

# ICPS newsletter

## Paralysed Enterprises

*The present government's economic policy supports nonviable, non-competitive enterprises. The government's activities including subsidising, settlement of debts of enterprises and defence of debtors from the creditors' actions lead to unbalanced state finances and build-up of indebtedness. This policy means preservation of the socialist system of redistribution of profits earned by efficient enterprises for the benefit of loss-making ones thus making economic growth impossible. This system may be demolished only by stopping subsidies, enforcing effective bankruptcy procedure and strict budgetary discipline.*

*This is the conclusion reached by the participants of the seminar devoted to the subject-matter of the first issue of the Policy Studies edition — Paralysed Enterprises.*

### Enterprises' debts were transferred to the budget

The ICPS economist Mrs Inna Lunina who had researched the threat posed to the state budget by the existence of nonviable enterprises stated that budget revenues did not cover current expenses on wages and transfer payments. For eleven months of 1998, budget revenues in Ukraine fell down to 26.7% of GDP, compared to 30.4% of GDP in 1997. One of the reasons for lower inflows to the budget was that enterprises continued to increase their debt in taxes and mandatory payments.

As at 1 October 1998, the outstanding payments to the budget, extra-budgetary funds and social insurance arrears reached UAH17 billion as reported by the State Statistics Committee. Non-payments were widely used in the Ukrainian economy, but outstanding debts to the budget grew faster than overall outstanding mutual arrears between enterprises. Consequently, mutual arrears between enterprises, first of all for energy sources, were concentrated in debts to the budget.

All the attempts by the government to reduce the enterprises' debts to the budget (by means

of write-offs and negotiation of debts, granting loans, carrying out mutual settlements and other specially designed measures) failed.

Mrs Lunina said that the main reason for existence and accumulation of indebtedness of the enterprises of all the sectors of the Ukrainian economy was the state support rendered to state and formerly state enterprises which enabled them to ignore the new market environment and encouraged non-payments and barter. This system produced many intermediators which used complicated schemes to revert real money flows to themselves and reload debts onto the state budget.

### Ukrainian economy ignores budget constraints

Since transformation processes were initiated, numerous enterprises that changed their form of ownership had to transform their structure and reconsider investment policies which could allow for adjusting quickly to new demand and sales conditions. The main idea of restructuring was to create competitive industries and change the behaviour of enterprises by means of introducing strict budget constraints typical to market economy.

But in fact, most enterprises were not restructured (in the sense of transfer from soft to strict budget constraints). Though the state policy was to support and implement market reforms, some enterprises still could influence price levels and terms of taxation, as well as relied upon state subsidies.

The state actually protected inefficient

### Last week

**Paralysed Enterprises Jeopardise Economic Development.** The macroeconomics seminar held in the International Centre for Policy Studies on 26 January saw the discussion of the problem of existence of many nonviable loss-making enterprises in Ukraine which have a destructive effect on the national economy and the state finances.

### Cluster Model Finds Followers in Ukraine.

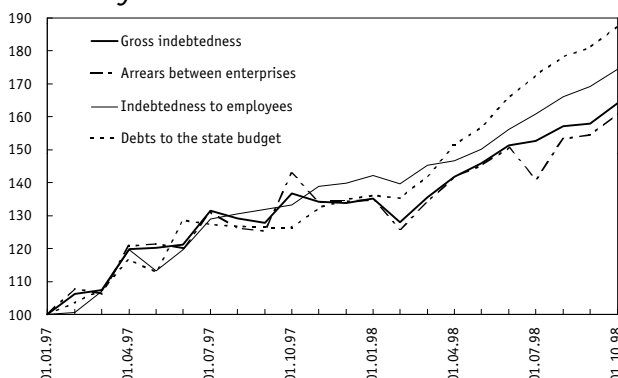
On Wednesday, 27 January, the International Centre for Policy Studies hosted a round table on the perspectives of the development of small and medium enterprises in Ukraine. The participants were given an insight into a cluster model of business organisation. Under the model, territorially adjacent enterprises of the same industry unity to enhance the efficiency of the use of resources. This organisational model eliminates competition amongst members of one cluster and enables its members to fully concentrate on manufacturing produce in which it is most competitive. The cluster model successfully serves the tasks of entering overseas markets and enhancing the cluster members' competitiveness. The model was presented by the head of a non-profit organisation "Podillya Pershyi" Mr Wolfgang Price. "Podillya Pershyi" is a programme for the revival of industrial production in Podillya region.

### This Week

**Methodology of Preparing Economic Reports of the Government.** On Tuesday, 2 February, the macroeconomics seminar at the International Centre for Policy Studies will be devoted to the issue of methodological support of the preparation of the government's reports on economic situation. A speech will be presented by the Head of the Economic Analysis Division of the Ministry of Economy of Ukraine Mr Evgen Frolov.

**The Final Stage of the Contest "Economic Reforms in Ukraine: Viewpoint of the Youth".** The contest "Economic Reforms in Ukraine: Viewpoint of the Youth" will come to its final stage on February 3–5 to take place at the International Centre of Policy Studies and the National Bank of Ukraine. The contestants will defend their projects on **the subject "Development of Economic Reforms in Ukraine" at the Centre on February 3–4.** The awarding ceremony will take place at the National Bank of Ukraine on 5 February.

### Undue debts payable of Ukrainian enterprises 1 January 1997



## Market Economy is Strict Budget Constraints

As described by Hungarian economist Yanus Kornai, strict budget constraints have five distinctive features: (1) prices are formulated by the market and enterprises cannot interfere in this process, (2) enterprises cannot influence the level of taxation, (3-5) there exists no governmental support; opportunity to receive credits or external financing.

the end of 1997 this number increased up to 71% of GDP. The share of outstanding debts in total debt grew from 79% in 1996 to 77% in 1997.

The size of total debt did not settle down in 1998, though it increased less rapidly: the average monthly increase in the stock of debts was 2.4%.

enterprises from strict budget constraints by means of subsidies, various money surrogates and permissions not to repay their obligations. This policy caused more and more potentially profitable enterprises and industries to enter the system of non-payments and debts to the budget, limited resources to be used less effective, and monopolisation and social stratification to grow. This support of loss-making enterprises preserved, economic decline in Ukraine would continue and large-scale crisis of the state finances would become inevitable.

## Non-payments were caused by slow reforms

The ICPS economist Mr Seryi Ilchuk analysed the reasons for accumulation of mutual arrears between Ukrainian enterprises and methods of dealing with this problem. The analyst stated that the main precondition of inter-payment arrears between Ukrainian enterprises was the external shock resulting from the collapse of economic systems of the former Soviet Union and the COMECON, as well as an internal shock caused by the transition from the administrative to the market economy. Ukrainian enterprises were severely hurt when, after the price liberalisation, energy became expensive and demand re-oriented from industrial products (extensively produced in the former Soviet Union) to consumer goods. At the beginning of transformation, actual overproduction and the inability to go by market mechanisms resulted in omnivorous shipments of goods to various customers, including those who were not able to pay for them.

At the same time, these debts gradually transformed into "strategic arrears". Enterprises continued to ship their products, leaving aside the question of payment. Moreover, they often postponed paying bills consciously, hoping that the government would be able to credit them and solve the problem of non-payments. In reality, the government followed this pattern and was giving firms evergreen credits, while the actual problem remained unsolved. Moreover, arrears began to grow even more rapidly.

These developments facilitated the process of accumulating unpaid bills on goods and services. Soon, their volume reached one of the highest levels amongst other transition economies. By the end of 1996, the total mutual debt of goods, operations and services between enterprises accounted for 54% of GDP, while by

## Few bad debts existed between enterprises

Mr Ilchuk noted that outstanding debts were normally divided into late payments, and bad debts those that were problematic and would not probably be redeemed if the enterprise were not restructured. Ukrainian bookkeeping system lacked this debt classification, which made it difficult to calculate the share of bad debts. The only way that allowed for defining this indicator was to base the evaluation on the analysis of the outstanding debt structure by terms, which was executed by the State Statistics Committee for the period from 1 January 1997 to 1 January 1998. The probability was rather high that debts with one year of maturity were accumulated by enterprises that suffered from the hard financial situation and could not be redeemed in the medium term. Therefore, the approximate volume of bad debts was the stock of debts with one year of maturity. By 1 January 1998 the stock of bad debts amounted to UAH10 billion, which was 15% of the total debt. This number was the lower bound of bad debt share in the total debt, as bad liabilities were also a part of debts that have 3 months-1 year of maturity. Therefore, the share of bad debts exceeded 15%.

Mr Ilchuk emphasised that in 1998, outstanding debt increased more rapidly in the share of debts with maturity up to 3 months (UAH8.4 billion, or 70% of the increase in outstanding debt). However, in this category of liabilities, the increase in bad debts was significantly smaller, as enterprises usually redeemed them. As a result, the increase in the stock of debt with 3 months-1 year of maturity was insignificant.

This fact proves that Ukrainian enterprises learned how to differentiate between bad and diligent customers, and moreover, they do not work under "soft budget constraints" and are not willing to grant trade loans to unverified firms.

## Government allowed for creating debts

As soon as the government gave up direct financing and unrestricted trade credit came to a stall directors of loss-making enterprises started to utilise barter operations and accumulate arrears. Nonviable enterprises were able to continue their operations only through postponing payments to the budget and to their employees. And the government implicitly allowed unprofitable "strategically important" industries and large enterprises to build up strategic debt.

Mr Ilchuk mentioned the following main reasons for build-up of mutual arrears between enterprises:

- unfavourable business environment which led to the spread of trade loans;
- the state support of inefficient enterprises which concentrated bad debts;
- absence of a straightforward mechanism of property liability.

To stop the growth in debts the following measures were suggested:

- passage of a real budget;
- tax cuts;
- implementation of effective bankruptcy procedure;
- prohibition of mutual write-offs;
- swift privatisation.

## Loss-making enterprises would not go bankrupt

When commenting on the future of nonviable enterprises after the introduction of strict budget constraints the World Bank chief economist Mr John Hansen said that one should clearly distinguish between loss-making, value-subtracting and potentially bankrupt enterprises. Mr Hansen stated that under the conditions of very unfavourable business environment in Ukraine many enterprises were loss-making "on paper" but did not subtract value: big costs did not allow them to reach at least the break-even points. Mr Hansen also emphasised that that not every loss-making enterprise would go bust. This would be the case with economic agents which hid their revenues from taxation. If a strict bankruptcy procedure was implemented many of these enterprises would prefer to repay their indebtedness including tax debts rather than to go bankrupt.

### "My mission was to accumulate debts"

"My mission was to accumulate debts of the factory. Debts to the state budget, debts to the employees. Of course in reasonable amounts. In amounts that would not cause strikes. It was very easy to do..."

"Notes from the underground". A story of the representative of a leading off-shore trader at one of Russian aluminium factories. *The Expert* (Russian magazine), #3, 25 January 1999.

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The International Centre for Policy Studies is an independent non-profit research organisation with the objective of improving the Ukrainian policy development process. This is achieved by increasing the know-how of key government officials for policy choices, formulation, and debate, and the awareness of the public-at-large of the benefits of the policy.

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