Of course, the introduction of the second pillar should generally not be understood as a substitute for urgently needed reforms in the first pillar of the Ukrainian pension system. The introduction of a proper second pillar will also positively contribute to the development of capital markets in Ukraine. Pension funds as large institutional investors play a crucial role for stable and liquid financial markets and create much potential for further investment. In Chile, for example, domestic pension funds bought most bonds that have been issued to finance many of the country’s recent infrastructure projects. Also in successful transition countries such as Poland pension funds have helped to develop deeper capital markets and have started to function as an important complement to banks in providing enterprise financing for investment.

Besides these long-term benefits, the suggested scheme could have also positive immediate effects. The facilitated introduction of the second pillar will create incentives to generally participate in the pension system in the first place. Currently, pension contributions in Ukraine are mainly seen as a burden, with no personal incentives to report the true level of income. Quite differently, the accounts in the second pillar will be individualized, with money belonging to the employees themselves. The employees’ part of the pension contributions may then be seen as a form of personal savings. The higher the reported income, the higher will be the contributions to ones personal account and the higher also the supplementary state support from the privatisation receipts. Besides benefiting the social security system, the reduction of pension contribution paid by employer will help in a better disclosure of true income, thus significantly contributing to de-shadow the Ukrainian economy as a whole.

The suggested arrangement may also be advantageous from a political point of view. Linking privatisations to the pension reform might ultimately strengthen the support for both agendas. In fact, as opposed to a situation were privatisation receipts are used to finance infrastructure projects or to retire debt, future pensioners will have a personal long-term benefit from

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16 The Bolivian "collective capitalisation fund", in which 50% of all privatisation revenues were channelled to support the capital-based pension pillar, were managed by the same fund management companies and were subject to the same investment rules as the pension funds that had been established before.

privatisations. Additionally, the scheme might have a disciplining “lock-in” effect. As soon of the government introduces the second pillar of the pension system, it will be obliged to finish the pension reform, thus finding the ways to minimize the transitory gap via reforming the first pillar of the system.

Summarizing, we believe that the financial support of the second pillar is an adequate use of privatisation receipts in the current Ukrainian situation. Such a spending option has the potential to largely benefit the whole economy on the long-run, benefits individual pensioners, is politically wise and contributes to foster structural reform.

5. Conclusions

In this paper we have outlined that additional budgetary funds from privatisations can easily be spent unwisely and in an unsustainable manner. To guarantee that the money is spent in the country’s long-term interest, two core principles of wise spending should be respected. First, the government should avoid a precarious fiscal mismatch, by using the temporary receipts from privatisations to increase recurrent expenditures. Second, it should avoid the consumptive use of the receipts. If these two principles are complied with, privatisation money can be highly beneficial for a country.

In the second part, we conclude that in the near future the probability of large privatisation deals is rather high in Ukraine. Since a sensible strategy on how to spend the receipts require proper and relatively long preparations, it is crucial that this topic is discussed before the inflow of funds into the state coffers takes place. Otherwise, some options will be excluded and the quality of the spending decisions might suffer under the necessity of rapid action. The third and main part of this paper discusses three key spending options for Ukraine.

In our view, no priority should be given to the repayment of state debt. The level of state debt is not particularly high in Ukraine. Besides, it has to be reminded that state debt has an important benchmarking function for private borrowers. The financing of infrastructure projects is in principle a good idea. But in order to avoid financing inefficient projects with doubtful benefits for the country, the state should as a rule only finance a small part of the project. The bulk of financing should come from the private sector and from multilateral financial institutions. The main spending priority should be given to the implementation of the second pillar of the pension system. In order to facilitate the planning of the pension reform, a special privatisation fund should be established with the only goal of supporting the financing of the transitory gap that arises due to the introduction of the second pillar.

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