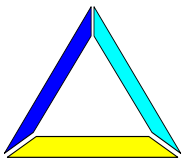
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State-owned Enterprises in Ukraine: How the Profit Should be Distributed

Summary

The existence of fairly large state sector in Ukraine determines the necessity finding the most efficient ways of managing state property in general and financial relations between the state and state-owned enterprises. One aspect of this problem has been already addressed in Policy paper N11 as of November 1999, which contains some quantitative assessments of profit the state could potentially received from its share in corporatized companies.

In this paper we analyze 1) the current state of financial management of state-owned enterprises 2) assess the relevant international experience of transferring state enterprises profit to the budget, and 3) propose how to improve disposition of profits of state-owned enterprises.

Certain solutions regarding financial management of state corporate rights in Ukraine may be regarded as transitional ones for the period of privatization while the proper regulatory framework for non-corporatized enterprises needs to be developed virtually from zero and for longer perspective.

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1 Introduction

Today Ukraine policy-makers have been intensively discussed the ways of increasing budget revenues and how to use state property to this end more efficiently. In practical terms these discussion have resulted in the form of Verkhovna Rada instruction to the Cabinet of Ministers to elaborate procedures to transfer the profits of non-corporatized enterprises to the budget. Verkhovna Rada also proposed to tax of depreciation deduction of the state enterprises at the rate of 10%. Besides, after long discussions Verkhovna Rada passed the Law on State Budget for 2003 obliging non-corporatized state-owned enterprises to transfer to the budget at least 400 mn UAH (Article 52). These funds shall be used to finance capital investments and pay subventions to the local budgets. This Article charges Cabinet of Ministers with the task to establish the procedure and rate of profit to be transferred.

Recently the President of Ukraine issued special instruction envisaging transfer of the state corporate rights (currently managed by branch ministries, private companies, etc.) to the State Property Fund.

These discussions and actions prove the necessity to formulate clear and economically rational policies towards the property still belonging to the state.

But in this paper we limit our analysis to the issues of financial relations between the state and the respective enterprises fully of partially owned by the state and will propose some arrangements for profit distribution of state owned enterprises aimed at forging proper balance between their autonomy and state control.

2 State-Owned Enterprises: Definition and Significance for Ukrainian Economy

State-owned enterprise in Ukraine is defined as a commercial enterprise with the state share exceeding 50% of authorized capital. As a rule state-owned enterprises have been managed until recently by the central and local governmental bodies. In Ukraine state-owned enterprises can be classified into two groups:

1) Commercial partnerships with the state share exceeding 50% of authorized capital. This group includes enterprises in the process of privatization.

2) State unitary (100% state owned) enterprises authorized to possess, use and dispose property as well as to conduct operational management. This group also includes the so-called "fiscal" enterprises (kazenni pidpruemstva)[1]. These enterprises are authorized to conduct operational management, to possess and use state property but they are deprived the right to dispose. Ukrainian legislation allows to transform the state-owned enterprise into fiscal one according to the decision of central governmental body if this enterprise is not liable to privatization. Widely used in Ukraine term "non-corporatized state enterprises" does not belong to standard ones but is similar to "state-owned unitary enterprises".[2]

State-owned enterprises continue to play important role in Ukrainian economy. As of 01.01.2002 there were 14938 state enterprises in Ukraine or 5,6% of all enterprises. Besides, the state also managed 2392 blocks of shares[3] belonging to the state. In 2001 state enterprises got 25,4 billion UAH in revenues, which makes up 18,4% of total revenues of enterprises of all forms of ownership. The share of state enterprises in total fixed capital is exceptionally high: as of 01.01.2002 depreciated cost of fixed assets of state enterprises made up 205,9 billion UAH or 52,3% of fixed assets value belonging to the enterprises of all forms of ownership.

There is a widely spread belief in Ukraine that the state-owned enterprises are predominantly loss-making and, therefore, there is no need to pose the question who should be authorized to dispose the profit of state-owned enterprises. But the statistics proves the opposite. In 2001 state-owned enterprises earned 6,58 bn UAH in net profits or 53,5% of total amount of profits in the economy (state-owned enterprises accounted for 18,4% of total sales proceeds).

Despite the scales of state sector and its economic significance efficient system of management of state assets has not been created so far. The financial relationships between the state and enterprise fully or partially owned by the state have remained indeterminate and non-transparent as well.

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1 Ukrainian legislation does not contain explicit definition of fiscal enterprise (kazenne pidpryemstvo). But according to the Law of Ukraine "On Enterprises in Ukraine" (Article 37) state-owned enterprise may be transformed into fiscal one if this enterprise 1) conducts activities which is allowed only to the state-owned enterprises, or 2) the state is the primary consumer of the output (more than 50%), or 3) the enterprise is classified as natural monopoly. Fiscal enterprise is managed by the ministries and central bodies of executive power.

2 For the sake of simplicity we shall use term state corporatized enterprises (group 1) and state non-corporatized enterprises (group 2) bearing in mind explanations given earlier.

3 Block of shares – certain quantity of shares of the enterprise belonging to one shareholder.

3 Managing State Property: International Experience

The international experience does not give single meaning answer how to shape the financial relations between the state and state-owned enterprises in order to meet wishful social and economic goals.

In Sweden, for example, the state obliges joint stock companies to add on dividends on the state share and make appropriate payments to the budget.

In Australia joint stock companies with state participation in capital are obliged not only to ensure certain level of profitability of state assets but also to pay as dividends at least 50% of profits after taxation.

In Netherlands dividends on state-owned equity are paid at the level of comparable private enterprises. But at the same time the amount of "market-type" dividend payments may be adjusted depending upon the investments needs of the company in question.

In New Zealand joint stock companies with state share are not required to transfer dividends to the budget, they have the right to use profit without any restrictions to increase authorized statutory capital stock, to invest profit into fixed assets and working capital.

As far as regulation of fiscal enterprises' activities is concerned, in Netherlands, for example, any current revenues exceeding expenditures is to be transferred to budget. Fiscal enterprises management is not allowed to use own revenues even for investment purposes. In order to finance investments these enterprises must prepare special budget request and get necessary funding if their request is approved.

The countries in transition have also opted for different schemes of financial relations between the state and state owned enterprises.

Taking into account diversity of approaches mentioned above Ukraine should elaborate its own regulatory model based on Ukrainian economic realities and accumulated international experience.

4 Financial Management of State-Owned Enterprises

4.1 State Corporatized Enterprises

According to the data of State Property Fund there are 1572 enterprises with state corporate rights in them (See Table 1).

Table 1
Joint stock companies with state participation (as of 01.01.2003)

State's share	Number of enterprises
100%	85
More than 50%	254
25-50%	704
Less than 25	529
Total	1 572

Source: Відомості приватизації, № 6 (243), 19 лютого 2003 р.

In accordance with recently adopted the Concept of State Policies in the Field of Corporate Management and Dividends[4] every year State Property Fund is obliged to elaborate and submit base normative rates of profit to be paid in the form of dividends for approval to the Cabinet of Ministers.

In principle, the issue of profit distribution can be successfully dealt by the enterprise themselves while the state representatives in the Board can protect the state interests. But taking into account poor corporate governance and deficiencies of respective legal environment this step can be seen as second-best solution. Such an approach allows:

[4] Order of State Property Fund of Ukraine No. 1262 as of 16.07.2001.

1) to fix commitment of the respective enterprises to settle with the state as the owner of the property;
2) to ensure coherent centralized approach towards state dividend policy;
3) to make enterprise environment more predictable by establishing certain profit distribution benchmarks;
4) to secure the right of shareholder to receive profit in the form of dividends.

The Concept envisages an opportunity to decrease this rate (of profit transfer) if the enterprise applies accelerated depreciation scheme, uses 100% of depreciation charges to finance capital assets reproduction and obsolete equipment modernization.[5] This provision allows to take into account specific needs of the enterprises to implement long-term investments.

At the same time this system of profit distribution does not eliminate the basis for arbitrary decisions on the amount of profit to be paid to the state and leaves substantial room for bargaining between the management of the enterprise in question and State Property Fund. To work properly it requires well-thought unified procedure of normative rates calculation.

Practice suggests that even formal compliance with State Property Fund regulations does not ensure payment of dividends due. As of 01.01.2002 respective bodies of the enterprises in question took decision to pay to the state 212.8 mn UAH in the form of dividends, but in fact only 74,6 mn UAH were transferred to the State budget. This fact reflects general shortcomings of current settlements system (when even the existence of profits does not guarantee availability of funds) and corporate management deficiencies (managerial board of the company may not implement the decision of stockholders meeting).

Besides, the practice of granting enterprises waiver of obligation to pay to the state as the equity owner has been achieving dangerous scope. For example, in 2002 Cabinet of Ministers adopted a number of decisions exempting open joint stock companies from paying dividends to state for the sum of 149,9 mn UAH. Such practice is detrimental in a number of ways:

- it creates conditions favoring rent-seeking behavior and corruption;

- it distorts competition (waiver of obligation to pay dividends to the state present in fact hidden subsidy);

- it causes losses in budget revenues.

4.2 State Non-Corporatized Enterprises

As of 01.01.2003 3327 state unitary enterprises functioned in Ukraine. Among them 55 enterprises received the status of the fiscal enterprises. Besides, municipalities owned 8840 communal enterprises. Data on the number of state unitary enterprises (without the communal ones) and the amount of their profits (estimates for 2003) are summarized in the Table 2.

Table 2
State unitary enterprises and their expected profits in 2003, mln UAH

Sector of the economy	Number	Profits before taxation	Net profits
Fuel and energy	847	631,8	306,3
Industry	414	973,7	657,1
Agriculture and forestry	774	201,6	147,3
Transport	558	156,8	-127,2
Defence	206	139,6	97,9
Construction and materials	72	10	6,7
Education, science, culture	55	2,5	1,8
Other branches of the economy	401	181,3	118,8
Total	**3327**	**2297,3**	**1208,7**

Source: Ministry of Economy

[5] The methodology of calculation of these normative rates requires special study , that's why we do not address this issue in this paper.

According to the legislation in force the state as an owner is virtually deprived of the right to get a part of profit of state unitary enterprises. There is only one explicit provision regarding fiscal enterprises. The Law "On Enterprises in Ukraine" stipulates that ministry or other body of executive power authorized to manage the respective state property determines the procedure of net profit disposition (profit of fiscal enterprises) by means of establishing mandatory rates of distribution of profit. But even this provision does not allow the state to claim a part of net financial result of fiscal enterprise.

This legislative gap was filled by amending the Law "On Enterprise Profit Tax". According to this Law non-corporatized fiscal enterprises and public utilities companies are charged with responsibility to add on and pay dividends; the amount of dividends are determined by the state and local bodies of executive power authorized to manage enterprises in question; dividends are to be transferred to the budget.[6]

But this system of profit distribution of fiscal enterprises provokes a number of objections:

- the term "dividends" can be used only in relation to the profit of commercial partnerships, in case of state unitary enterprises it is appropriate to talk about the transfer of profit;
- empowering branch ministries to establish profit distribution procedure including profit transfer to the budget will result in negative consequences, since in Ukraine corporate, clannish and narrow departmental interests dominates upon national.

5 Policy Proposals

In principle the state may receive revenues from state property in a number of ways:

- **Via privatization.** In this case the Government must seriously consider the issue of selling their share in the enterprises as part of economic reform package. The intention of SPF to sell all blocks of shares of enterprises where the state has less than 50% stake is correct and the Cabinet of Ministers must take decision about enterprises with state share more than 50%. The same refers to non-corporatized enterprises;
- **Via improving enterprise performance** by using different forms of public-private partnership which can be seen as tool of attracting private capital and preparing the ground for the subsequent privatization in some cases;
- **Via improving corporate governance** by improving its legal framework, combating corruption and eliminating conditions favoring rent-seeking behavior.

But implementing these systemic measures under present conditions requires clear understanding how much state is necessary in the real sector.

Generally speaking under stable economic environment, sound market institutions and developed corporate management the high degree of autonomy of state-owned enterprises is the necessary precondition for their sound economic performance. But at the moment taking into account the quality of Ukrainian institutional environment there is a strong necessity to find the optimal balance between entrepreneurial autonomy and administrative (state) control. **Taking into account the acute need to modernize outdated technical facilities of a majority of Ukrainian enterprises any scheme of profit distribution must envisage real possibilities for financing investments.**

Establishing the rules of profit distribution in general and the very procedure of determining amount and structure of enterprise investment presents a separate and rather difficult problem. International experience provides no definite answer to this question. That's why we can identify several approaches and give some comments regarding their pros and cons:

Negotiations - based approach. This approach implies that the enterprise in question negotiates the allocation of profit with the respective branch ministry or ministry of economics. Theses negotiations must include discussion of investment proposals of the enterprises (Switzerland, Russia).

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6 Law of Ukraine "On Enterprise Profit Tax" (Article 7).

Such an approach is rather flexible and permits to take account the "specificity" of the enterprise (its current stand, perspectives, economic and social importance, etc). In this case it is important to determine the time span of such an agreement in order to take into account the fact that some investment programmes needs several years for implementation.

Such an approach requires certain guarantees that agreement won't be violated by the decision to transfer all the profits to the budget in case of fiscal problems.

No-rules approach. In this case the enterprise defines how to use profit according to its investment plans, etc. Such an approach is dangerous because in Ukrainian environment there is a high probability of misusing financial funds at the level of enterprise.

Rules-based approach. In this case the state determines certain strict rules of profit distribution. These rules may take the form of special rates for profit distribution (for example, 50% of profit forms investment fund, 40% goes to the state budget, 10% forms "material stimulation" fund). In principle such an approach can clearly define the relationship between the state and enterprises in terms of profit distribution securing both the interests of enterprises (getting proper funds for investment purposes) and of the state (getting income from the state property).

At the same time the efficiency such an approach will depend upon finding economically expedient ratios. Failure to do it will result either in underinvestment of overinvestment.

We believe that under present conditions when the **state property management** has been on the earliest stages of development **the negotiations - based approach** is the most efficient solution due to a number of reasons:

1) Its implementation requires **mandatory audit of the state enterprises,** this audit will allow to get a realistic picture of financial condition of the enterprises;
2) It allows to take into account specifics of environment where the enterprises are operating;
3) Once agreement on profit distribution is reached the enterprise gets clear perspective for planning its commercial activities while the state gets the necessary information for planning budget revenues and expenditures (budget-financed investments);
4) It allows to limit state support to certain enterprises and avoid misallocation of scarce budget resources;
5) It allows enterprises to implement medium and long-run investment projects;
6) It creates necessary stability allowing to improve management by introducing different public-private partnership schemesб etc.
7) At the moment this approach is rather easy in terms of implementation because it does not require in depth data on the branch level, which the state cannot obtain and process at the moment.
8) It allows to use some rules and procedures as normative rates of profit distribution allowing to secure interests of the enterprises and the state.

To be efficient negotiations-based approach must include the following elements:

1) Clear and transparent explanation of the principles of profit distribution which will prevent appearance of arbitrary decision in the field and make regulatory environment more stable and predictable;
2) Guarantees against "requisitioning" of whole amount of profit and its transfer to the state budget;
3) Externally audited business plans of the enterprises to take into account commercial and financial perspectives in terms of necessity to make medium and long-run investment projects;
4) Flexibility in terms of negotiating changes in normative rates of profit distribution on case-by-case basis.

Implementation of negotiations-based approach requires the following measures:

1) **introduction of requirement of mandatory audit of the state-owned enterprises by renown auditing firms** at least once a year. Such an audit will help to get a clear picture of what's going on in the audited company and assist in calculation of normative rates mentioned earlier.

2) **abandoning the current practice of granting certain enterprises waiver of their liabilities to the state**, since it undermines the very basis of the state as property owner. This aim can be reached, inter alia, through the state representatives in the board of the company in question.

At the same time it's application has some peculiarities depending upon the type of an enterprise:

1. Policy towards state corporatized enterprises (commercial partnerships with the state share exceeding 50% of authorized capital.

1.1. Acknowledging that in general existing legal model of regulation of transferring state corporatized enterprises profit to the budget is in line with Ukrainian realities; introduction of normative rates calculation (clear and transparent procedure of such calculation is a must) might contribute to improvement of financial relations between the state and state corporatized entities.

2. Policy towards state non-corporatized enterprises:

2.1. The very idea to consolidate a certain share of profit earned by the state unitary enterprises is well grounded. The state as owner of these enterprises has the right to expect net financial result from their activities. This position fully complies with international experience.

2.2. Due to the fact that in Ukraine only enterprise's own profit and depreciation can be the source of investments (because external funding – budget funding, bank credits, etc. – is practically unavailable), the transfer of whole amount of profit to the state budget will lead to further degradation of material and technical basis and hampering development of economy in general. It means that attempts to extort the whole amount of profit will intensify the process of "eating away" fixed capital.

In the meantime, these enterprises practically do not receive any funds from state budget for investment purposes. After all, their losses are covered from the state budget, at the expense of consumers or their business associates, but the necessity of clear and transparent budget investment financing procedure cannot be contested.

That's why we propose to distribute the profit of state unitary enterprises profit in the following way:

1. Any scheme of profit distribution must include provision of establishing investment fund. The amount of the fund and the ways of its disposal must be determined by the administration of the enterprise together with the branch government body empowered to manage the enterprise in question.

2. One and the same central governmental body must control decisions of all state unitary enterprises regarding capitalization of earnings for the investments purposes.

Taking into account the fact that at given amount of profit the amount of investment fund will determine the amount of net profit to be transferred to the budget, it is expedient to agree investment decisions of state unitary enterprises with the Ministry of Finance.

In fact, we propose to change the existing model of branch management of state non-corporatized enterprises for the mixed model combining both branch and centralized approach.

Deficiencies of "branch managerial model" have been clearly revealed in Russia. In Russia branch bodies of executive power failed to determine the amount or share of profit of subordinate enterprises to be transferred to the budget despite directives of the Government. Only Ministry of Natural Resources adopted special regulatory act, but the Ministry does not

control whether the enterprises transferred profit to the budget or not.[7] As a result, in 2000 state unitary enterprises earned 50 bn roubles in net profits and transferred to the budget only 50,4 mn roubles.

3. Once the procedure for determining amount and structure of enterprise investment fund is established, it is expedient to envisage the creation of special fund to stimulate employees and top-level management of state unitary enterprises. Rate of profit distribution for these purposes must be one and the same for all state-owned enterprises and legally fixed (for example in Russia and Romania makes up 5%).

This measure is necessary in order to stimulate employees to contribute to revenues maximization and costs minimization in order to increase profits.

4. When these funds are formed the residual part of profit is to be transferred to the budget. Thus we recommend introducing into legislation special norm stipulating the obligation of state non-corporatized enterprises to transfer share of profit to the state budget.

We believe that the proposed scheme of profit distribution of state unitary enterprises has the following advantages:

- establishing transparent and easy to control procedures of forming development fund of state-owned enterprises;
- replenishment of budget revenues through the transfer of unitary enterprises profits to the budget;
- strengthening state influence on profit distribution of state non corporatized enterprises.

There is one more danger – danger of overcapitalization (so to say "excessive" investments) or/and forming rather big "material stimulation fund" thus avoiding transfer of some profit to the state budget.

In order to avoid somehow this problem the state can introduce mandatory auditing procedure.

Such an approach requires certain guarantees that the plans of the enterprises won't be violated by the decision to transfer all the profits to the budget in case of fiscal problems.

At the same time the efficiency such an approach will depend upon finding economically expedient ratios. Failure to do it will result either in underinvestment of overinvestment as it was described earlier.

To solve this problem it is advisable to use the ratios determined on the basis of relevant practice of profit distribution (investment expenditures) in the industry where the state enterprise is operating. In this case we propose to use the average industry indicators of profit distribution and investment activities (that is ratio of profit used for investment purposes) as a benchmark for calculating respective norm for the state enterprises.

Whatever procedure is selected there is one more positive result which must not be overlooked: this procedure will allow enterprises to secure necessary funds for investment which allows to modernize existing capacities and to attract to the field private capital via different types of arrangements (like public- private partnerships mentioned earlier).

These measures proposed will result in substantial increase of state revenues generated by state property and state entrepreneurial activities as well as strengthening control over efficiency of using state property.

T.V., I.B. Lector: F.P.
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[7] С. Бурков. Неналоговые доходы от госсобственности и бюджетный потенциал страны // Российский экономический журнал. – 2001. - №9.