



RESTRUCTURING THE MILITARY INDUSTRY IN UKRAINE: RESULTS, CHALLENGES, PROSPECTS



- The Conversion of Ukraine's military-industry sector: guidelines applied and lessons learned
- Low efficiency and poor performance as a result of mismatched efforts and predominantly chaotic and poorly managed restructuring process in the Ukrainian military-industry sector.
- Restructuring Ukraine's military-industrial complex: a handful of fragmentary success stories.
- Further evolution of Ukraine's military-industrial complex: some real and illusory highlights in its development.

Some general comments

The breakdown of the Soviet Union was followed by a collapse of its military-industrial complex (MIC). Each of the newly independent states that came into being following the disintegration of the USSR found itself facing the challenging task of patching up their own economies, including their MIC sectors, from what was left over. Restructuring the military industry and ensuring its conversion are the parts and parcels of economic reforms. To this end, it would only be beneficial to learn from and wisely apply the general rules and common patterns, and use one's own experience gained within the MIC of the USSR, and also build on what industrially developed nations have achieved, as well as learn from East European neighbors how to best restructure the military-industry sector.

Lessons learned and conclusions drawn, in a nutshell:

- The need to restructure an economy and its components, including the MIC sector, normally arises at a time when the existing social and economic mechanisms have exhausted their potential in terms of effectiveness/efficiency and achieved a certain cut-off point beyond which they already fail to adequately meet the needs of society and the military and therefore require structural or systemic changes. Reform in the military-industry sector affects, directly or indirectly, such relevant sectors as: (a) financial resources; (b) fixed assets and other types of assets; (c) the commodities market and finally (d) management and human resources. Only when attempts at reform are well balanced throughout the system in all the above areas can some positive results be achieved.
- One should carefully distinguish between reforming the economy as a whole and restructuring its branches or individual enterprises. With respect to the extent of government involvement, it would be fairer to make a reverse statement: at the macroeconomic level the state plays the key role, whereas within industry branch or at the level of individual enterprises its involvement should be as minimal as possible. In case, when government provides financial support for Military-Industry Programmes, its control has to close at level, which the budget lines are assigned to. The state could concentrate its efforts primarily on: (a) setting strategic goals and developing long-term plans for the national economy to evolve in an orderly manner ensuring consistency and transparency in all subsequent government programs and/or initiatives, and monitoring the operations of economic entities on its territory; (b) setting the rules for behavior of Ukrainian businesses in the world arena; (c) awarding state contracts thus motivating further technological growth, and exercising control over the use of government appropriations, (d) creating an investor friendly environment, using its law-making powers, fiscal tools, human rights and other leverage; and (e) providing support to science and education, and taking measures aimed at enhancing intellectual capabilities throughout the system.
- Conversion of military industry can be aimed at achieving the following goals and objectives: (a) making sure defense projects pay back, scaling up military production by using its components for civilian purposes; (b) operating unused military-industry sector production capacities to meet the needs of civilian production; and (c) increasing the technological intensity of the economy as a whole by means of spin-offs and promotion of military-industry sector hi-tech achievements into the civilian sphere. These goals can vary from country to country, overlapping or complementing each other. Whatever the combination, though, it is extremely important to have them identified and defined very clearly. Having a whole system of well-defined strategic goals and shorter-term objectives in place makes it possible to avoid incurring unnecessary costs and bringing about disparities and irregularities in the military industry, in particular, and in the economy in general.
- Most industrially developed nations use an effective and time-tested strategy that provides for the hi-tech development of "non-military" industries and their prompt and adequate responsiveness to a defense contract. Privatization of once government-owned military-industry enterprises does not necessarily result in undermining the technological capabilities of the military, provided the state develops and pursues an intelligent economic policy. Nevertheless the privatization of defense firms is after all meant to improve their effectiveness/efficiency and boost their performance in full accord with the above policy aimed at meeting defense and civilian needs.
- As the military industry or its individual enterprises were being reformed, conversion measures quite often turned out to be an additional pain in the neck rather than a cure. This was true of industrially developed nations and emerging economies alike. The main reason behind this frustration was the fact that the complex and integrated nature of the problem required a comprehensive solution, and this fact was underestimated. Positive results were only achieved where streamlining the production process per se was coupled with complex of measures including: changes in the very structure and infrastructure of the whole industry and individual enterprises, in the management system; granting the tax exemptions and other fiscal benefits; providing government assistance for enterprises with promotion and marketing efforts, etc. However, a magic formula can hardly be derived and offered for conversion to be successful at all times, for the reason that its ingredients would be very much contingent on the specific conditions of every new country.

Some not very encouraging results

The past decade can hardly be accounted as beneficial in full measure for Ukrainian military industry. Ukraine inherited from the former Soviet Union 700 military-industry enterprises, including the very backbone of the military industry consisting of 344 major production and R&D organizations. Reform of the sector was conducted in a chaotic manner. Following a 70-year long period of command and administrative methods that prevailed in the management system, the military-industry sector found itself in a new market environment on the brink of ruin. Already by 1997 the number of defense enterprises was reduced 5 times. During the same period of time the share of military industry in the total output of the mechanical engineering industry plunged sevenfold, with the GDP falling three times.

The number of contracts awarded to the military industry by both domestic and foreign customer fell drastically. What the Government earmarked for weapons for its Armed Forces and further development of the military industry fell under the dollar-a-year bracket, if any, and even that little bit was often used for other than stipulated targets. In 1997-2000 appropriations for conversion, armament procurement, and R&D shrank fourfold. Moreover, these budget lines were not used only for the above purposes. As per estimates by the Chamber of Accounts of the Ukrainian legislature, in 1999 the greater part of all funds earmarked for conversion needs, or nearly \$2 M, or 37% of actual spendings (under \$6 M or 61% of what was budgeted), were used to meet the needs of government staff, or to support other than defense needs.

In the estimation of the Kyiv's International Center for Prospective Studies, the way in which the State interfered with the process quite often lacked competent approaches and even looked like cold acts of racketeering on by greedy government officials. A survey run amongst CEO's of a sample of firms evidenced that their confidence in the present government system has been shaken as over 52% of respondents did not even bother to file their cases with courts every time they felt they were being mistreated or their rights encroached on. The respondents indicated to the following major factors that negatively affected their economic development: deficit of working capital and insufficient capitalization – 75%, poor tax system – 74%, high credit rates – 32%. Only 20% of companies can get access to short-term loans while long-term loans are available to 10% of potential borrowers. As a result, in 2000 only 18% of mechanical engineering enterprises had innovative projects running, and as few as 10% were able to renew their product lines, with the volume of their output still falling short of a mere 4% of total output in the industry.

Further progress with privatization in the military-industry sector is very slow due to legislative uncertainties with regard to strategically relevant enterprises. For instance, the concept for privatization of some firms of Ukraine's Ministry of Defense (there are around 170 organizations) was already approved back in 1998, nevertheless its implementation phase has been hampered by absence of corresponding law, passed only last year. Accordingly, no revenues accrued to the State budget from their unrealized offering and no new investments flowed into the economy. As many as 45 government owned companies that belong to the Ministry of Industrial Policy system, find themselves in a similar situation. Given their current ownership status, governance forms and inadequate management solutions, such enterprises do not live up to the imperatives of time and are therefore highly detrimental to the Ukrainian economic system that is already in dire straits. High production costs reduce their sales and their competitiveness beyond acceptable levels, which negatively affects the generation of revenues necessary for reproduction. Although, the overall share of non-government enterprises in the Ukrainian industrial sector exceeds 85% of the total number of enterprises and is nearly 76% in terms of volumes of production.

Inadequate fiscal policy, limited access to financial resources, social pressures, high production costs, the absence of innovative management skills are the factors that hold back further growth of companies even though there are some modest and positive success stories going on. The bottom line is, though, that conversion attempts failed to lead to an effective recovery for the ailing military-industry sector of the Ukrainian economy.

Growth points

Companies with export capabilities that produced missiles, aircraft, armored vehicles, ships, and, to some extent, radio-electronic equipment were somewhat better off. For instance, 2000 saw a 39% growth in aircraft production. Ukrainian military industry enterprises: export civilian aircraft to Russia, other CIS countries and Asian countries; have a beneficial business in the international market of the aerospace facilities; transfer to the arms market high quality tanks, radar equipment, navigation and sea traffic control systems. Some of them share alike in constructions of the heavy truck, aviation, tank plants in Iran, Egypt, Pakistan. Ukrainian shipbuilders have good military and civilian contracts with Greece, Norway and others.

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The program is aerospace industry. Earlier this year, on June 27 a State Program was launched for the introduction of aerospace technologies for the development of high-tech civilian products for the domestic market. Developed by the National Space Agency, the Program includes 165 projects in six areas: energy, industrial technologies, telecommunication, transport and medicine.

Success story in the Ukrainian military industry conversion chapter is the Ukrainian Science & Technology Center; its creation had the support of the US, Canada, Sweden, etc. The Center takes on the task of finding new applications for the intellectual potential of Ukraine (and also for that of Uzbekistan and Georgia) which in the past was used to develop Weapons of Mass Destruction and delivery means thereof. The Center has already a record of almost four thousand successfully accomplished projects, including over two thousand projects for the defense and around 1,500 civilian projects, and currently over 3,500 projects are underway (2,500 and 1,000, respectively). The projects are funded by the USA, EU, Canada, Sweden, and Japan and cover the following major areas of research: nuclear safety, environmental protection, energy production and energy saving systems, medicine and biotechnology, transport and communications infrastructure, information technologies, industrial technologies.

These positive trends are being against the background of the Ukrainian economy growth in late 2000 and early. The main parameters of this growth are:

- The economic growth rate came to 6% in 2000, and 8% in the first quarter of 2001;
- Industrial output grew by 13% in 2000 and by 20% in the first quarter of 2001;
- The government revenues went up by 40%;
- Households' incomes grew by 6%;
- The interest rates fell twofold; and
- The inflation rate fell two times in 2000 year-on-year.

With some difficulties still prevailing, such results are quite inspiring and make it possible to believe in that the Ukrainian economy is starting to pick up which gives room to certain optimistic forecasts for the future of the nation's MIC.

Reference Points and Scenarios to Play

Whether or not the reform of Ukraine's military industries winds up being a success and its sustainable growth and efficient performance are reached is totally conditional on how clearly and correctly strategic goals (highlights) are set and techniques to achieve them selected. At present such highlights can hardly be seen through the heavy smoke of arguments, heated discussions and political declarations about the future of Ukraine. What one can make out through the mist, more or less clearly, is the "shores" on both sides between which a ship called "Ukraine" is struggling to make her way. Further liberalization of the economy or centralization of government control instead? Continuing with the sweeping privatization program the way it was conceived or bringing the program in harmony with government strategies for national social and economic development? Giving priority to further development of hi-tech sectors or rather opting for the exporter-of-raw-materials model? Seeking cooperation with partners in the West or in Russia? How well Ukraine manages to navigate between these shores will determine her prospects for a sovereign and prosperous future.

The specificity of the transition stage, the complexity of tasks to be accomplished and the challenges to be addressed require more State involvement in all post-Soviet economies, including that of Ukraine. However, this is only true if the State is capable of developing an effective strategy that can work, pursuing a development policy that can be monitored, and if the State possesses powerful fiscal, legal, and administrative leverage to be able to keep the general economic situation under control and counteract corruption. Absent such preconditions, it would make more sense to aim at checking the State's regulatory functions in running the economy, without excluding the military-industry sector. The fact that many defense firms are idle while still being controlled by the state (machine-building companies operate hardly at 35% of their capacity and situation on the defense enterprises is more difficult) does not add to the nation's defensive capacity.

At the same time, many enterprises in Ukraine have found an exit from a difficult situation and could improve the states just due to a privatization and effective change of management, and they could affect positive changes in structure of economy of Ukraine. Here are only some conclusions from results of a privatization in Ukraine:

- Volume of manufacture on the privatized enterprises exceeds a parameter of the State sector 2.4 times, the size of average monthly wages is higher on the 7%, and in separate branches - 2-2.5 times;
- By results of 2000 cost of actives of the privatized enterprises grows with rate 3-4 %, cost of a fixed assets in actives makes more than 50%, that provides reproduction of the capital;
- The speed of capital turnover at the enterprises of private sector is higher 1.8 times, than at the State enterprises;
- In 2000 the enterprises of private sector receive almost 80% of the profit from a total sum on all enterprises of Ukraine.

Despite of it, the situation in economy of Ukraine and in its military-industry sector remains difficult. Deterioration of a fixed assets of the enterprises exceeds 60 %, their updating goes by low rates. The rates of development of new technologies and new production also remain low (in 2000 around 7,000 new technologies and techniques were developed but only 469 items of new production are mastered). Low-technological production continues to prevail in structure of manufacture and in commodity circulation (production of mechanical engineering occupies about 12% in total volume of manufacture and 9% - in volume of export of industrial production). The continuation of these tendencies can threaten further degradation of a military industry, which makes a significant part of machine-building branch of Ukraine.

For the radical turn of these trends significant investments are needed. But it's too early to expect the strategic investors for Ukrainian military industry (it's possible for few companies only). The majority of Ukrainian military enterprises (especially converted firm), regard less to there long-term age, are at the beginning of the way to market economy (they are in a "risk phase"). So the coming of foreign portfolio or direct financial investors is more realistic for them. To make it happens the changes of government politics and enterprises' management are needed.

Perspective direction of improvement and development of the defense enterprises of Ukraine is the promoting of production on the external markets, as the internal demand for the majority of kinds of their production is limited. While the annual needs for armament procurement programs are \$2-3 Bn, the Ministry of Defense has the capability of earmarking as little as \$25-40 M a year. The demand for "civilian" products is limited by the low purchasing power of individual consumers and cash-strapped businesses. High production costs so typical of military enterprises coupled with fickle government support do not at all add to its competitiveness. Currently, the Ukrainian government is taking measures to improve the situation. These legislative measures include: provision of tax breaks for hi-tech businesses; permission to restructure over 5 years accounts payable accrued by military-industry enterprises; exemption of military-industry enterprises, up to the year 2009, from the land tax and other local taxes; granting of non-tariff relief for export transactions settlements; and introduction of an accelerated rate of depreciation (20%) for their capital assets. Moreover, the Concept of restructuring and development of MIC of Ukraine foresees the stock-taking of military-industry enterprises, forming the main body (or a "core") of the MIC, cutting down its infrastructure, privatization of the rest of military-industry firms.

Certain improvements in the current status of the Ukrainian military industry can motivate potential partners to start cooperating with its enterprises. There are some preconditions that make interest of such cooperation: a capacious labour market (the offer-load per job vacancy is 17); sweated labour (the average monthly wages are around \$57 within industry and \$40 within machine-engineering); meanwhile there are up-to-date machinery ready for some segments of buyers refer above: Ukraine has effective export control system meeting the western standards and which reduces the risks on armament and two-used technologies markets At present, however, desire to enter into a partnership with their Ukrainian peers on the part of Western nations and corporations is next to none. Such a position can be easily understood – like Ukraine, the West is also concerned with creating new jobs, increasing the competitiveness of its own products, and ensuring sustainable growth for the economies within the EU. Such European reservations wind up pushing Ukraine, slowly but surely, more closely towards Russia and Asian countries.

The great mass of the Ukrainian people and CEO's of major military-industry enterprises alike are all supportive of the idea to re-establish cooperation with Russia. Yet, expectations of tangible results deriving from such a policy are often exaggerated / overstated to a large extent. First of all, Ukraine's ailing military industry is in bad need of cash way before the production cycle begins, and neither Ukraine nor Russia can afford the luxury of untying their already scarce capital resources. Secondly, all military production cycles are usually finished off in Russia, so that Russia would have an upper hand in dealing with finished products. Thirdly, under the circumstances, it would be a Russian government controlled intermediary organization that would ultimately market finished products, leaving Ukrainian subcontractors with at best 50-55% of pre-estimated revenues.

In addition to that, hopes to be paid in full and on time by their Russian contractors are hardly taking into account Russia's internal issues: high costs associated with Army downsizing programs, heavy burden of unsolved issues related to capital and housing construction, new projections for growing costs of recovery from the Chechen campaign. Also, Russia spends quite sizeable amounts to restructure its own MIC, and its whole economic system; on top of that funds are being set aside to face the peaks of physical wear and tear of fixed assets anticipated in 2003, repayment of, and settlements under, their foreign debt. All this is accompanied by jumps in world prices for oil and oil products which are the main source of revenues for the Russian government. In other words, there are no grounds for hoping that the Russian government is willing to invest in the military industry of Ukraine. On the other hand, one should not rule out a possibility for the most appealing Ukrainian military-industry enterprises to be taken over by private Russian companies. Also, Ukraine can hardly hope that the Ukraine's enterprises will hold a key role in new-founded companies and in Russia's long term plans for military-technical cooperation. In the view of Mr. B. Kuzyk, General Director and CEO of New Programs and Concepts, a Russian Holding Company, Germany, France and the UK are more likely to become Russia's strategic partners in the fields of military, technological and economic cooperation. Russia's growth in the area of military technologies draws on revenues from the sale of its armaments to China, India, Iran, Egypt, Algeria and Syria.

Ukraine's military industry, or rather its indispensable part only, in most cases is viewed by Russia as an opportunity to potentially reduce at-the-factory-gate costs of its own (Russia's) defense products through the use of cooperative ties with Ukrainian suppliers of less expensive parts and components for hardware. So at an initial stage cooperation with Russia can only in part make up for the Ukraine's need for cash, while setting increasingly higher standards with respect to the contents of their defense budgets, and working on an increment in domestic investments. There is probability of threats at the next stages: to be deprived of control for military enterprises and to lose an ability for self-



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he is busy trying to get access to the markets of Asia and Africa. Though characterized by a lack of stability at the moment, these markets appear to be...
one... accessible to the Ukrainian military industry.

However, bearing in mind the issues of globalization, and seeking to build a stable and secure Europe, both Ukraine and the EU nations should try to find a reasonable trade-off between whatever internal and external political and economic priorities they may have on their agendas. What it all means for Europe is that it is only in its own interest to be neighbors with a stable and secure Ukraine, with its political, economic and military parameters brought in line and in harmony with those of the rest of Europe. What is definitely holding back potential Western investors is indecisiveness and the poor performance displayed by Ukraine's establishment. On the other hand, though, the Ukraine's MIC can only be effectively reformed and brought in harmony with European standards if it is offered an opportunity to "field-test" its competencies and capacities under the foreign investments and pilot contracts with Western customers; otherwise its successful reform and conversion are out of the question.

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