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Does Ukraine Need a Special Law on Re-privatisation?

Summary

According to international standards the definition of re-privatisation is pretty close to the definition of nationalisation. Common justifications for nationalisation are the "sick industry argument"; product quality, national security, and fair income redistribution considerations; regional development issues; and the solution of regulatory problems due to alleged market failure (e.g. externalities, yardstick competition). As a rule, nationalisation is exercised on an industry-wide scale, and basically rules out insolvencies of "socially important" enterprises. However, the attempts to support industries in decay via direct ownership control by the state have only rarely turned out to be successful.

In Ukraine, in contrast to western industrialised countries, re-privatisation disputes can primarily be attributed to the pitfalls of the privatisation program. Multiple cases of shadow privatisation, non-privatisation mechanisms of state property alienation via bankruptcy procedures, or violations of investment obligations have raised discussions about adopting a special law on re-privatisation.

We argue that a special law on re-privatisation is not recommendable at the moment, since a) most of the problems could be corrected through amendments and a better (more rigorous) implementation of the existing legislation; b) a focus on re-privatisation/nationalisation issues could harm the investment climate, aggravate the non-transparency of the privatisation process, create additional opportunities for corruption, and serve as an instrument of re-distribution of attractive assets between the groups of owners according to the political interests of business elites.

Instead, more emphasis should be put on *a) setting up an appropriate regulatory framework for the infrastructure sectors and amending privatisation procedures for "sick" industries before their wide-scale privatisation has started; b) improving the implementation of the existing legislation that settles the cases of violation of privatisation rules; c) increasing the security of property rights.*

Introduction

Recently, the Ukrainian mass media devoted significant attention to the issue of re-privatisation. This can be attributed to the proposal of the President and the head of the presidential administration concerning the preparation and adoption of a special law on re-privatisation. Two related draft laws were submitted to the Parliament of Ukraine by Semenyuk ("On the re-privatisation of property in Ukraine") and Matveev ("On the alienation of property into state ownership") which are both trying to cover a wide range of cases of alienation of private property. While the draft by Semenyuk was negatively evaluated by the relevant parliamentary committee and suggested for rejection, the latter by Matveev was recommended for a second reading.

The constitution of Ukraine states that private property can be alienated without the consent of the private owner only in cases of social necessity, on the basis of a proper

legislation, and on the condition that a redemption fee is prepaid (with a few special exceptions). However, the question arises *whether Ukraine needs a special law on re-privatisation*.

The re-privatisation issue is extremely politicised, since a number of interest groups (both within and outside Ukraine) are involved into a redistribution of ownership in Ukraine. In this paper, however, we concentrate only on the economic nature of the problem and try to evaluate potential costs and consequences of this policy without providing detailed comments on the existing draft laws on re-privatisation.

We start from the definition of "re-privatisation", then turn to the international experience of nationalisation (re-privatisation), analyse motives and costs of re-privatisation in Ukraine, and finally provide recommendations.

Definition of re-privatisation

In Eastern European countries, the term "re-privatisation" is mainly associated with the compensation payments to the former owners of enterprises and capital assets who have been deprived from their property during the Second World War.

In Western European countries (as well as in developing countries), usually a transfer of ownership from private agents to the state is considered as nationalisation, and the term "re-privatisation" is not used.

In Ukraine, according to both draft laws, re-privatisation is defined *as alienation (to the state) of private property previously acquired by privatisation*. This concerns the major part of private assets. In principle, alienated assets can be kept in state ownership or become subject of a new privatisation round. In public discussions one can find a narrow definition of re-privatisation as alienation of privatised property in case when privatisation contracts are found to be invalid. This narrowly defined re-privatisation can be enforced within the existing privatisation legislation and does not need an additional law. Therefore, in this paper we discuss only a wide definition of re-privatisation, which is – from an economic point of view – a special case of nationalisation. In order to make a comparison with the international experience, we consider both terms as identical.

International experience: motives behind nationalisation (re-privatisation)

In the past, nationalisation has taken place several times in different countries. In most of these cases the necessity to correct market failures as well as social security issues and income redistribution reasons served as justifications of nationalisation cases. The following arguments were frequently used to justify nationalisation:

- ***Service/Product quality*** considerations. Intentions to improve the quality of services without an increase in prices for final consumers (e.g. electricity in the UK) or provide a uniform level of service quality, particularly in the field of essential facilities (e.g. British railways) were behind turning back to public ownership in the United Kingdom.
- ***Re-distribution of income*** and ***regional development*** considerations. Considering utilities as a source of profits, which might be more fairly redistributed by the state authorities and contribute to regional development, was in the background of nationalisation of electricity companies in UK.
- An intention ***to reduce prices*** for electricity due to available tax immunisation in the state sector was behind the nationalisation of electricity utilities in British Columbia and Quebec, Canada.
- ***Uncertainty with regulations***, using public enterprises as an instrument for ***yardstick competition***, and ***dealing with externalities*** (e.g. nationalisation of a river dam in order to provide flood control and irrigation in addition to electricity production) were also offered in the international practice as arguments in favour of nationalisation. This implies the substitution of weak regulations by direct ownership control, which might weaken incentives for efficiency.

- ***Threat-to-competition*** argument was used to justify the nationalisation of the British steel industry in the mid 60s, when the level of its cartelisation had increased substantially. ***On the contrary, exploiting economies of scale*** was behind nationalisation of the British aerospace industry which was found to be too fragmented for being competitive.
- The ***sick industry argument*** is related to the nationalisation of the enterprises in "depressed" industries, which are considered to be important for social and/regional reasons and seek state aid (e.g. British shipbuilding, where GB£ 300 m was committed to buy out shares).
- ***National security*** considerations gain a higher weight compared to efficiency-related goals and sometimes lead to nationalisation.
- ***Nationalisation of foreign-owned property***, (e.g. Suez Channel by Egypt in 1958, and copper-mining in Chile, 1971), is typically aimed at getting rid of foreign control of particular industries and/or the total economy.

As it can be seen, nationalisation has mainly been used as an instrument to correct some regulatory or market failures in the short run, and is applied *on the industry level*. British experience provides some examples of an enterprise-level approach, when bankrupt private companies were returned to public ownership, since the government regarded their products as socially important.

International experience: waves of nationalisation and privatisation in the United Kingdom

The major force behind the waves of nationalisation in the UK was the Labour party.

British post-war nationalisation was based on the British socialist doctrines and conducted using the experience of French industries. In 1945-1951, many basic industries, including gas, electricity, coal, steel, transport, and the Bank of England (the Central Bank) were nationalized. The ownership of the steel industry was among the most controversial issues. This industry was nationalized by the Labour government in 1951 to save it during the economic decline; the owners of the industry were handsomely compensated. In 1953, the steel industry was denationalised by the Conservative government, and some degree of price and investment control was established. As the steel industry was getting more cartelised, in 1967 it was accused of competitive malpractice and renationalised by the Labour government.

In the 60s and 70s, due to the efforts of the Labour government, the list of nationalised industries slowly expanded and covered atomic energy, shipbuilding, the sugar industry, transportation, and aerospace.

Did nationalisation succeed in overcoming problems as specified above? The answer is rather negative. For each case, international experience offers ***a better solution***:

- Quality: Indeed, issues of coordination and security of services are among the most crucial ones, which may subordinate productive efficiency considerations. In such cases, **privatisation in these sectors should be delayed until a proper regulatory environment is established** (thus, it is a matter of phasing rather than nationalisation)
- Redistribution of income: **A proper taxation system** accompanied by private management of the firms might lead to higher budgetary revenues than that of a state run company, thus providing more opportunities to address social and regional problems.
- Reduction of prices: Nationalisation creates a risk of deterioration in technical efficiency of the nationalised enterprises in the medium run, thus preventing a real reduction in prices of their products. Development of a **proper regulatory environment** for private operators seems to be a better solution.
- Monopolistic structure: An alternative solution is offered by the development of appropriate regulations, the **introduction of competition *for* the market** where competition *in* the market is hard to provide (e.g. in infrastructure sectors), and

using **different forms of public-private partnerships** (e.g. concessions, management, ROT, BOT contracts, etc.), which compromise between public ownership and private management thus providing appropriate economic incentives.

- Lack of competition: Development of an **appropriate legal and institutional basis for competition** while preserving private incentives constitutes a better solution compared to direct ownership control.
- Sick Industry: Though nationalisation is intended to improve international competitiveness, this goal is rarely achieved. International experience shows that a **reallocation of capital and labour resources** is a more efficient solution than subsidisation of production in nationalised sick industries.
- National security: However, it usually concerns the cases when there is a danger of military conflicts and wars (e.g. in 1914, when the British government acquired significant shares in the Anglo-Persian Oil Company to ensure oil supplies for the navy).
- Foreign property: nationalisation of foreign property concerns the cases of social revolutions/wars for national independence, and poses complex problems for the International Law.

Thus, in the late 70s, the disadvantages of nationalisation-based economic policies motivated the British government to turn back to privatisation. The Conservative party which came to power in 1979 provided strong support to private ownership. First of all, it was related to the general economic decline in the UK during the seventies and poor performance of nationalised industries. Secondly, the regulators faced substantial difficulties with setting targets and influencing the performance of nationalised companies. Thirdly, the US - traditionally opting for private ownership - demonstrated an example of better performance. In 1979, the Conservative government began the privatisation and deregulation and thereby marking a break with the past.[1] Consequently, more economic regulation to ensure true competition among the enterprises had to be introduced after the privatisation of telecommunication, gas, water, and electricity. Before 1980, regulation was mainly applied to transport, financial institutions, and broadcasting.

Motives for re-privatisation issue in Ukraine

What are the ***motives*** behind the discussion of re-privatisation legislation in Ukraine? Are they similar to those in the developed countries?

Contrary to the developed countries, where the waves of nationalisation were mainly produced in order to deal with weak regulations in natural monopoly sectors or save sick industries, the primary argument for the adoption of the re-privatisation law in Ukraine is the necessity *to correct the drawbacks of large-scale privatisation in order to ensure efficient use of assets and production of socially important goods*. Major concerns are related to conflicts based on pre-qualification requirements of privatisation tenders, shadow privatisation, and non-compliance of new owners with privatisation contracts that include investment obligations.

a) Pre-qualification requirements

In Ukraine, closed tenders that are organized for privatisation of strategic enterprises admit only those potential buyers that fulfil pre-qualification requirements (e.g. have relevant business experience, financial, investment and operational ability). A pre-qualification procedure based on technical and financial criteria is intended to reduce the

[1] The privatisation was introduced in British petroleum (1979, 1983, 1987), British Aerospace (1981, 1985), Cable and Wireless (1981, 1983, 1985), National Freight (1982), British Telecommunications (1984), British Gas (1986), British Airways (1987), British Layland (1984, 1988), electricity, water and steel (1988-1992).

risk of attracting inefficient owners, who will not be able to comply with the conditions of privatisation contract. According to the effective legislation, pre-qualification requirements are set by the SPFU and can vary in each individual case. Given the low level of transparency of the privatisation process in Ukraine, a great discretion in setting the pre-qualification requirements provides room for corruption and increases the risk that the potentially most efficient private investors are eliminated from participation in the privatisation tender due to political or other subjective reasons (for detailed discussion see Analyse A10). In practice, spoilt privatisation tenders generated a number of conflicts, when results of the closed tenders were challenged in court immediately after the tender's winner was announced, and the losers demanded re-privatisation, i.e. a repeating of the privatisation procedure.

b) *Non-compliance with investment obligations*

Another controversial issue of Ukrainian privatisation concerns the fulfilment of investment obligations by private entities as stipulated in the privatisation contract. It is not exceptional that a new owner alters the size of investment obligations, or significantly delays the implementation of these investments. SPF faces a difficult task of monitoring and enforcing the execution of privatisation contracts. The cases of non-compliance with investment obligations raise the question of re-privatisation, i.e. cancelling the existing privatisation contract and searching for new owners.

c) Prevention of shadow privatisation

During the last two years several state enterprises were transferred to private owners violating privatisation rules through a bankruptcy procedure (e.g. Lugansk oblenergo, Donbasenergo, Rosava, etc).[2] This practice invoked a lot of critique, since it stipulated asset stripping at the state enterprises, reduced potential budget revenues from privatisation, and prevented some investors to participate in the privatisation of these objects. An immediate ad hoc solution of the government was a moratorium on transferring such enterprises into private hands via bankruptcy procedures. At the same time the problem of restitution of state property acquired by private owners in illegal (or semi-legal) ways became obvious.

d) *Ensuring production of socially important products*

The present draft laws on re-privatisation (alienation of private property) that have been submitted to Verhovna Rada also include also the *satisfaction of needs in socially important products, ensuring control over production of goods/services vital for national defense and security, and promotion of regional and infrastructure development* in the list of motives for re-privatisation.

There is no doubt that the problems of the privatisation process need to be solved. *However, does this solution necessarily require the adoption of a special re-privatisation law?*

The answer is ***negative*** for the following reasons:

a) ***Most of the conflicting cases can be handled with the existing legislation***. Problems of pre-qualification requirements of closed tenders are subject of privatisation legislation. Presently, with the new privatisation programme for 2003-2008 still being in discussion, there is a possibility to draft some necessary corrections to the bidding procedure. Non-compliance with investment obligations is a reason to appeal to the court for cancelling the privatisation contract. Then, the transfer of ownership is reversed automatically. Violations of the legislation (including that on privatisation) are normally regulated by civil or criminal codes. It seems that the **major problem lies in the *implementation* and further development of *existing legislative acts rather than producing a special re-privatisation law***.

[2] According to the statement of the Head of State Property Fund of Ukraine, interest groups have a set of standardized legal procedures to block official ways of privatisation of enterprises.

b) *Contrary to developed countries, the nationalisation (re-privatisation) issue in Ukraine is put on the agenda* ***before*** *privatisation of strategic enterprises in national monopoly sectors and "sick" industries (e.g. coal mining) is completed* (in fact, it has hardly started). The privatisation programme for 2003-2008 proposes a long list of enterprises, privatisation of which is intended to be postponed for "strategic" reasons or until proper regulations are developed. *Therefore, presently, there is a possibility to set up an appropriate regulatory framework for the infrastructure sectors before their privatisation instead of correcting regulatory failures via nationalisation afterwards*.

In case the enterprise was then recognized as strategic or crucial for issues of national defence after its privatisation, a special law may secure its transfer to the state ownership. Taking into account the uniqueness of the outlined situation, it cannot and should not be regulated by a law of common application. ***Under the current circumstances, the promotion of a special law on re-privatisation reflects a firm-level approach*** (contrary to the industry approach in the developed countries where nationalisation waves, usually, covered the whole industry) ***which is appropriate rather for redistribution of ownership than reaching efficiency- or redistribution-related aims.***

Costs of re-privatisation

Presently, the development and implementation of the special re-privatisation/nationalisation legislation makes sense if it meets an urgent need to start a wide-scale re-privatisation/nationalisation campaign. As we have shown, this need does not exist, since most of the doubtful cases can be managed within the active legislation.

Moreover, the implementation of re-privatisation/nationalisation implies inevitable costs. In terms of ***financial expenditures***, re-privatisation transactions require significant budgetary funds in order (1) to cover the transaction costs of ownership change, and (2) to pay redemption fees to former private owners. Both components may constitute a significant burden for the budget when taking into account that mainly large strategic enterprises and monopolists are potential targets for nationalisation. At the moment, the budget of Ukraine does not have a special item to cover re-privatisation costs, and thus the implementation of any changes in that direction will become a very difficult political task.

The calculation of ***redemption fees*** is a very sensitive question. First of all, the redemption amount should be adjusted for inflation and time discount factors (capital opportunity costs). Besides, it should cover the changes in the firm's assets and investment plan that has been introduced by the previous owner. What method will be used to determine the size of the redemption fee? Will it be the market price of the enterprise? The present draft law states that the redemption fee is calculated using the methodology by the Cabinet of Ministers. This implies that the probability of under- or overvaluation of nationalised firms (and, consequently, relevant conflicts) is significant.

Another cost of focusing on the development of a special re-privatisation law is that the ***mere existence of such a law has a negative influence of investors' perceptions of the security of property rights in Ukraine***, thus producing an obstacle for the privatisation process and further restructuring of the enterprises. The investment climate in Ukraine continues to be very risky, which is reflected in the low level of FDI (102 US$ per capita). Though the investment volume has increased in 2002, its growth rate is lower than in 2001. Under these conditions, and taking into account the necessity to attract effective domestic and foreign investors for the privatisation of the strategic enterprises, a focus on re-privatisation issues seems to be grossly counter-productive. Investors could regard this as an increasing risk of nationalisation of attractive enterprises (with social necessity as an argument) after investments have been made. An important aspect is that even a discussion of re-privatisation issues (without practical development and implementation of a special law) can negatively influence expectations regarding the investment climate. At the moment, it is much more vital to **stress the improvement of the security of property rights** (though nobody proposes to develop a special law on security of property rights!).

The deterioration of economic incentives to run the firms efficiently may be another consequence of focusing on the development of re-privatisation legislation. If legislation stipulates that privatised strategic enterprises (that produce socially important goods) under the threat of bankruptcy are taken over by the state, it produces incentives for asset stripping by inefficient owners and consequent reselling of the enterprise to the state. The high level of corruption and state capture (which is anecdotal for Ukraine) increase the probability of encouraging such behaviour.

Finally, given the weak regulatory climate in Ukraine, the development of a special legislation on re-privatisation might, at the moment, ***contribute to non-transparency of the privatisation process, create additional opportunities for corruption, and serve as an instrument of re-distribution of attractive assets between the groups of owners according to the political interests of business elites***. Some clauses in draft laws create an impression that this possibility should not be excluded. For example, the statement that redemption fees can be covered by the revenues from a new round of privatisation that follows nationalisation of the enterprise implies a re-distribution of ownership. A concentration of power to draw up lists of enterprises subject for nationalisation/re-privatisation as well as to determine the level of redemption fees in Cabinet of Ministers provides room for both a discretionary interpretation of the legislation and corruption.

Conclusions

The re-privatisation/nationalisation issue has important economic implications. International experience reveals that nationalisation mainly aimed at correcting market failures or protecting industries in decay have grossly failed. Though based on efficiency-relevant claims, such attempts often had the hidden political background to serve powerful interest groups and thus appeared not to be successful in promoting efficiency. They showed that private incentives in a properly designed regulatory environment are better instruments for dealing with undesirable social consequences of structural changes than direct ownership control by the state. The development and adoption of a special law on re-privatisation/nationalisation in Ukraine could thus turn out to have detrimental effects on the overall goal to achieve economic growth through market competition.

First of all, the multitude of privatisation-related problems hardly allows for solving all of them by relying on a single legal act.

Second, contrary to the developed countries, the major motive behind the idea of re-privatisation in Ukraine is correcting the drawbacks of the privatisation process. In practice, most of the doubtful privatisation cases can be solved within the existing legislation. Thus, the problem can be tackled by properly implementing and improving the existing legislation rather than in the development of a separate legislation on re-privatisation.

Third, re-privatisation will most probably add an additional heavy burden to the budget, which will be difficult to deal with.

Fourth, the costs of focusing on re-privatisation issues include a decrease in the security of property rights and a swift change of the investment climate for the worse; a decrease in transparency in the privatisation process, and an unnecessary creation of additional opportunities for corruption. Besides, there is a risk of using the re-privatisation mechanism as an instrument for the re-distribution of attractive assets between the groups of owners according to the political interests of business elites.

Therefore it is not recommendable to promote the adoption of a special legislation on re-privatisation. Instead, the focus should be put on:

a) *Setting up appropriate a regulatory framework for competition in the infrastructure sectors and amending privatisation procedures for "sick" industries before their wide-scale privatisation will be started;*

b) *Improving the implementation of the existing legislation that settles the cases of violation of privatisation rules;*

c) *Increasing the security of property rights.*

Nationalisation in special cases may be governed by special legal acts being valid only within a very narrow and clearly defined range.

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