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**Working Paper**

## Company restructuring and privatisation in Ukraine

LICOS Discussion Paper, No. 70

**Provided in Cooperation with:**

LICOS Centre for Institutions and Economic Performance, KU Leuven

*Suggested Citation:* Estrin, Saul; Hare, Paul; Rosevear, Adam (1998) : Company restructuring and privatisation in Ukraine, LICOS Discussion Paper, No. 70, Katholieke Universiteit Leuven, LICOS Centre for Transition Economics, Leuven

This Version is available at:

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# LICOS Centre for Transition Economics

## LICOS Discussion Paper

Discussion Paper 70/1998

### Company Restructuring and Privatisation in Ukraine

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# Company Restructuring and Privatisation in Ukraine<sup>1</sup>

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January 1998

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<sup>1</sup>This research was funded by the Overseas Development Administration of the United Kingdom. However the Overseas Development Administration can accept no responsibility for any information provided or views expressed.

## 1. Introduction

In this paper we report on the preliminary findings from a survey of Ukrainian enterprises undertaken in the first half of 1997. The survey instrument was designed to address questions of corporate ownership, performance and restructuring in Ukrainian industry during the transition period 1991-1997. This paper provides descriptive results, to be supplemented by empirical work in a later study.

This paper is organised as follows. We first outline the original objective of the data collection examined and set the Ukrainian economic context, in which our sample firms were operating. This highlights some key issues for future analysis of the data. We have not yet had the opportunity to analyse the data set in full. However, some exciting preliminary results are presented in the fourth section, which focuses on ownership structures, company performance and restructuring.

## 2. Objectives and Data Collection

The project proposed to discover hard economic facts about the operation of state owned firms in Ukraine, about the nature and scale of restructuring and the form and extent of privatisation. The proposed method was to undertake a survey of enterprise behaviour which would derive qualitative information about company performance and behaviour as markets were liberalised, budget constraints were tightened and ownership was changed. It was also intended to collect hard economic data going back to the Soviet era, to provide a quantitative record of enterprise behaviour in this fascinating period, which could be related to the external environment changes through the use of regression analysis. If successful, the project therefore proposed to collect a large variety of data on a considerable sample of Ukrainian firms. We sought to cover six regions in Ukraine (Kiev, Khmel'nitsky, Odessa, Dnipropetrovs'k, Ivano-Frankivs'k, L'viv and Kharkiv).

One hundred and fifty enterprises were visited between March and July 1997, with the supplementary contacts noted above for final data information during the autumn. The sample of firms was drawn from the population of firms listed at the State Property Fund (SPF). This list includes firms of all ownership types. It is the most complete list of firms available in Ukraine. However, the list has two drawbacks. Firstly, there are some 'sensitive' companies from the military-industrial complex that do not appear on it. Secondly, a large proportion of firms in Ukraine operate in the informal economy. By definition, these firms would not appear on any official lists. Even so, we believe that the SPF list is the most complete available.

The omission of some military firms removes some of the reputedly worst performing firms in Ukraine as the majority of the military market of the FSU has been lost to Ukraine. Thus, this provides a 'positive' bias to the survey. The second omission from the population is likely to bias the survey in the other direction. The most dynamic firms in neighbouring Poland and other transition economies have been small de novo firms (see World Bank Development Report, 1996).

In Ukraine, stifling bureaucracy and endemic bribe-seeking has forced many of *de novo* firms into the informal sector. In addition to their absence from official lists, it is unlikely that these firms, which are subject to legal censure and extortion by organised crime would provide answers about ownership, restructuring and performance to an interviewer. Some, more dynamic, firms in Ukraine may therefore not be covered by the sample. Thus, the survey may exclude some of the best and some of the worst performing firms in Ukraine and the biases are likely to be offsetting, though it is impossible to evaluate their impact.

The sample was stratified by region and by industry. The six regions chosen were taken from all parts of Ukraine. The history and regional economy of Western Ukraine differs from both the East and the South. Ukraine is an heterogeneous country in terms of political allegiances and economic development. The eastern regions have a larger industrial base and have traditionally favoured strong links with Russia. The reason for this attitude can be found in both the importance of economic relations with Russia and on ethnic and cultural factors. The western regions have a more Ukrainian nationalistic outlook, a more important agricultural sector and a lower degree of urbanisation. Electoral results have repeatedly confirmed the political differences between these areas of the country.

This sample was stratified regionally as follows. In the West, 8 firms were interviewed in L'viv and 14 in Ivano-Frankivs'k oblasts. In the East, 31 firms were visited in Dnipropetrovs'k, 24 in Kharkiv. In the South 24 were questioned in Odessa and 24 in Khmel'nitsky and 24 in the capital, Kyiv oblast.

The sample concentrated on eight industrial branches (code in parentheses) metallurgy (12) chemicals (13) machine building (14), wood, paper and pulp (15), construction materials (16), textiles (17), food processing (18), and pharmaceuticals (19).

The final version of the questionnaire covered questions of performance, behaviour, ownership and restructuring. A copy of the final draft is covered in the Appendix. Access to firms was facilitated with the help of official letters of support from both the State Property Fund and the League of Industrialists and Entrepreneurs.

### **3. The Business Environment in Ukraine, 1992-97**

Ukraine is the second largest country in Europe with a population of 51.7 million. It declared independence from the Soviet Union in 1991. The Ukrainian economy has shown the typical pattern that has characterised the initial stages of transition of the former Soviet Union countries. GDP; fell sharply and its composition changed. Table 1 shows that GDP has been falling steadily since 1991, and has now declined to less than 50% of its pre-reform level.

Economic conditions remained harsh when our sample was undertaken in mid-1997, though the recession was at its worst in 1994. During the first half of the year, GDP fell by 7.5% compared to the corresponding period in 1996. The main contributors to output decline were the construction industry, agriculture and transport and communication. Agriculture has a large share of GDP (see Table 2) and its performance has a significant impact on the dynamics of total output; poor economic results were partly due to an exceptionally bad harvest in 1996.

The output drop of more than 50% is not all bad; it includes the elimination of unwanted products, some limited restructuring and the removal of statistical biases for output over-reporting. It may also be overstated. It is a commonly held view that the underground economy is particularly large in Ukraine and that economic growth may have already started if the unregistered sector were to be taken into account.

Table 1 also shows the very high rate of inflation after independence. During some months in late 1993 Ukraine even slipped into hyperinflation (> 50% per month). Inflation is now under control and is expected to be only 12% in 1997, but the very high inflation rates in the early years of the period make data collected in value terms very hard to analyse. For this reason, we avoid nominal value data in the analysis which follows.

**Table 1**

**Basic Economic Indicators**

	1992	1993	1994	1995	1996	1997
<b>GDP, m Hrn</b>	51	1,483	12,038	52,933	80,510	90,428
<b>GDP per capita, \$ at PPP</b>	3,480	3,227	2,559	2,322	2,168	2,102
<b>GDP growth, %</b>	-9.9	-14.2	-22.9	-12.2	-10.0	-4.0
<b>Industrial production growth, %</b>	-6.8	-8.0	-28.2	-11.5	-5.1	-4.5
<b>Agricultural production growth, %</b>	-8.3	1.5	-16.5	-4.0	-14.6	-3.0
<b>Budget deficit, % GDP</b>	-12.2	-6.3	-9.5	-7.6	-4.5	-5.6
<b>Consumer price inflation, yoy, %</b>	2,730	10,155	401	182	40	12
<b>Wholesale price inflation, yoy, %</b>	3,828	9,667	555	181	17	15
<b>Average monthly wage, Hrn, end period</b>	0.2	8	33	123	164	193
<b>Auction exchange rate, Hrn/\$, end period</b>	0.007	0.25	1.04	1.79	1.89	1.9
<b>Exports, bn \$</b>	11.3	12.8	13.9	14.9	15.5	16.2
<b>Imports, bn \$</b>	11.9	15.3	16.5	16.9	19.8	21.9
<b>Current account balance, bn \$</b>	-0.62	-0.85	-1.16	-1.15	-1.18	-1.72
<b>Foreign debt, bn \$</b>	0.55	3.71	5.43	8.43	9.20	10.90
<b>Foreign investment, end of period, bn \$</b>	-	0.21	0.37	0.56	0.92	1.5

Sources: *Ukrainian Economic Trends*, World Bank, SIEGA, EIU, DIR.

Ukraine, like other transition economies, has experienced a relatively rapid evolution in the composition GDP, as can be seen in Table 2. The service sector, traditionally underdeveloped in the planned economies, has increased its share in total GDP, while the manufacturing sector has been declining. The official figures probably underestimate the extent of this transformation, since they are unable to capture small, unregulated activity that encompasses mainly the provision of services. The share of agriculture in total GDP has shrunk over the transition, despite the fact that the sector has fared relatively well in terms of output in comparison to the precipitous decline of industrial production. This is a phenomenon connected with the adverse evolution of relative prices, with agricultural prices growing more slowly than industrial ones.

Output change has also varied widely across industrial branches, resulting in substantial shifts in the composition of industrial output. The pattern of industrial change has also varied across time. In the first years after independence, when reforms were largely absent, machine-building performed relatively well. However, after they began to gather momentum, the sector entered into a deep recession, and over the whole period shows the largest fall in output. Overall, different performances have resulted in an increase of the share of base industries (coal, energy, ferrous and non-ferrous metallurgy) and falls in machinery and light and food industries. We see this pattern in our enterprise data.

**Table 2**  
**GDP, Branch Composition**

	1994		1995		1996	
	bn Hrn	%	bn Hrn	%	bn. Hrn	%
<b>Industry</b>	4215	39.0	16873	34.6	23695	32.5
<b>Agriculture</b>	1754	16.2	7507	15.4	9749	13.4
<b>Construction</b>	895	8.3	3753	7.7	4449	6.1
<b>Services</b>	4619	42.8	21853	44.8	36242	49.7
<b>Imputed Bank Services</b>	-684	-6.3	-1243	-2.6	-1216	-1.7
<b>Total value Added</b>	10799	100	48743	100	72918	100
<b>Net Taxes on Products and Imports</b>	1239		5773		7592	
<b>Total GDP</b>	12038		54516		80510	

Source: *Ukrainian Economic Trends, DIR*

Table 1 reveals that exports and imports have risen sharply owing to the recession, with a gradually deteriorating balance of payments and debt situation. Russia is still the most important market for Ukrainian exports. Ukraine also sources almost half of its imports from its northern neighbour and a large part of this is accounted for by oil and gas. Despite some domestic production, most of the energy requirements of Ukraine are imported and energy imports represent 53% of total imports, with Russia and Turkmenistan as the main suppliers. One might still argue that the continued dependence on Russia and the former CMEA countries demonstrates a lack of restructuring of trading relationships, an issue to which we return in the survey.

**Table 3**

**Geographic Structure of Trade**

	1996				First quarter 1997			
	Exports		Imports		Exports		Imports	
	\$m	%	\$m	%	\$m	%	\$m	%
<b>Total</b>	14061	100	18203	100	2923	100	4159	100
<b>Russia</b>	5448	38.7	8548	47	849	29.1	2329	56
<b>China</b>	759	5.4	87	0.5	254	8.7	221	5.3
<b>Germany</b>	405	2.9	1004	5.5	96	3.3	217	5.2
<b>Turkmenistan</b>	263	1.9	1604	8.8	38	1.3	265	6.4
<b>Belarus</b>	711	5.1	375	2.1	211	7.2	76	1.8
<b>Poland</b>	332	2.4	495	2.7	110	3.8	99	2.4
<b>USA</b>	356	2.5	541	3	74	2.5	130	3.1

Source: *Ministry of Statistics, DIR*

Despite the fall in economic activity, registered unemployment has been low, rising from only around 80,000 in 1995 to some 500,000 in June 1997. There are reasons to believe that the 'real' rate of unemployment could be as high as 30% however. Ukrainian measures of registered unemployment significantly underestimate the total, since only those who are not registered as workers in any enterprise and are applying for a job are included. The survey reveals increasing mobility of the labour force, and provides data on "hidden unemployment".

#### **4. Some Preliminary Findings**

Data was collected for almost every variable in the questionnaire for every year covered. The project has therefore yielded an unusually rich and reliable enterprise level data set containing an important element of panel data. Full analysis of this data will take some time, and is complicated by the ravages of inflation on nominal variables through time. However, a considerable amount of preliminary work has been undertaken, which is reported below. We cover three topics; the ownership structure which had emerged post-privatisation in Ukraine; company performance between 1992-1997; and restructuring, including the restructuring social assets.

##### **4.1. Privatisation and Ownership Shares in Ukraine**

Of our sample of 150 firms, 5% are non-incorporated state owned firms; 3% are commercialised or leasehold state owned firms and the rest are partially or entirely privatised, or cooperatives 81% of firms are joint stock companies. 91% firms in the sample have been privatised; but there is only one entirely new firm and there are no spin-off enterprises.

There are a number of ways to think about ownership in transitional economies. One is to distinguish between state owned, commercialised and private firms as is done above. A second is to consider who owns the shares - the state, insiders or outsiders to the firm. We can take the latter two categories further; insiders can be divide into workers and managers, while outsider owners could be grouped into banks and other financial institutions foreign firms or private individuals. We can either analyse average shareholdings by each category, or divide companies according to the majority shareholders, for example majority insider owned, or majority outsider owned. In this paper, we first present our findings on average shareholdings in each ownership group, and then analyse company performance primarily categorised according to majority owners.

Little has been known until now about the ownership structure which has emerged in Ukraine post-privatisation. However there are Russian surveys by the World Bank (see Earle and Estrin (1997)) and by Professor Joseph Blasi (see Blasi et al (1997)). These studies establish that the Russian privatisation process resulted in predominantly insider-dominated ownership structures. In July 1994. Earle and Estrin report that using weighted data insiders owned 54% of shares in privatised firms; of which workers owned 40% and managers 14%. Outsiders owned 21%, of which 9% were in the hands of financial institutions and 1% foreign investors, while the state retained an 25% share. These numbers had not altered greatly by the time of the Blasi survey two years later.

The process of privatisation in Ukraine has been longer and more tortured than in Russia, in part because of the government's more ambiguous attitude to reform in general. However, it is generally argued that the Ukrainians sought to avoid the most serious errors of the Russian privatisation by reducing the distribution of discounted shares to insiders, thus hopefully encouraging more outsider ownership (see Leschenko (1998)). The process has been in two phases. A virtually case-by-case approach pertained between 1991-93, followed by mass



privatisation based on voucher auctions from 1994. Some 40,000 firms had been privatised by 1996, predominantly by buyout, lease buyout and auctions.

It can be seen from the survey results in this area that this strategy has not been entirely successful. We report in Figures 1A and 1B the ownership stakes in the 150 firms of the sample, using a disaggregated set of ownership groups. The holdings of insiders can be constructed by summing the workers' and managers' stakes; of outsiders by summing foreign, Ukrainian citizens, Ukrainian banks and Ukrainian firms. The state holding is not disaggregated between regional and national government stakes.

Using unweighted shareholdings, we find that post-privatisation, insiders owned 53% of all shares in Ukrainian firms; outsiders 31% and the state the remaining 17%. The insiders stake is only slightly below that found in Russia, and insiders have majority control on average in Ukrainian firms. However, it is noteworthy that "outsiders" hold a rather higher proportion of shares than in Russia, though almost half of these are "Ukrainian citizens" who might in practice be relatives or friends of insiders. Holdings by financial institutions are very modest - 7% - and by foreigners are negligible (1%).

The picture changes somewhat when firms are weighted by size (employment) as in Figure 1B. The combined insider stake drops to 41%, while the state share increases to 27% using the weighted measure. There is virtually no change in the average outsider stake. This is because the state's shareholdings are concentrated in larger firms, while insiders have obtained shares predominantly in smaller enterprises. The point is established more clearly in Figure 2, which reports ownership structure by size of firm in seven size classes. The shareholding of workers exceeds fifty percent on average in all firms employing fewer than 500 workers, and the managerial stake exceeds 25% on average in firms employing fewer than 100 workers. However, the average government holding in firms of more than 3000 employees exceeds 30% and the state is the largest shareholder in firms of this category. On the other hand, the state holds no shares in firms employing fewer than 50 workers, and its stake is also very small in the size class 100-200 workers. Outsiders taken together hold approximately the same stake in all enterprise size classes. However, the holding of private citizens is slightly higher in small firms, while banks are more involved in middle sized enterprises.

The distribution of ownership stakes by region and sector are reported in Figures 3 and 4 respectively. It is interesting that employee ownership is more concentrated in the West, a region usually assumed to be more "Westernised", while both the state and workers holdings are on average larger in the West. We note in Figure 4 considerable sectoral variation in ownership stakes. The state has retained very modest holdings (less than 10%) in the chemical, construction material and food processing sector. Its residual holdings exceed 20% in the metallurgy sector, machine buildings and pharmaceuticals. Employee shareholdings exceed 50% on average in construction materials, textiles, food processing and pharmaceuticals. Ukrainian banks have invested disproportionately in the machine building sector, the only branch where their holding exceeds 10%. Foreign investment is everywhere very low, but is highest in textiles and machine building.

#### 4.2 Enterprise Performance, 1991-96

The performance of Ukrainian firms during the first six years of transition is the subject of this section, which illustrates the richness of the longitudinal dimension of the data set.

Though we do not yet have adequate deflators to permit reliable analysis of value data, the impact of the deep recession can be seen clearly in Figure 5, which shows the average employment in enterprises by firm size class categories, with the classes being defined in 1991 employment levels. It can be seen that average employment levels are falling in all firms which employed more than 200 workers in 1991. However, the decline is most marked in the very largest enterprises, which employed more than 3000 workers in 1991. In contrast, average employment in the smallest firms, a non-existent category pre-1991, tended to rise very slightly between 1991 and 1996. This suggests that Ukraine has been following the pattern in the size distribution of firms common to all transition economies (see World Bank Development Report, 1996), with the share of the very largest firms, which was enormous pre-reform, shrinking while the deficiency in the share of small firms begins to be made good.

Ukrainian data on profitability is notoriously unreliable and the difficulties are exacerbated by the effects of hyperinflation on asset and stock valuation. To indicate trends in this area, we report in Figures 6A-6D costs as a percentage of output by year end enterprise size class (figure 6A), by ownership (Figure 6B) by region (Figure 6C) and by sector (Figure 6D). Commencing with Figure 6A, it can be seen that “profitability” commences low in most size classes, improves slightly until 1993 and then deteriorates sharply. All size classes are on average loss making by 1996, though only three of the six are so in 1995.

The losses are by far the greatest, as a proportion of cost, in gigantic enterprises employing more than 3000 people. Costs exceed output by around 50% in these firms from 1994, and costs are double output by 1996. This suggests that particular problems for the Ukrainian economy are concentrated in these firms. It is however disappointing to see that even the smallest firms, employing fewer than 100 workers, have slipped into slight loss by 1996, and the situation is even worse in middle sized enterprises employing 200-500 workers.

In Figure 6B we report costs as a percentage of output for the three main ownership categories - state, insider and outsider - defined in 1996. In the early period of transition, 1991-93, profitability as measured by costs/output was broadly similar in all the firms later to be privatised. However, performance began to vary markedly from 1994. In 1995, firms owned by insiders on average made profits while all other categories on average broke even or made losses. The deteriorating profitability situation in 1996 was concentrated in outsider owned firm and especially in the state sector; the latter presumably because the state retained higher ownership shares on average in the largest firms.

Figures 6C and 6D describe the ratio of costs to output by region and sector respectively in each year. The “profitability” of firms deteriorated least in Kiev and Odessa, and the decline was most marked in Dnipropetrovskaya and Ivano-Frankivska - regions in the East and West of the country respectively. In terms of sectors, costs exceeded output in most years in food processing, while there were “profits” in most years in the chemical sector (including petrochemicals) and pharmaceuticals. The deterioration in “profitability” was most marked in 1995/6 in the textile sector, construction materials, wood and machine building.

An important indicator of restructuring concerns exports, and whether firms are successfully shifting their sales from the domestic market, or traditional customers in the former Soviet Union (FSU) to the more competitive markets of Europe and North America. The survey suggests that developments in this area have been modest, and that privatisation has not been an important factor motivating this type of restructuring, at least in the period to 1996.

In Figure 7, we report on the percentage of output sold to the domestic Ukraine market 1991-96 by ownership type. Export shares are typically low in 1991, around 10% in firms that by 1996 would be insider owned; 20% in firms that would continue to be state owned but almost 30% in firms later controlled by outsiders. This suggests that outsiders may have sought to buy exporting enterprises. Export shares did not change markedly in insider or state owned firms over the period, while falling slightly on average in insider owned firms. However, export shares rose markedly on average in outsider controlled firms in our sample, to reach around 45% by 1996. The reason for this is a sharp increase in exports to CMEA by outsider owned firms from 1993. Thus even outsider owned firms are not yet increasing their sales to the West, and these remain pitifully low. In fact, as can be seen in Figures 8, the share of sales to the OECD only reaches 2.5% on average by 1996, and that is in government owned firms. In fact, the proportion increases most rapidly in state owned firms and least in outsider owned ones.

A final indicator of enterprise performance concerns how expenditure on social assets has been altering during transition. In Figures 9A-9D, we report managers' responses to a question asking them to evaluate the extent of changes in social asset expenditure on a scale from 1 (increase a lot) to 5 (decrease a lot). In Figure 9A, the enterprises are categorised according to ownership, and it can be seen that while all enterprises are on average reducing social expenditures somewhat, adjustments are least in insider owned firms, and, surprisingly, greatest in government owned firms. The adjustment by outsiders is intermediate. When we break ownership categories down more in Figure 9B, the results are very revealing. Managers as owners are altering expenditure on social assets least, followed by enterprises owned by workers. Decreases are greatest in foreign owned firms, followed by state owned enterprises. The latter result may reflect the worse financial situation in state owned firms suggested in Figures 6. Financial institutions as owners are not more aggressive about this issue than other outsider owners or even than the state. Figures 9C and 9D report changes in social expenditure by region and sector respectively. There seems little regional variation, but social asset expenditures decline least in food processing and most in the electrical energy sector.

#### 4.3. Restructuring Indices

The survey questionnaire instrument gathered a considerable amount of information about the extent of restructuring in Ukrainian enterprises. A total of 27 questions were asked, requesting managers to evaluate the extent of restructuring since 1991 on a scale from 1 (no change) to 5 (everything has changed). The 27 areas of restructuring are outlined in question 20 of the questionnaire in the Appendix.

The survey discovers that on average the extent of restructuring in Ukrainian enterprises is perceived, even by Ukrainian management, to be very low. For the 27 questions, the highest score on average is 3.78 (change in inventory policy) and the lowest score is 1.18 (change in new loans). More striking, the average score is less than 2.0 ("Small amount of change") in 12 areas of the 27; and less than 3 ("moderate change") in 23 of the 27. Clearly Ukrainian

firms are doing surprisingly little restructuring on average, despite the severe depression, privatisation and market liberalisation.

This can be seen in more detail from Figures 10A and B.

One can aggregate the restructuring indices into five main areas of restructuring, namely:

- restructuring products (including outlets and quality)
- restructuring the use of inputs
- asset disposal and acquisition
- restructuring employment and management
- financial restructuring (including acquisitions and disposals)

In Figure 10 we report the average degree of restructuring each of the five brand areas by ownership type. The indices reveal that there has been such restructuring as has occurred has been concentrated on cost cutting and reducing input use, followed by attempts to improve the quality of the product and its marketing. There has been at least modest attempts to address employment and management issues and financial questions have hardly begin to be raised. From an ownership perspective, it is encouraging that firms dominated by outside owners typically seem to have restructured more in all areas than firms controlled by insiders. This is especially noticeable in the area of employment reduction; insider controlled firms appear more unwilling to reduce the labour fare. However, there has actually been marginally one restructuring in government owned firms, at least in the areas of reorienting sales outlets, asset disposal and employment and managerial changes. Once again, this may reflect the greater need to restructure within the state sector.

## **5. Conclusion**

We have collected an important data set, which contains unique information on:

- Enterprise restructuring
- Enterprise performance, with longitudinal economic information
- Ownership structures at a highly disaggregated level

as well as sectoral, regional and financial data. We have attempted in this report to provide a provisional outline of some key findings in the area of ownership and restructuring. Much more data analysis, based on multiple regressions, will be needed to pin down the complex relationships between restructuring, ownership and performance discussed in the project proposal.

We have found that Ukraine has indeed had a lot of privatisation, though as in neighbouring Russia the predominant beneficiaries are insiders - managers and especially workers. Though the outsider share is higher than in Russia, the stake held by financial institutions is lower. The performance of firms in the survey reflects that of the economy as a whole, and is poor. Moreover despite the extensive privatisation, the extent of restructuring has been low. There is evidence that outsiders undertake more restructuring than insiders, especially with respect

to social expenditure and employment. However, the state has undertaken similar degree of restructuring.

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