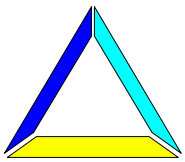
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S5

On the Design of State Support: the Case of Ferrous Metallurgy

Intro (not to be translated)

This is more a methodological paper on the issue of state support rather than a recipe for subsidizing metallurgy. The topic is timely, because the Parliament has to decide on the program (10 year plan) for metallurgy. Discussions in the last months made clear, that there is no coherent attempt to justify state support and develop the appropriate means accordingly. In particular, the Ministry of Industrial Policy (responsible for the program) largely argues in Soviet style: "Helping metallurgy is helping the state". The addresses of the paper are foremost the committee in Parliament as well as parts of the Ministry of Economy that is more aware of the problems in the design of state support.

Introduction

For years the Ukrainian Government supports the domestic metallurgy by various measures, which cost the taxpayer billions of Hryvna. Whether this money was spent wisely and achieved the goals of the state is, however, doubtful; not least because the aims of the support programs were not spelled out clearly. This paper tries to point out the steps to develop an efficient program of support. It is a guideline for the preparation of support programs illustrated by the case of metallurgy. Thus, it is about putting the right questions rather than providing final answers, which have to be given finally by the policy makers.

The paper discusses the elements of state support in three sections. Firstly, we discuss the requirements on information which are not only a prerequisite for the design of the program but that are also needed to avoid divergence of the state money. The second section deals with the goals of the state support. The concluding section elaborates on the choice of appropriate measures to achieve the goals without too much interference in the market.

1. Without information and transparency any support will fail

The first step in thinking about state support will be a true picture of the performance, prospects, and role of the metallurgy sector in the Ukrainian economy. No doubt, ferrous metallurgy is a leading sector of the Ukrainian economy, which earns 40% of the export income, employs 500 thousand people and has a share of 27% in total industrial output. These data attest to the scope of the industry, but tell less about the economic performance and contribution to final production. It is revealing that not only in the media but also from senior officials it is repeatedly stated that ferrous metallurgy contributes about a quarter to GDP. This is plainly wrong. The share of (value added) metallurgy in GDP is about 5–6%. Given that in the documents of the government continuously the increase of high value added production (in contrast to gross production) is rightly stressed, it is puzzling to see confusion even about the basic figures of ferrous metallurgy.

Turning to the performance and prospects of the industry, the information to judge the prospects of the industry and its firms are not sufficient. Balance sheets and

income statements of the steel firms do not give a complete picture of the economic situation. In addition, firm data do not always coincide with other statistics. This makes it difficult to assess the competitiveness of the sector. Questions about the organization and free play of market forces in the sector remain. More information on the following topics is essential before a support program is designed:

- concentration of ownership, including the shares of non-residents, in order to avoid collusive behavior and use of market power,

- degree of competition on the domestic market,

- possible existence of cross-subsidization within the producing firms and the large trading houses,

- distribution and amount of subsidies for each firm including indirect subsidies by allowing non-payment.

A market is basically about open information available to every market participant. Thus, before any state money is spent, strict requirements on the financial reporting, e.g., audited balance sheets, should be set. The state can help in collecting, preparing and publishing information about the relevant markets in- and outside Ukraine. Strict applications of the anti-monopoly laws as well as surveillance of the usage of state money by independent organizations is needed. Any state support in markets where collusion and corruption prevail is bound to be wasted.

Given the situation in Ukraine and the experiences of the past, there is a real danger that any active industrial policy is used to divert state money and increase the incentives for corruption and bribery. Therefore, the control of any program has to be extremely strict. If this cannot be guaranteed, this is a strong reason to abstain from a program. Independent reviewers of the program, public disclosure of information of the proceedings of the program and halting the program immediately if information is not provided timely by the participants might be some measures to tackle the problem.

In addition to the crucial role of information for the functioning of any market, information is also a prerequisite for state support. If it is missing or blurred, it is neither possible to target the correct problem areas of support nor the effects can be monitored.

Despite some lack of information, there is some understanding that the economic performance of the industry badly needs to be improved (If this would not be the case, there would be no reason at all to provide state support to the industry). Most observers – although to different degrees - agree about the following statements:

- on average, the production technology is outmoded (e.g., open hearth furnaces)
- inherited production capacity is too high, which shows in low rates of capacity utilization, which in turn increases average costs,
- over the past years there was no reduction of the employment. In international comparison, the steel industry is overstaffed and, therefore, has a low labor productivity,
- financial discipline of the firms is low despite the fact that it suffers much less from the chain-effects of non-payment. Metallurgy is, in terms of payables and receivables, a net-debtor of the economy despite the fact that it can count on prompt payment (export earnings) from their (foreign) customers.

It would essential that the Parliament and Government find a consensus in assessing the main strong and weak points of the Ukrainian ferrous metallurgy before considering state support.

2. State support – what for?

After the analysis of the situation the next step would be to identify the objectives of state support. Many reasons for support can be thought of and might even apply simultaneously. However, to design the state support it would be inexpedient to have a priority ordering of the objectives. In the following we give a list of reasons, which we encountered in the discussion of the topic.

1. Acknowledging that some downsizing of the employment of the industry is needed, state support will aim to moderate the speed of job losses and provide social support. State support should not prevent the reduction of labor but should reduce the speed of the adjustments, which would otherwise happen much more abruptly. Obviously, the speed of adjustment will be slower and more costly in regions where employment is concentrated in metallurgy.

In getting a quantitative assessment of the needed reduction of labor, one has to distinguish the shedding of labor through the closure of the least efficient production sites from job losses, which result from a general improvement of the organization and technology in the firms. Note that by moderating the social consequences of job losses the incentives of the firms to shed labor and increase productivity are strengthened.

2. Often it is argued that the steel industry is such an important customer of other sectors that its decline will cause an even greater decline in the upstream sectors. This is partially true as it concerns the raw material basis and some parts of energy suppliers. As mentioned in the first point, the most what state support can do is to slow down the adjustment process to dampen the social consequences. However, the sheer magnitude of a sector alone (too big to fail) can be no reason for preserving it.

3. As in other branches, the lack of financial means in Ukraine is proposed as a justification for the support of the steel industry. This argument is generally incorrect, because it would apply to all branches and industries as long as they are treated equally. Of course, any branch or firm would gain by getting "cheap money" but there is no reason why a Hryvna invested in metallurgy will earn higher return than a Hryvna invested in any other branch. In addition, the lack or high costs of credits is to the most part a consequence of the high risks perceived by the creditor. Again, sufficient and detailed information about the finances, costs and returns of the firms will reduce this risk of the creditor. The lack of credit should first of all be viewed as a result of too high uncertainty and the high costs of enforcing contracts. Any improvements the state can do in this area would be welcome.

4. With respect to international trade it is pointed out, that state support is needed to counteract the unfair practices in the world steel market. In addition, most other countries support their domestic steel industry. This is seen as the "best world practice" and, therefore, Ukraine should do the same.

It is true that world wide state support in steel industry abounds and that the world market is distorted. But three points have to be kept in mind.

Firstly, the widespread support for steel does not prove that it is beneficial for the economies applying this support. More often than not such actions are taken for political opportunism and to strengthen the political power of the incumbents. The resistance of the taxpayers, which pay finally for it, is small because the costs of the subsidies are diluted among a big number of people. Widespread political practice is not a proof for sound economic policy.

Secondly, state support in industrialized countries is mostly a costly surrogate for social policy. State support programs as any entrepreneurial activity might fail, i.e., the money is lost. Therefore, the question arises of how much risk a state should take. In rich industrialized countries the state support for steel as a portion of GDP is rather small. In Ukraine, however, a similar support would amount to a large share of GDP. Concerning rich and poor countries, the state should rather behave like an individual. Most of us would take a gamble (a risk) of winning, e.g., twice the stake by betting 10 UAH, if chances of winning or loosing were equal (That is why, public lotteries with small stakes, high prizes and low chances work). But only a few of us would gamble, with identical chances, if a large part of our wealth would be at stake. Thus, a poor country should not gamble with the same amounts as rich countries do.

Thirdly, some countries (Korea, Japan, etc.) supported temporarily their steel industry, which developed afterwards prosperously. These countries also engaged in a gamble (with uncertain outcome). However, the stakes, chances and prizes of this gamble, which was done fifty years ago, have dramatically changed. Steel industry does not any longer belong to the booming industries that it was half a century ago. If Ukraine wants to target high value added industries, as the Ukrainian government demands, steel industry does not belong to this class. The competition in the steel market is today much more fierce than half a century ago, as can be seen by the new entrants as India, Russia, China which are directly competing with the Ukrainian products. The partial success story of development via steel in Asia half a century ago cannot be repeated today.

5. State support for environmental reasons and to foster technological research can be justified for economic reasons. In both cases positive external effects for the whole economy can be expected. Thus, there is some reason that the financing of these areas should not be shouldered by the metallurgy alone.

One should be aware that the goals can easily conflict with each other. The goal of moderate lay-offs and the objective of increasing the efficiency of the firm is an example. Only in case that the increases of productivity and the resulting higher competitiveness leads to significant increases in sales, both goals can be followed simultaneously. In general, however, this would not be the case. Support for technological improvements most likely goes together with the reduction of the labor force. For Ukrainian metallurgy probably more than one goal will be set: moderate reduction of labor, improvement of technology, reduction of capacity, etc. The interaction of these goals has to be studied carefully before one can decide about a program.

Whatever weights one puts to the different objectives of state support, it is necessary to have rough quantitative figure about the effects, which should be achieved with the state money. Otherwise, any control about the efficiency of the money spent would be impossible. Such "success indicators" might be, e.g., physical units of capacity reduction, maximum shares of certain technologies, amounts of labor, financial discipline (incl. timely tax payments) or even international benchmarks. Of course, the specific indicators used depend on the goals of the program.

3. Achieving the goals with minimum market distortions

Once the objectives of state support are decided on, it remains the task to design measures to achieve the goals. Obviously, different measures will apply depending on the targeted outcome.

Concerning the difficult question of employment, the first choice is to target the support to the laid-off workers in terms of an active labor policy including retraining programs, initial credits for establishing small enterprises, and even public work

programs in one-factory-towns. This as well as the money for social expenditures has to be controlled and allocated by the regions concerned.

Most of the proposals, however, target the firms as recipient of subsidies. In the forefront stands the aim to improve efficiency. As spelled out above, this objective might easily conflict with employment goals. Thus, one has to combine productivity enhancing support with active labor market policy to achieve both goals. In general, for each goal to be achieved one instrument is needed.

They're many ways how subsidies to metallurgy can be provided. It has to be decided in relation to which economic indicators the subsidies should be paid. The subsidies might be related just to production or to capital stock or might be related to the fulfillment of success indicators mentioned above. The favored approach in Ukraine is to increase the self-financing capacity of firms by tax reductions. Another possibility would be generous amortization allowances. Given the weak financial markets, it seems appropriate to enhance the self-financing capacities. However, a high degree of self-financing is not without dangers. It hampers the cross-aboard allocation of financial means and works to the disadvantage of new firms, which cannot accumulate profits. But on the other hand, it favors automatically those existing firms, which are most productive. Subsidies through exemptions from the profit tax have the advantage that it automatically benefits the most productive firms while loss-makers do not receive subsidies. Subsidizing firms according to a single formula, which applies to all firms in the branch, does only mildly distort the competition within the branch. However, as always, subsidies distort the allocation among the different branches.

Another concept foresees that part of the tax exemptions is collected in a centralized fund. This raises the problem how and to whom this money is allocated afterwards. Foremost this money should be geared to the establishment of new small enterprises which arise as spring-offs from the big enterprises or which are established in the region, which is hit by lay-offs. The preferred allocation mechanism of the centralized funds would be bank-like credits to those that are prepared to pay the highest interest, which, however, will be below the market rate. Again, this is only possible if it can be guaranteed that the allocation of money is strictly monitored, immediately suspended if agreed conditions are not fulfilled. The sad experience with the state guarantees in the past should be kept in mind. It would be better to abstain from a potentially useful policy if misuse is likely, as it was done with state guarantees.

Any redistribution of centralized funds among the existing metallurgical firms is likely to distort badly the market incentives. A minimum requirement on the allocation mechanism is that it does not reduce the pressure on the most inefficient plants to close production. The closure of inefficient plants and, thereby, the reduction of overall supply will help the more productive firms to gain cost efficiency by better utilization of capacity.

It was also suggested to help metallurgy by increasing the demand for its products. In this context the development of the Ukrainian automobile industry was mentioned. This, however, as the past has shown, is a very risky approach, if it implies to spend state money for the development of the car production. In addition, it is doubtful that the Ukraine steel industry has the sophisticated steel products for a competitive automobile production. Positive impacts for the steel industry can be expected from increased construction work, which will develop as the economy continues to grow. As long as public construction can be fostered it will also help metallurgy.

The concrete steps which have to be taken to manage the downsizing of the industry and simultaneously improve its efficiency should be as much as possible left to the industry itself. The branch itself can and should decide which capacities are inefficient

and have to be closed. The state will only provide aggregate benchmarks that the industry should achieve. Only if the industry is not willing to enter a binding contract, say tax exemptions of a certain amount against capacity reduction, which is enforced by the industry itself, other measures has to be thought of. Within these broad benchmarks, however, any firm is free to follow its own strategy to survive competition.

It has to be stressed, that the main task of state support is to moderate the existing market trends and the necessary adjustments, in particular for employment, to avoid too harsh changes. This is different from a strategy of "picking the winner", where the state tries to work as an entrepreneur himself. The later would rest on the belief that metallurgy in Ukraine can and should be expanding beyond its existing scale while the former is about managing the downsizing of an inherited, oversized industry.

A very important element of any state support is its limited length. It has to be made clear from the beginning that the subsidies will only flow for some time depending on the goals that should be achieved. Most naturally subsidies should be degressive, i.e. decline by a pre-announced portion each time span. The temporary nature of the state program has to be fixed in the law or official documents and should be controlled by Parliament.

While help for structural adjustment would likely also be accepted from the international community, improvements of the competitiveness of Ukrainian steel through subsidies will encounter strong resistance of the international competitors. Given the high share of exports of Ukrainian ferrous metallurgy, Ukraine has to seek agreements with the relevant international institutions (WTO, OECD Steel Committee, etc.) for any support plan. A development of the ferrous metallurgy in conflict with the international organizations and regulations can not be regarded as a feasible option.

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