Mass Privatization in Ukraine

Bernard Drum

Ukraine has so far been unable to activate its mass privatization program. However, in early March 1994, a multidonor mission to Ukraine signed a memorandum of understanding (MOU) on mass privatization with the government. If this MOU and the 1994 State Privatization Program approved by Parliament in early 1994 are both implemented, the Ukraine mass privatization program could become one of the largest in the world. This Note reviews the developments since Ukraine's independence, including the main provisions of the 1994 State Privatization Program and the MOU.

Background
The challenge facing the designers and implementers of a mass privatization program in Ukraine is enormous by any standards. The Ukrainian economy has been in continual crisis for the last few years. GDP is thought to have fallen by about 40 percent since 1989, and by 15 percent in 1993 alone. Inflation during 1993 was estimated to be 5,000 percent, reaching as high as 75 percent per month for a time during the second half of the year. This inflation was a direct result of government efforts to support existing production patterns through expansionary fiscal and monetary policies, following the collapse of the Soviet Union. At the same time the government has been slow to relax its grip on the economy or to allow market forces and the private sector to lead the way out of decline. Although there have been many pronouncements on the need to move to a market economy there are, as yet, few tangible signs of a coherent approach to economic policy.

Details on the total size of the enterprise sector in Ukraine are hard to come by but the state sector is estimated to be in excess of 10,000 medium and large enterprises and well over 100,000 small enterprises. Much of the Soviet Union's diverse heavy and light industry, including some of its largest monopolies, was located in Ukraine.

Privatization in Ukraine, as with other aspects of economic reform, has been paralyzed by a lack of consensus among policymakers, an absence of leadership, an ambiguous legal and institutional framework, and weak implementation capacity. While in neighboring Russia, the spontaneous privatization which had been gathering momentum in early 1992 was effectively captured and institutionalized...
by the Russian Mass Privatization Program, the absence of a similar program in Ukraine has encouraged spontaneous privatization to accelerate. Enterprise employees in Ukraine, and particularly the workers' collectives, perceive that they have ownership rights to the enterprises where they work. Their perceptions of ownership rights have been reinforced by a series of laws and decrees that have given workers the right to lease enterprises with exclusive buyout options at the very low book value.

The legal and institutional framework
The basic statutes governing privatization in Ukraine are the laws on (i) Privatization of Property of State Enterprises, (ii) Small Privatization, and (iii) Privatization Certificates. These laws were passed by Parliament in 1992. They have since been supplemented by many other laws, decrees, and regulations which have further defined the process. In 1992 Parliament approved the 1992 State Privatization Program which gave concrete targets for the period 1992-1994, and earlier this year the 1994 State Privatization Program set new targets for 1994.

All state-owned enterprises now come under the authority either of the State Property Fund (SPF) or the regional or city property funds, which have full responsibility for privatization of the enterprises within their portfolios.

A first important principle underlying the privatization laws for medium and large enterprises is that all citizens of Ukraine are entitled to a share of the enterprise assets. This entitlement is exercised by means of privatization certificates which are to be distributed to the population free of charge. A second important principle is that workers in the enterprises have first priority and the balance of shares can be distributed and sold by a mix of methods including auctions, tenders, or public offering.

Privatization certificates are nontradable and take the form of privatization accounts opened for each citizen in the Savings Bank. The original value of each citizen's certificate was Krb 30,000. This was increased in 1993 to Krb 1,000,050. Hyperinflation has made a precise determination of the US$ face value equivalent difficult but at today's market rate the value of a certificate is approximately US$30. (The certificate face value is in any case related to the book value of the enterprise assets rather than to their market value.) Each enterprise has to submit a privatization application to its parent privatization body and create a privatization committee to prepare a plan and oversee the corporatization and privatization process. For small enterprises (i.e., those with a 1992 book value of Krb 1.5 million or less) the law provides for employee buyout or for competitive sale by auction or tender.

A distinguishing feature of Ukrainian privatization is the widespread leasing of enterprises of all sizes and the special privileges and priorities given to leaseholders in the privatization process. Leaseholders were well represented in the outgoing Parliament. Their influence on the legislation has been significant, despite attempts by some reformers in the government to limit leaseholder privileges by issuing decrees which have sometimes contradicted the law. The Privatization Law allows lease buyouts and the Leasing Law, also passed in 1992, gives lessees the exclusive right of buyout for a period of three years. Leaseholders are also allowed to apply retained earnings during the lease period to the purchase price of the enterprise. In general the leaseholders have been winning the battle against those favoring more open forms of privatization. This also reflects the extent to which leasing has spread.

Foreign investors can participate in medium- and large-scale privatization on the same basis as Ukrainian nationals, except, of course, that they will not have privatization certificates to redeem, nor can they benefit from employee privileges. In small-scale privatization, Ukrainian investors are given the right of first refusal but if no local buyer emerges then foreign investors can take part. Foreign investors do, however, have to convert their foreign currency at a less advantageous rate than the market rate of exchange.
Privatization results to date

The 1992 State Privatization Program sought to privatize 15 to 30 percent of assets in retail trade and consumer services and several hundred medium and large enterprises during 1992, and to complete small-scale privatization during the following two years. The program also included a plan to privatize 80 to 90 percent of industry and 100 percent of trade over the period to the end of 1994. But no serious attempt was made to realize these targets. Satisfactory progress in meeting them could only have been made by designing and initiating a mass privatization program and through a program of very rapid small-scale privatization. Neither of these things happened. In 1993 individual privatization transactions did take place and small-scale privatization had started. By October 1993, according to information from the SPF, several hundred medium-scale enterprises belonging to both SPF and Regional Property Funds and 200 small-scale enterprises had been privatized. The total book value of these enterprises was Krb 130 billion. But the absence of a mass privatization program and the inability to replicate small-scale enterprise auctions have prevented the process from building up the same level of momentum that has existed in Russia since 1992.

This lack of progress at the center prompted the international donors during 1993 to support local-level programs in an attempt to jump-start the process. The World Bank, with grant finance from the Dutch and Swiss governments, provided assistance to the privatization bodies in the city and oblast of Kharkiv. The Bank also worked using a Swiss grant and the proceeds of the World Bank Institution Building Loan in the city of Kiev. The Kharkiv program included assistance with small- and medium-scale privatization and private sector development and the Kiev program gave assistance in preparing for small-scale privatization. International Finance Corporation (IFC), with grant finance from USAID, worked on small-scale privatization in L'viv, Zaporizhe, and several other cities and carried out a number of successful medium-scale pilot transactions. USAID has worked directly in Odessa and other cities on small-scale privatization. The European Bank for Reconstruction and Development (EBRD) initially provided assistance with European Union (EU) finance to the SPF in Kiev, but then focused its effort on pilot privatization transactions. The EU has worked directly on medium-scale pilot transactions. All of these initiatives have produced and continue to produce concrete results. They are being extended but have yet to lead to the widespread replication that was originally hoped for.

The 1994 State Privatization Program

The 1994 State Privatization Program provides for mass privatization of medium and large enterprises and for a computerized communications network and data base to support implementation. The program also proposes rapid and widespread small-scale enterprise privatization. Privatization targets for 1994 are 24,000 small-scale enterprises, 1,680 units of unfinished construction, and 8,000 medium and large enterprises. Transfer to citizens via certificates will account for not less than 70 percent of the total value of assets privatized. Foreign investors will have to convert their currency at the rate of Krb 420 per US$, compared with the current market rate of around Krb 37,000.

In preparing the pipeline of enterprises for privatization, priority will be given to retail outlets and consumer services and those medium and large enterprises that have the greatest impact on the consumer market, as well as loss making enterprises. Cabinet of Ministers' approval is required for privatization of monopolies and of enterprises such as those involved in fuel, energy, transport, medical equipment and pharmaceuticals, certain media, paper, and bread. No privatization is planned this year for "strategic activities" such as ports, pipelines, military equipment, public utilities, publishing, education, and the space complex.

Memorandum of Understanding

In February 1994, a joint mission including the World Bank, EBRD, USAID, and the EU worked in Ukraine with privatization and other government officials. This was a highly collaborative initiative driven by a
realization on all sides that the time for implement-
ing mass privatization in Ukraine was long overdue
and that the donors were ready to finance the im-
plementation of a program if agreement could be
reached with the government on the program con-
tent. A first premise on which the agreement was
negotiated was that there should be no major chan-
ges to the existing legal framework for privatization.
Refinements would be made where necessary but
the time required to get Parliament to make changes
would not be worth the wait and the uncertainty.
The objective was to get the program up and run-
ning as soon as possible.

The main commitment agreed to by the government
in the Memorandum of Understanding is that it will
begin implementing a mass privatization program in
accordance with the 1994 State Privatization Program.
Innovations agreed to by the government in the
Memorandum include (i) the use of paper vouchers
or certificates instead of the previous plan to use
non-paper privatization accounts in the Savings
Bank; (ii) the creation of a network of private bid-
ding and processing centers to exchange the certifi-
cates for shares, thus removing the need for the al-
ready overburdened Savings Bank to play this role;
and (iii) streamlining the process for preparing enter-
prises for sale. By law, the certificates will not be
transferable between individuals but will be tradable
for shares in enterprises through the bidding centers
or for units in private investment funds. These funds
will be actively promoted and they will be allowed
to use the certificates they receive to buy shares
through the auction process. These innovations
should allow very rapid implementation.

In return the donors who participated in the mission
agreed to provide US$30 million to support the pro-
gram over the first four to six months. In the World
Bank’s case these funds would be provided from the
Institution Building Loan supplemented as far as
possible by Trust Fund grants, (i.e., grant funds from
bilateral donors administered by the Bank). The ex-
ternal support will include financing of the design
and printing of the certificates, implementation of
the independent bidding network including comput-
ers and telecommunications equipment, training and
equipment for the privatization agencies, a large
public information campaign, support for the devel-
opment of investment funds, secondary securities
markets, and postprivatization support for enterprises.

There are no specific agreements to deal with the
leaseholder problem but the donors are committed
to provide advisers on incentives to promote rapid
privatization of leased enterprises.

**Next steps**

Recent parliamentary elections have temporarily
deviated the attention of some decisionmakers.
However consultants are now in the field making
progress with the program design details. Issues still
to be resolved include how certificates will be ex-
changed for shares and how the enterprise prepara-
tion process can be streamlined without major
changes to the legislation. Incentives also need to be
developed to encourage leaseholders to go through
the privatization process as soon as possible. As
soon as agreement with the government on the de-
tails of the program is reached and implementation
begins, the government and donors will be carefully
monitoring the need for further assistance. If the
ambitious plans at last show signs of being realized
there should be no shortage of further financial sup-
port from the donors.

---

Bernard Drum, Senior Enterprise Reform and Privatization Specialist,
Europe and Central Asia Region.

---

This series is published to share ideas and invite discussion. It covers financial and private sector development as well as
industry and energy. The views expressed are those of the author(s) and are not intended to represent an official statement of
Bank policy or strategy.

Comments are welcome. Please call the FPD Note line to leave a message: 202-458-1111, or contact Suzanne Smith, editor, Room
G8105, The World Bank, 1818 H Street, NW, Washington, DC 20043, or Internet address ssmith@worldbank.org.