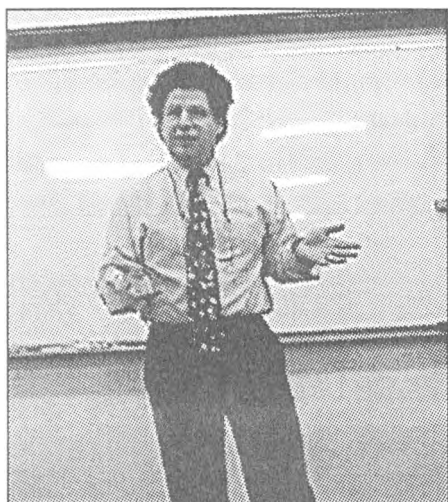


ECONOMICS THEORY FAILS... IF WE TALK ABOUT UKRAINE

Analysis of transition economies has emphasized the pivotal role of privatization, and especially of outsiders, in economic development. Recent studies of Central Europe point to the strong impact of privatization and highlight the role of outsiders in restructuring and improving economic performance. Privatization in Ukraine was designed to formally encourage outsider investment. But did this improve the performance of private enterprise in Ukraine? Saul Estrin, professor in economics at the London Business School tried to answer this question during a recent stay in Kyiv.



Saul Estrin

EDITOR'S NOTE

Saul Estrin, BA, MA (Cambridge), DPhil (Sussex), Professor of Economics, is director of the CIS Middle Europe Centre. Professor Estrin is an author of numerous publications, such as "Self-management: Economic Theory and Yugoslav Practice" (CUP, 1983), "The Economics of Profit-sharing and Employee Share Ownership" (with S.Wadhwani and P.GROUT), "Economic Policy" (1987), "Introduction to Micro-economics" (with D.Laidler) (Philip Allen, 1994), "Privatisation in Central and Eastern Europe" (Longman, 1994), "Enterprise Performance and Corporate Governance in Ukraine," and "Enterprise Performance and Ownership: The Case of Ukraine" (with Adam Rosevear, 1998).

Estrin is a consultant for the World Bank, associate editor of the international journal of Industrial Organisation, the Annals of Public and Cooperative Economy, the journal of Comparative Economics, and Business Strategy Review.

Since 1991 Ukrainian firms have been in a difficult situation: output and employment had fallen every year, and profitability was low or negative.

There had been only modest changes to production and export structures. The process of privatization was very limited and had many unpredictable effects.

Though privatization in Ukraine was designed to encourage outside investment, it had in fact led to an outcome similar to that in Russia: insiders control more than half the shares in Ukraine (51% compared to 54% in Russia). However, outsiders' stake is higher in Ukraine (35% compared to 21% in Russia), because the retained state share is lower.

In January Professor Estrin, shared with EERC students the empirical results, of a survey he conducted on 100 firms with different forms of ownership in eight regions of Ukraine. The objective of this survey was to test hypotheses on the relationship between enterprise performance and ownership in Ukraine, a country that has lagged in the transition process. Professor Estrin and a group of researchers explored whether privatization has yielded improved company performance, and whether specific ownership forms (insider, manager, worker or outsider) have led to dif-

ferentiated enterprise performance.

The following theoretical hypotheses were tested by Professor Estrin:

Central hypothesis: Economic performance of state-owned firms is inferior to that of privatized ones.

Hypothesis 1: Privately owned firms perform better.

Hypothesis 2: Performance will vary depending on ownership type. In particular, firms owned by outsiders will perform better than all other ownership types.

Hypothesis 3: Insider control may yield some improvement in performance relative to state ownership.

Hypothesis 4: Workers as owners may be less willing to reduce employment than managers.

Professor Estrin arrived at the conclusion that theory does not always check with practice. Those economics hypotheses that are true in Western countries and the countries of Central Europe very often do not work in Ukraine. For example, during his research in Ukraine, Estrin found no evidence that private ownership is associated with improved enterprise performance. Most privately owned firms, including firms owned by outsiders, earn the same level of profit as nationalized, state-owned firms. Moreover, contrary to expectations, outsider owned firms do not

perform better than insider or even state-owned ones. Insider ownership is sometimes associated with improved performance, and sales adjustment is significantly better in such firms. But there is no difference in the adjustment of employment between different types of privately owned firms, including outsider owned ones. Also, barter - a key phenomenon in the countries of former Soviet Union - is associated with lower profitability, but not with lower sales or employment. Moreover, commercialized firms, firms with no majority owner, and outsider owned firms undertake barter to the same extent as nationalized state-owned firms.

Though harder to explain, Professor Estrin believes that failure of outsider ownership to cause restructuring in Ukraine is apparent. According to Estrin, one possible interpretation is that the weak legal framework makes it very hard for outsiders to exercise any real control over companies in which they have a majority stake. A second explanation is that, since insiders controlled the privatization process, they ensured that outsiders gained dominant shareholding in only the worst firms.

The Master's Program in Economics announces that on April 14-15, 1999 there will be the EERC international conference. The topic of this year conference will be: 'The Welfare Costs of Quotas, Tariffs, Subsidies, Taxes and Licences'.

CHECK OUT THESE EERC WEB SITES

EERC Master's Program
Home Page:
<http://www.eerc.kiev.ua>

Gateway to Ukraine, the Economics of Transition, and the World of Economics:
<http://intranz.eerc.kiev.ua>

40% OF UKRAINIAN GDP IS IN THE "SHADOW ECONOMY"

Nowadays there is a widely accepted opinion in most strata of society that the existing government gave birth to the current "shadow" economy as well as to the contemporary mafia in Ukraine. People also believe that the rise of the mafia and the shadow economy was exclusively promoted by the country's transition to a market system. But the analysis of the "shadow" economy and its qualitative peculiarities in Ukraine must be based primarily on scrutiny of the process of "shadowing" that took place in the economy of the former USSR.

On the 3rd of February 1999, Viktor Mandybura, head of the scientific-analytical department of the secretariat of the Ukrainian Parliament, visited the EERC Master's program. Viktor Mandybura is the author of the current popular book "The Shadow Economy in Ukraine and the Legal Strategy of Its Restriction." In the

author's opinion, the authoritative system of management in the former Soviet Union created favorable preconditions for the formation of a "shadow" economy. The value of the Soviet "shadow" economy (i.e. the expert estimates of its annual gross product), provides evidence in favor of this: according to Derzhkomstat of the USSR, at the end of the 1980s and beginning of the 1990s,

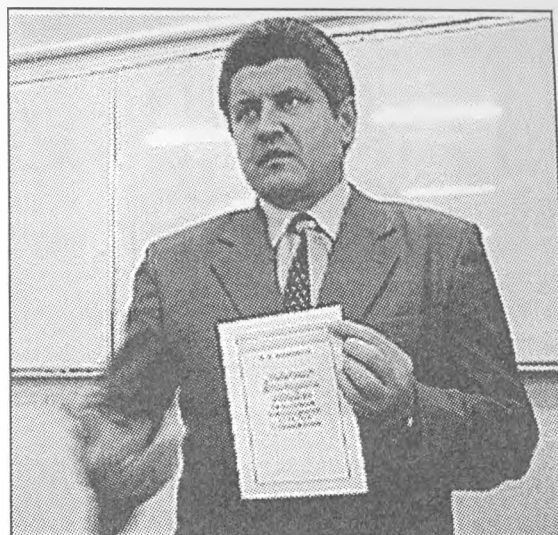
this value was estimated to be about 130-200 billion rubles or close to 10-20% of GDP.

"At first sight one can perceive that radical economic and political reforms, with the main goal of building a legal state, were implemented to ruin the administrative system itself as well as its mirror image - the "shadow" economy of the bureaucratic type," says Viktor Mandybura. "But, by contrast, the practice proves that in reality it didn't happen so. Moreover, in times of transition the level of "shadowing" of the society increased and, as a result of it, our country acquired a unique phenomenon - the formation of the so-called "shadow" hybrid with an extremely powerful "black"

criminal kernel, a hybrid of which can instantly adapt to any economic or political changes in the country," explains Mandybura.

In Mandybura's view, there are many objective and subjective factors that encourage "shadowing" of the Ukrainian economy and create certain conditions for its growth. Among them are:

- inclusion of new objects in the process



Viktor Mandybura

of division of property (such as land, strategic factors of production, natural resources, and others which have previously been excluded);

- deepening of the breach of traditional economic relations both between particular enterprises and between whole regions, as well as the conspicuous growth of unbearable barterization of economic relations;
- an underdeveloped legal base for economic reforms and an ineffective system of state accounting and control;
- existence of high tax burden; the absence of conditions for attracting "shadow" non-criminal capital into the official economy;

- an increase in the number of criminal structures;
- economic agents being completely legally unprotected, etc.

According to Mandybura, "shadow" economy is the economy hidden from the state, one that doesn't pay taxes. Some idea about the true volume of the hidden economy as well as about reported income of certain groups of the population is given by the fact that in 1994 alone citizens of Ukraine purchased some 164,000 imported cars, the total value of which is estimated to be 1.5-2.0 billion U.S. dollars. Ninety percent of those who imported the cars had privileges that freed them from paying excise taxes, import tariffs, value-added tax, etc. There was another fact mentioned. According to expert estimates, up to 20 billion U.S. dollars was unofficially exported from Ukraine. In addition, information from various data sources, indicates that Ukrainian households keep 4-10 billion U.S. dollars in cash, 50% of which serves the "shadow" economy. As reported by the National Bank of Ukraine, since 1996 the amount of cash in the shadow economy has accounted for more than 40 % of the total money supply. (Compare: according to statistics services of Germany and the U.S., the share of cash money in the total money supply amounts to 1.8% in Germany and 5% in the U.S.).

Mandybura also informed the students that, judging by the size of monetary resources that serve the "shadow" economy in Ukraine and applying different methodologies of its analysis, the parameters of the "shadow" sector of the Ukrainian economy are not lower than 40% of the officially reported GDP and not likely to exceed the level of 50%. According to the calculations of some western specialists, when the level of the "shadow" economy in market countries reaches 15-30% of GDP, this sector becomes critical to the economy of the state.

In Mandybura's opinion, creation of a reliable system to legally prevent existing

possibilities for money-laundering as well as establish a well-developed legal base for effective functioning of the tax system can stop the dangerous path of further "shadowing" of the Ukrainian economy. "Otherwise," says Mandybura, "it can ultimately lead to lethal consequences for the social and economic well-being of the country."

SUPPRESSION OF UKRAINIAN ENTERPRISES CONTINUES

Speaking at a meeting with students of the EERC Master's program on the 17th of February, 1999, Viktor Lysytskiy, head of the advisory group of the National Bank of Ukraine, focused on problems connected with the transformation of the Ukrainian economy. "What can explain the poor state of the economy of Ukraine? Why is Ukraine doing worse than other post-socialist countries?" - these and some other issues were the key questions the speaker addressed.

In Lysytskiy's opinion, the problem is that Ukraine is trying to build up a real economy based on the administrative system it inherited from the Soviet Union. In other words, Ukraine must create a new system of market relations that was absent under the Soviet regime. This new system should include:

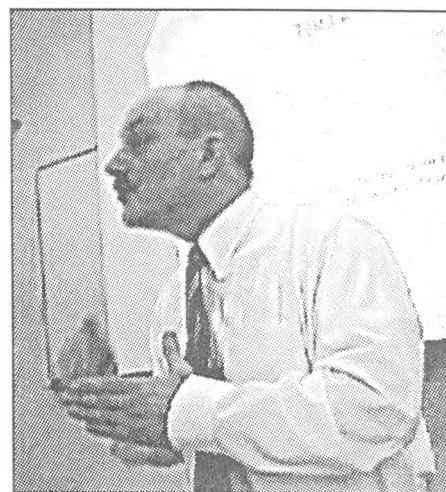
- 1) a complex structure of relations between economic agents acting independently of state;
- 2) state supporting for an easy exchange of their products by buying and selling;
- 3) creation of proper conditions for agents' natural functioning.

According to Lysytskiy, there are three essentials of the market that are missing in Ukraine today:

Firstly, producers and consumers are only partially independent of the state (this is proved by the existence of intolerable restrictions and regulations by which the authorities attempt to control business in Ukraine);

Secondly, the high level of barterization implies that the majority of Ukrainian enterprises don't sustain monetary relations between each other (the relations of buying and selling);

Thirdly, high tax rates show that the state not only doesn't provide appropriate conditions for normal functioning of Ukrainian enterprises but, on the contrary, discourages them.



Viktor Lysytskiy

Therefore, in Lysytskiy's view, it is important to urgently consider the following actions:

1. a decrease in government spending, which appears to be extremely high today (22-24% of GDP);
2. establishment of favorable conditions for production and business (the state should lift all unreasonable administrative regulations and show great consideration for Ukrainian producers).

The issue of the reduction of the current level of government expenditures frequently faces strong opposition from the various political forces. Taking this into account, Lysytskiy believes that granting enough freedom to Ukrainian enterprises can noticeably improve the financial situation in the country. Although this issue has been declared a priority, the authorities continue to suppress Ukrainian enterprises, which are deteriorating with the economic conditions in Ukraine.

SOFT BUDGET CONSTRAINTS DEEPEN THE BUDGET CRISIS

On February 1-2, 1999, three EERC second-year students participated in a scientific conference at NaUKMA on economic policy in Ukraine. Among them were Veronika Movchan ("The Problem of Barter in Russian-Ukrainian Relationships"), Stanislav Vornovitsky ("High Level of Government Spending: Welfare Costs for Ukrainian Economy"), and Maria Vyshnya who presented the results of her research paper on soft budget constraints in Ukraine. After her presentation we had a chance to talk with her.

EDITOR: Maria, with which experts are you working on your research?

MV: EERC gave me the wonderful opportunity to have Professor Janusz Szyrmer, Executive Director of HIID, as my research director. Also, due to EERC I work very closely with government officials from the Ministry of Finance and State Statistics Committee.

EDITOR: I am sure that the subject of your research is very topical. The problem with non-payments to the state budget is discussed on various levels from government officials to the general population. What are some of the more interesting results you found during your research?

MV: First, I would like to say that soft budget constraints are based on the new theoretical concept invented by Czech economist Janos Kornai in 1986. Originally this concept was used to analyze the problem of shortages in Socialist economies caused by preferential government assistance to some branches of industry. This preferential aid takes the form of soft subsidies, soft credits, soft taxation, and soft administrative prices. In recent years the problem of soft budget constraints in Ukraine was compounded by a new variable - the possibility of not paying taxes to the state and insisting on

relief of overdue debts. It was extremely interesting for me to realize that a tradition of such government "aid" to Ukrainian enterprises and bargaining for additional privileges for them is deeply rooted in Ukraine. Whole branches of the economy are not used to relying on their own resources instead of covering their additional expenses with the help of the state.



Maria Vyshnya

This procedure has become so beneficial for firms that tax arrears have grown drastically during the last few years. For instance, in 1996 arrears were 5.3% of Ukrainian GDP, while at the beginning of 1998 they amounted to 12.7% of GDP or three times higher than in Poland or Hungary.

EDITOR: Are there branches in Ukrainian industry that get such government "aid" constantly?

MV: Yes, according to official statistics among these branches are agriculture,

coal mining, transportation, and the energy sector. At the same time, the statistical data confirm that these four industries are monopolists that demonstrate a high potential for profitability even without state assistance. At the same time, the data show that their willingness to pay taxes to the state declines persistently - on average two months after "aid" was acquired.

Therefore, it is obvious that soft budget constraints are inefficient. Moreover, it is possible to state that the application of this form of government assistance to Ukrainian producers reduces their willingness to perform their duties in general and stimulates an increase in non-payments to the consolidated budget of Ukraine in particular.

EDITOR: Maria, I see you are strongly interested in analytical work. Could you share with us your ideas about where you want to work after graduation?

MV: I do not know exactly where I would like to work in the future. But I can say with confidence that the master's degree in economics from EERC opens for me a new world of opportunities, where I am sure I can find something interesting and useful.