Closing the Productivity Gap in Ukraine

Further privatization and competition-enhancing reform will stimulate greater dynamism

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Productivity growth in Ukrainian industry was remarkably strong during 1999-2004 but slowed in 2005-2006. Performance in manufacturing has been particularly impressive: output rose by roughly 10% per year during 2001-2006, while employment fell by approximately 15% over the period.

Intensive labor-shedding contributed significantly to the rise in productivity, at least until 2003. This was undoubtedly a direct consequence of more active restructuring of firms, at a time when Ukraine was "catching up" on reforms. During 2000-2005 the gross job turnover ratio, defined as the sum of hiring and firing over total employment, rose steadily, from 45% in 2000 to 58% in 2005. Since 2004, industrial employment has stabilized and productivity growth has slowed, which suggests that this phase of relatively "easy" restructuring is over.

While there has recently been some progress in making entry easier, impediments to entry, exit and restructuring remain substantial. Empirical analysis confirms that Ukraine has particular problems with exit. Firm-level data for Ukraine show overall firm turnover rates in manufacturing to be rather low by OECD standards — about 10% in 2002-2005, as against 15-20% typically found in mature market economies.

Given such low levels of entry and exit, it is no surprise that product markets in Ukraine are highly concentrated and heavily regulated. The Herfindahl-Hirschmann indexes (HHIs) that we have calculated are higher than the indicators for Russia in every major sector. Concentration levels have risen in key export sectors recently, including metallurgy, chemicals, machine-building and food, while they have declined modestly in the construction materials and light industries.

We find that market concentration has a negative and highly significant impact on labor productivity growth: a one percentage point decline in the HHI is associated with an increase in labor productivity growth of 0.2-0.3%.

High levels of market concentration and weak competition are partly a product of Ukraine's inherited economic structure, but they are also, in large measure, the result of misguided policies. To be sure, competition law is now much improved and, on paper at least, it is broadly in line with international norms, but anti-competitive policies and practices are still widespread.

Product–Market Reform

Competition-enhancing product-market regulation (PMR) reform can help raise productivity growth through a number of channels, including the direct impact of competition on both market efficiency and technical efficiency, as well as its indirect impact via the role of competition in spurring innovation. Reforms that liberalize entry are also likely to spur fixed investment in some sectors.

The PMR review of Ukraine, undertaken in 2007 by the OECD Secretariat, has arrived at four broad conclusions:

- the level of overall product-market regulation was higher than that of any OECD country in 2003;
- the burden of product-market regulation is well above the OECD average with respect to all three major components of the aggregate indicator: state control, barriers to entrepreneurship and barriers to trade and investment;
- overall, barriers to business growth appear to be more constraining than barriers to entry;
- regulatory process is in some respects as much of a problem as the substance of regulation.

However, it should be borne in mind that the PMR review assesses formal regulatory policy settings, which have improved substantially in Ukraine, while the implementation of these policies remains incomplete and inconsistent.

Analysis of the specific PMR indicators finds that:

- recent efforts to improve conditions for entry have had a marked positive effect; yet start-up procedures remain costlier and more time-consuming in Ukraine than in most of the region;
- the regulatory impediments to growing businesses of any size remain extremely onerous, especially those associated with licensing and permits;
- the size of the public sector remains too large, with about 48% of the country's capital stock in the hands of the state or municipal authorities, and a further 10-11% in public-private ownership. Yet although the problems associated with such a large population of SOEs are widely recognized, privatization has effectively been stalled for the last few years.
- Pressure to restructure or wind up many inefficient firms is limited by the widespread availability of explicit or implicit subsidies to favored enterprises. Direct support from the state to industry is estimated at 1.7% of GDP in 2007.

Further Privatization Needed

Closing the productivity gap between Ukraine and the more advanced economies will require increasing efficiency of resource allocation and efficiency of production. Strengthening competition can contribute a great deal to the achievement of both these ends. Our econometric analysis of the relationship between competition and enterprise performance in Ukraine finds that:

- concentration has a negative impact on labor productivity growth;
- import competition has a positive impact on domestic firms' productivity, with the stronger effect in sectors with lower foreign penetration.

Ukraine's stalled privatization process is particularly regrettable in view of mounting evidence that it has improved enterprise productivity and efficiency. Further privatization could play a major role in stimulating greater dynamism and flexibility, particularly together with competition-enhancing regulatory reform: in the case of privatization to domestic owners total factor productivity increases by between 10% and 25%, during the seven years following privatization.

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